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The Effects of Interest Rate on Financial Performance of Micro Enterprises: A Case Study of Makutano Township in West Pokot County

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Abstract: **The study was guided by the following objectives; to examine the effect of risk free rate on micro enterprises in Makutano Township in West Pokot County. The study employed a survey research design to select micro enterprises in West Pokot County. The study targeted 5 micro enterprises in West Pokot County which comprised of 10 micro enterprise managers and 108 employees. Hence, the target population of the study comprised of a total of 118 respondents.The study used census sampling as the study population thus the sample size of the study was 102 of the respondents. The study used questionnaires and interview schedule to gather the relevant information under the area of the study and data was analysed using both qualitative and quantitative techniques. The study results revealed that there was a significant relationship between risk free rate and financial performance (p=0.000). The study recommended that government should empower the SMEs to access and get credits from the commercial banks through formal and informal entrepreneurship education for SMEs to develop their managerial capabilities, accounting skills and overall, be more credit worthy.**

Keywords: **Expected inflation, interest rate, maturity premium, micro enterprise.**

1. INTRODUCTION

Kimutai (2013) expresses interest rate as the price one pays for using borrowed money or loans. In monetary economies money creates claims because it is an asset, store of value as well as a medium of exchange. Therefore those who lend money expect to be compensated for handing over their claims for the period of the loans to those who borrow money. This interest rate also covers the expose to credit risk by lenders. Therefore interest rate can be defined as the price lenders expect (and borrowers pay) for exchanging current claims for greater future claims to goods and services. Interest rates represent the cost of money. Ingram (2011) states that interest rates are important because they control the flow of money in the economy. High interest rates curb inflation but also slow down the economy. Low interest rates stimulate the economy, but could lead to inflation. When interest rates are high, people do not want to take loans out from the bank because it is more difficult to pay the loans back, and the number of purchase of real assets goes down. The opposite is also true. The effects of a lower interest rate on the economy are very beneficial for the consumer. Micro enterprises being small businesses that may employ nine people or fewer, and having a balance sheet or turnover less than a certain amount (Accion,2011). Microenterprises typically have little to no access to the commercial banking sector; they often rely on micro-loans or microcredit in order to be financed. Microfinance institutions often finance these small loans, particularly in the Third World. The financial institutions in question usually place an interest rate on loans that may allow the small enterprises to access the loans with ease and at an appropriate time frame and allow them to have sufficient time frame to repay the loan (Kelvin, 2010). In Africa, access to loans and credit facilities has been a major problem for a large portion

of South African society (Aryeetey, 2015). The problem is most significant amongst the disadvantaged and especially in rural areas where the majority of people don't have access to formal banking services due to lack of collateral. The lack of physical access to banking facilities and the unattractiveness of this large section of society to the banking sector have contributed to millions of unbanked and under-banked South Africans (Wood,2009). Access to credit allows financial leverage and financial leverage creates wealth (Levine,2012). The emergence of the micro lending industry in South Africa can be ascribed to a 2012amendment of the Usury Act that exempted loans of less than R6000 from its provisions. This was designed to open up the market for servicing small borrowers. The micro lenders are opening shops everywhere and the industry grew from nothing into a multibillion Rand industry between 2012 and 2010. Interest rates are typically a topical and emotional subject in the micro finance industry all over the world. The obvious and emotionally compelling arguments to highly subsidized credit to the world's poor communities can be persuasive, particularly towards the cause of political expediency. Offering cheap credit can often win quick political points for those who champion such approach (AMEDP, 2015). One of the key factors influencing the lack of supply of credit to small enterprises is the non-recoverability of costs. Charging a rate of interest on credit is the main source of income for many organizations in micro lending industry. It is the only way by which they can recover their costs financial, operating and risk (Aryeetey and Nissanke, 2010). The components of an interest rate in a small loan includes, Cost of capital, Sufficient return to cover the risk of loan loss or bad debt, Operating costs and a profit margin. Given these, the micro-lending institutions can only survive by fully recovering all the costs of the first three components, and grow if they can also receive the third component (Agbelie, 2011). These components were calculated based on information provided by the Micro Finance Regulatory Council (MFRC). The detailed information supplied by the MFRC and the financial statements of institutions also supplied by the MFRC were merged in one database reflecting a sample of 90 institutions drawn from the more than 800 registered institutions as at the endof February 2010(Bevan and Danbolt, 2010). In Kenya, lower rates can make borrowers to be more dependent on donor's money while high rates can lead to higher regulatory scrutiny and attract the worst borrowers (adverse selection). The question around fair rates is therefore key to policymakers and MFIs. Most micro-finance institutions in Kenya charge interest rates that range from between1.8 per cent to 2.5 per cent per month. Others, on the other hand, charge at least 0.5 percent per week (Atieno, 2011). This translates to between 21.6 per cent and 30 per cent per year. The institutions have repayment periods of weekly and monthly depending on the size of the loan, lending rules and how one agrees with other members of the group ran by the micro-finance institution, who jointly act as guarantors of the loan. Loans offered by such institutions do not have grace period, borrowers start servicing the loans as soon as they receive them.

