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Does Collateral Security Still Determine Performance of SMEs? An empirical Study from Arua Municipal Council, Uganda.

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Abstract

Collateral security is viewed by many scholars as factor that has a direct influence on the performance of SMEs. This paper therefore examined the relationship between collateral security and the performance of Small and Medium Enterprises (SMEs) in Arua Municipal Council, Uganda. A cross-sectional design adopting both the qualitative and quantitative approaches was utilized. With a population of 224 SMEs, a sample of 149 respondents was drawn using both purposive and simple random sampling techniques and this yielded a response rate of 87.3%. Validity and reliability of instruments was taken care of, and data was collected using self-administered questionnaires and interview guide. Quantitative data was analysed using SPSS while the qualitative data was based on the content analysis. The results indicated that, there is a positive relationship between collateral security and the performance of SMEs in Arua Municipal council with insignificant correlation coefficient ($r = 0.052$, $sig = 0.01$). In conclusion, the paper established that though collateral security does not influence SMEs performance, it hinders SMEs access to financial services as MFIs prefer collateral security as precondition for loan disbursement. Though collateral security plays an insignificant role in SMEs performance, SMEs' access to microfinance is vital for its performance and should be softened through government guarantee.

Key Words: *Collateral security, Performance, SMEs*

Introduction

Globally, provision of credit has been a longstanding strategy subject in the stages of development in all countries. In rural agrarian economies, local shahukars (a bill launched for those who faced some problem in the hands of money lenders before Maharaja Hari Singh) played the role of credit suppliers even before the entry of East Indian Company in India. After the Second World War, the rural credit supply basically to mobilize the much-needed support for agrarian services predominantly and to meet domestic market requirements, became part of strategy in the emancipated countries (Sharma, 2010).

Providing small loans to individuals, possibly within the groups as capital investment to enable income generating opportunities is the essence of microfinance. As the finding frontiers and helping the push out strategy of international finance capital progresses, various agencies took steps to project the microfinance as omnipotent concept in fighting poverty and meeting the needs of marginalized (Sharma, 2010). General Kofi Anan, in his briefing to the United Nation Capital Development fund (UNCDF), declared 2005 as the year of microfinance by the general assembly, He requested that the year (2005) to be a special occasion for giving impetus to microcredit programs (Anan, 2005)

However, the efforts to reduce poverty through microfinance cannot address the multidimensionality of poverty. It considers poverty as a consequence of unrealized market potentials. This is the reason for its focus on supply of credit as a way to realize the market potentials, leaving the structure of poverty untouched. It also refuses to recognize that the structures of poverty and social exclusion are widely spread and reinforcing each other. Microfinance is fully a commercial concept which cannot satisfy the socio-political needs to address the problems arising out of political economy. A borrower is supposed to be helped through micro-credit for one time to put it in use for productive purposes. This does not deal with market side ramification. In case of incomplete cycle of credit, the clients again are forced to borrow to repay the old dues. This results in a vicious cycle rather than creating a virtuous cycle (Sharma, 2010).

There are principal relationships that exist between MFIs and SMEs. Both rely on each other despite the fact that one's improvement can be said to profoundly depend on the other (SMEs on MFIs) (Salomey et al., 2013). SMEs and MFIs are tipped to lead the voyage into a destination of prosperity and supportable development (Danjuma et al., 2016). SMEs keep attaining dynamic levels of innovation through various services that are provided by them in the area of sales distribution supply, manufacturing and other services. A new wave of change on small-scale businesses has been introduced through the use of technology.

Local farmers are embracing agricultural inputs like fertilizers and modern technology through resourceful and attractive services that are being made accessible by both MFIs and SMEs (Opare-djan, 2002). The poor people do not have access to formal banking services and they represent more than half of the population; hence, they rely on informal and formal microfinance institutions for loans (Danjuma et al., 2016). Access to loans is a major problem that SMEs are facing regionally, to keep in line and to guarantee that the needed funds are available and accessible at the right time.

In Uganda, lack of reliable information, as listed by all banks and MFIs, is the main hindrance to SME lending. However, the issue of collateral is a significant aspect in Uganda with 50 percent of the banks state the lack of adequate guarantees as an obstacle to SME lending (Calice, 2012). The Bank of Uganda stipulates that, all loans above a certain minimum must be adequately secured with first-class guarantees or a bond over property as the preferred security type. However, this makes it difficult for

Ugandan MFIs to lend to SMEs, due to the various challenges that this sector faces with such acceptable security.