1.1 Problem Statement:

The ability of SME to grow depends highly on their potential to invest in restructuring and innovation (Ayyagari et al., 2011). The rate of SMEs failure in developing countries as well as developed countries is alarming 33% to 41% of new SMEs fail within the first five years of their business operation (Thaimuta, 2014). Three out of five SMEs fail within their first three years of operation in Kenya (RoK, 2011). It is therefore widely recognized that 'bank lending gap' exists in the provision of modest amounts of finance to SMEs since all investments need capital. SMEs continue to face constraints caused by many common factors including commercial bank's lending policies. In line with this argument, bank lending has influence on performance of SMEs (Sabana, 2014). In contrary, (Ifeakachukwu 2013) found out that bank lending to the SME sector had insignificant impact on their performance. Most SMEs use credit from the MFls to finance their operations. According to Mwindi (2012), higher amounts of credit granted to SMEs are charged higher levels of interest rates but enable them to meet more of their planned operations. This result in higher profitability to the SMEs hence a positive relationship exists between the interest rates charged by MFls and the profits of the SMEs mainly because of the amount of credit associated with these high interest rates. It is therefore evident that the above mentioned local studies have focused more on the impact of microfinance on growth and performance of SMEs in Kenya. This study examined and evaluated on the effect of interest rate on micro enterprises and make necessary recommendations based on the findings of the study.

1.2 General Objective:

The main objective of this study was to examine the effect of interest rate on micro enterprises in in Makutano Township, West Pokot County.

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1.3 Specific Objective:

To examine the effect of risk free rate on financial performance of micro enterprises in Makutano Township, West Pokot County.

1.4 Research Question

1. What is the effect of risk free rate on financial performance of micro enterprises in Makutano Township, West Pokot County?

1.5 Research Hypothesis

There is no significant relationship between risk free rate and financial performance of micro enterprises in Makutano Township, West Pokot County.

2. LITERATURE REVIEW

2.1 Theoretical Review:

2.1.1 Classical Theory of Interest Rates:

The classical theory of interest rates applies the classical theory of economics to determining interest rates. It defines the interest rate as the element that equates savings to investment. The theory compares the supply of savings with the demand for borrowing. Using supply and demand curves the equilibrium rate is calculated by determining the curves intersection point. Thus if savings are greater than investments the interest rate drops until they reach equilibrium and vice versa, if savings are less than investment the interest rate increases until the reward for savings encourages increased savings rates causing the market to again reach equilibrium (Gorder 2009).

Other proponents of the classical theory of interest rates look at it differently. Marshal argues that interest rate is the price paid for the use of capital and that it is determined by the intersection of aggregate demand and supply of capital. According Keynes, interest rates definitely influences the marginal propensity to save. He concludes that the rate of interest should be at a point where the demand curve for capital at different rates intersects the savings curve at a fixed income level. However the classical theory of interest rates fails to account for factors besides supply and demand that may affect interest rates such as the creation of funds, the importance of income and wealth and changes in the primary borrowers in an economy.