Literature review

The study was based on Microfinance theory of change which was developed by Srikan et al. (2008) and assumes that, a poor person goes to a microfinance provider and takes a loan (or save the same amount) to start or expand a microenterprise which yields enough net revenue to repay the loan with major interest and still have sufficient profit to increase personal or household income enough to raise the person's standard of living. Access to a savings mechanism increases choices and financial freedom, working to buffer shocks and helps households maintain consistent spending level over time (Dupas & Robinson, 2013).

The theory establishes that small loans fuel economic self sufficiency. MFIs such as Grameen Bank, Action International and Opportunity, have given millions of dollars to small time, impoverished entrepreneurs. Further research indicated that, micro loans increase household consumption; give women more clout in their communities; encourage the use of contraceptives and improve the nutrition of young children (Nathanael, 2004). Not so many are using microfinance in a way that will raise them from the ranks of poor- poverty reduction because there aren't that many opportunities the thriving enterprises in the absence of robust local economic development (Dunfor, 2013). Robust microfinance policies encourage investment opportunities that comes with its associated benefits to the small and medium enterprises.

This theory aided the study because it established the relationship between MFIs and SMEs. This relationship develops when an entrepreneur visits a micro finance provider to request for a loan to expand the venture, and is able to pay back the loan as per the agreed terms and conditions stipulated in the agreement.

This aids the development of trust and mutual respect among the parties involved. The microfinance theory of change is based on the belief that, low-income earners (SMEs) will take microfinance loans from MFIs and will invest the money in a viable business and manage the business to yield major return on the investment. Lenders often want to minimize risk with appropriate collateral for loan, with preference for physical assets such as land, while SMEs tends to averse to using the latter as collateral.

In Mozambique for instance all land belongs to the state and cannot be sold or used as a guarantee to finance, which poses a vital limitation to raising collateral. Barro (1976) focused on pricing issues when collateral value was stochastic. However, the practical significance of collateral is recognized in recent studies on financial contracts in securing repayments, which put collateral as a primarily important factor in determining external financing and investment (Leitner, 2006). Firms with tangible collateral seem to be doing well in terms of access to credit than those that do not. There is therefore a positive but insignificant relationship between collateral and performance of SMEs generally.

Collaterals are used as a mechanism to reduce equilibrium credit rationing and other problems that arise due to asymmetric information between borrowers and lenders. Besides, increase in a firm's collateral value relaxes the credit constraint faced by the firm, enabling the firm to borrow more (Chen, 2001; Hall & Fang, 2004).

According to the CBK (2013), collateral is regarded as a secondary source of repayment; therefore, it is only used in assessing the amount of loan loss provision required for non-performing loans. Where securities are obtained, they must be perfected in all respects, namely; duly charged, registered and adequately insured. The greater the amount of collateral possessed by an SME, the lower is likely to be the extent of the financial limitation. In more general terms, it can be postulated that, the greater the financial depth or development of a financial system, the greater will be the availability of loans to firms, including SMEs, and, therefore, the lower will be the extent of any financial gap (Margret et. al, 2019).
Access to collateral can be hypothesized to be positively related to firm performance, as with business transparency, preparation of business plans, the skill level of the entrepreneur and credit rating of the business (Harvie, 2015). Lending decisions of Thai financial institutions are traditionally based on the availability of collateral security, a sound business plan with sufficient cash flow, and personal guarantors for loans. Full collateral, using land and buildings are often required by banks to cover losses in case of default.

The effect of collateral security on performance of small firms is negative as it is a major deterrence to access to credit (Punyasavatsut, 2011). Though Punyasavatsut agrees with the level of significance, Haron et al. (2013) contradict with him on the relationship and direction of significance. These results agree with Anyieni (2014) who did similar research in Kisii town and Nyabicha, Nairobi and found that there was a positive relationship.
Siyad (2013) carried out a study on the effect of MFIs' lending on the growth of SMEs in Somalia. The study, which adopted descriptive design on 60 SMEs, found that most of the requirements, as collateral for loan application, could not be afforded by most SMEs; hence, opting for cheaper sources of capital hence the low adoption of the loan services by businesses. Most of the studies focused on collateral availability; however, it is the cost the business incurs in the course of using collateral to secure a loan that affects its performance in the real sense. It would therefore, have been prudent to use collateral insurance fee and registration fee to measure the effect.

Methodology

To explain the relationship between collateral security and performance of SMEs in Arua, Uganda, a cross-sectional design using both qualitative and qualitative research methods was used. The study population was made by SMEs in Arua Municipal Council. The study targeted 149 respondents from a study population of 224 SMEs in Arua. The samples were drawn from Small, and Medium Enterprises. A mixed method approach was used by the study using both qualitative and quantitative approaches. Given the objective of the study, the quantitative data from the respondents was the most focused on and it was substantiated by qualitative data from key informants. Key informants' interviews were conducted using key informants interview guide. A total of 137 respondents were involved in the study. To ensure data quality, reliability and validity tests were conducted.

The Content Validity Index was calculated and found to be greater than the minimum of 0.70 as stated by Amin (2005). The reliability was calculated based on the Cronbach Alpha coefficient (CAC); all the variable items were found to be reliable as their values were greater than the 0.7 threshold.The sample was drawn into strata of SMEs categories. The selection of the sample from the categories was randomly done. Based on calculations made using the Yamane (1967) formula, the sample was made by 149 SMEs. This sample was distributed using proportion of each category; the SMEs to be part of the study were randomly selected while interviews with key informants were purposively done. Completed questionnaires were reviewed to ensure accuracy, consistency and completeness of

information before leaving the field. Data from the questionnaires was arranged, coded, edited for consistency and easiness and later entered using Statistical Package for Social Scientists (SPSS). The qualitative data from key informants was triangulated to ensure completeness and substantiate the quantitative data.

Results and discussions

This study had a sample of 149 distributed in the 2 SMEs categories from the total target of 224 SMEs, the researchers were able to collect both quantitative and qualitative data from 137 respondents that yielded 92% response rate.

According to the results in Table1, the findings show that demographically the majority 60.4% of the study respondents were males whereas 39.6% were females. The high percentage of the male respondents reflects the general pattern in those who are engaged in SMEs.

Descriptive statistics on collateral security:

The descriptive statistics on collateral security is presented in table 2 attached in the annex. The global mean for collateral security was 3.45 with standard deviation of 0.458. This meant that respondents in Arua municipal council agreed that collateral security is precondition for loan accessibility. The respondents agreed that MFIs offer loan upon reviewing the collateral security of the

SME's Performance:

In order to examine the level of agreement and/or disagreement on the different items used to measure the dimensions of employee performance in the questionnaire, item mean and standard deviation were used. The responses were anchored on the five-point Likert scales ranging from strongly disagree, disagree, neutral, agree and strongly agree. The details are shown in Table 3 in the appendix. Furthermore, SME's performance was measured in terms of sales turnover, employment creation, growth in capital and profitability. The agreement or disagreement as to whether collateral security influence SME's performance or not is widely spread around the mean of around 2.78 with a standard deviation of .200. This means that, the respondents were divided on the state of SMEs performance in Arua Municipal Council. About a half the number agreed that SMEs performance had improved, while the other half disagreed.

Inferential Statistics:

To understand the relationship between the study variables: collateral security and SME's performance, the Pearson's correlation test was performed. This test provided coefficients that allow numerical interpretation between the two variables. The interpretation was made based on the results summarized in Table 4 below:

Table 1: The correlation between the variables

Variables	Mean	Std. Deviation	Coefficient (r)
Collateral Security	3.43	.458	1
Performance	2.78	.200	.052
** Correlation is significant at the 0.01 level (2-tailed)			

N=137

Source: *Primary data (2019)*

The results reveal that Pearson coefficient of correlation for collateral security and performance is 0.052 with the correlation insignificant at 0.05. Hence, we conclude that there is insignificant positive correlation between Collateral security and SME's performance. In other words, if demand for

collateral security as precondition for financial accessibility is minimized, there would be increased number of SMEs access to loan facilities hence better performance of SMEs in Arua Municipal Council, Uganda.

To predict the performance of SMEs in Arua Municipal council, a regression model was used (Table 5). The results revealed that collateral security (high, low value of collateral security) explain 7.6% of the performance of SMEs. This means that there are other factors that explain the performance of SMEs in Arua Municipal Council, Uganda. Further, the results indicated that collateral security (beta=0.009, p>0.05) is insignificant predictor of SMEs performance. Such collateral security parameters are combined predictors of SME's performance (*F=3.559, p<0.01*).

Table 2: The regression analysis of the variables

Model	**Variables**		**Unstandardized Coefficients**		**Standardized Coefficients**	**T**	**Sig.**
			B	Std. Error	Beta		
1	(Constant)		2.169	.267		8.121	.000
	Collateral		.004	.037	.009	.101	.920
R		.275[a]					
R Square		.076					
Adjusted R Square		.055					
R Square Change		.076					
F Change		3.559					
Sig. F Change		.016					
Dependent Variable: Performance							
Predictors: (Constant), Collateral Security							

Source: *Primary data (2019).*

Conclusions and Recommendations:

The study examined the relationship between collateral security and the performance of Small and Medium Enterprises (SME's) in Arua Municipal Council, Uganda. Data was collected by administering self-administered questionnaires as well as face to face interview with key informants. The data was coded and analysed using SPSS and descriptive and inferential statistics were generated. Most of the respondents were males (60.4%), the highest age range was 31-35 year (32.1%) and 58.2% had attained basic education requirement of certificate while 50% had been in business for between 5-10 years

The correlation results reveal that there was insignificant positive correlation between collateral security and SME's performance in Arua Municipal Council. The lower the value of collateral security or the more collateral security is removed as precondition for loan accessibility, the more SMEs can access loan facilities hence better the performance of SMEs in Arua Municipal council became.

The study revealed that, though collateral security insignificantly influences the performance of SMEs, many are limited to access loan facilities due to failure to present valuable collateral security. This means, through microcredit, individuals do manage to come out from poverty and can improve

on income of the households which enabled them to fulfill their basic needs, hence there is reduction in vulnerability. In addition, MFIs can enhance the expansion of business of their clients when they incorporate other services such as, training and regular monitoring. Therefore, provision of sufficient fund without collateral security could enhance creation of a new class of small businesses leading to the expansion of middle class and widen the distribution of economic resources. MFIs provide affordable finance services which help the small and medium enterprises to maintain the self-sufficient financial sustainability, directly having a positive impact on their livelihood. High value of collateral security and other unknown costs not mentioned are challenges in accessing microfinance credit which leads to poor performance.

The study recommends that;

MFIs and SMEs should build sustainable relationships. Government should ensure that, institutions adhere to the laid down laws, principles and regulations put in place in a sincere manner. The study recommends that, though collateral security plays an insignificant role in SMEs performance, SMEs' access to microfinance should be softened through government guarantee. It has worked in Germany and will play a vital role in propelling economic development in Arua and Uganda at large.

Financial institutions, including Microfinance Institutions (MFIs), should reassess their collateral requirements for SME loans. While collateral may serve as a security measure, stringent collateral demands can limit SMEs' access to finance. By revisiting and potentially relaxing collateral prerequisites, MFIs can facilitate greater accessibility to loans, thereby fostering improved performance among SMEs.

Implementing comprehensive financial literacy programs tailored to the needs of SME owners could significantly improve their understanding of financial management, including collateral-related matters. These programs can empower entrepreneurs to make informed decisions regarding loan accessibility and utilization, ultimately contributing to enhanced SME performance.

MFIs should diversify their loan products to cater to the varying needs and capacities of SMEs. Introducing flexible loan options that do not solely rely on collateral security can broaden the scope of financial assistance available to SMEs. Such tailored loan products can align more closely with the specific requirements and capabilities of SMEs, thereby promoting their growth and sustainability.

Exploring and promoting alternative guarantee mechanisms beyond traditional collateral could alleviate the burden on SMEs seeking financing. Initiatives such as peer-to-peer guarantees, where community members vouch for each other's loan repayments, or insurance-backed loan schemes can provide viable alternatives to conventional collateral requirements. By fostering trust and cooperation within communities, these mechanisms can enhance access to finance for SMEs while mitigating risk for lenders.

Government authorities should actively support policies that incentivize financial institutions to adopt more inclusive lending practices for SMEs. This may involve providing subsidies or guarantees to encourage MFIs to extend credit to SMEs without stringent collateral demands. Additionally, policymakers can advocate for regulatory reforms that promote innovation in financial services and facilitate the development of more supportive frameworks for SME financing.

By implementing these recommendations, stakeholders can work towards creating a more conducive environment for SME growth and prosperity in Arua Municipal Council, Uganda, ultimately contributing to broader economic development and poverty alleviation efforts in the region.

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