2.1.2 Interest Rate Parity Theory:

Interest Rate Parity (IPR) theory is used to analyse the relationship between at the spot rate and a corresponding forward (future) rate of currencies. The IPR theory states interest rate differentials between two different currencies will be reflected in the premium or discount forthe forward exchange rate on the foreign currency if there is no arbitrage the activity of buying shares or currency in one financial market and selling it at a profit in another. The theory further states size of the forward premium or discount on a foreign currency should be equal to the interest rate differentials between the countries in comparison (Bleaney, andFielding, 2012).

The theory of interest rate parity, relates the difference between foreign and domestic interest rates with the difference in spot and future exchange rates. This parity condition states tha tthe domestic interest rate should equal the foreign interest rate plus the expected change of the exchange rates. If investors are risk-neutral and have rational expectations, the future exchange rate should perfectly adjust given the present interest-rate differential. For example, if the differential between one-year dollar and pound interest rates is five percent with thepound being higher, risk neutral, rational investors would expect the pound to depreciate byfive percent over one year thereby equalizing the returns on dollar and pound deposits. If theexchange rate did not adjust, then arbitrage opportunities would exist. Consequently, thecurrent forward rate should reflect this interest rate differential as a forward contract locks inthe future exchange rate.

2.2 Conceptual Framework:

Conceptual framework is a figure that indicates the independent and dependent variable of the study. The study ought to investigate the effects of interest rate on micro enterprises: a case study of Makutano Township in west Poko County. The study independent variable has its indicator of risk free rate.

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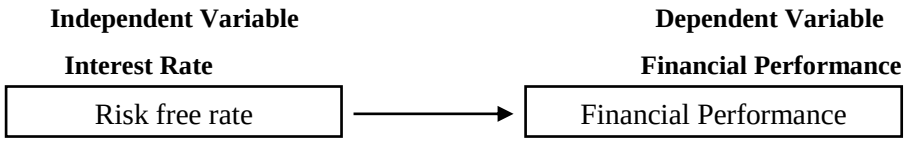

Figure 2.1 Conceptual Framework

2.3 Empirical Review:

2.3.1 Risk free rate and Micro Enterprises:

Micro enterprises is not a new development. Its origin can be traced back to 1976, when Muhammad Yunus set up the Grameen Bank, as experiment, on the outskirts of Chittagong University campus in the village of Jobra, Bangladesh. The aim was to provide collateral free loans to poor people, especially in rural areas, at full-cost interest rates that are repayable in frequent installments. Borrowers were organized into groups and peer pressure among them reduces the risk of default (Khan and Rahaman, 2011). Von (2011) maintains that micro finance came into being from the appreciation that micro entrepreneurs and some poorer clients can be bankable, that is, they can repay both the principal and interest, on time and also make savings, provided financial services are tailored to suit their needs. Ledgerwood (2009), Christen and Rosenberg (2010) perceive the concept of micro finance as the provision of financial and non-financial services by micro finance institutions (MFIs) to low income groups without tangible collateral but whose activities are linked to income generating ventures. These financial services include savings, credit, payment facilities, remittances and insurance. The non-financial services mainly entail training in micro enterprise investment and business skills. Roth, (2012) believes that micro finance encompasses microcredit, micro savings and micro insurance. Webster and Fidler (2015) advocate that in many cases, basic business skill training should accompany the provision of micro loans to improve the capacity of the poor to use funds. Micro enterprise investment training mainly addresses capital investment decisions, general business management and risk management. Capital investment decisions include allocation of the micro enterprise limited capital funds most effectively in order to ensure the best return possible. Therefore, a wrong decision can have long

3. RESEARCH DESIGN AND METHODOLOGY

This study employed a survey research design to select micro enterprises in West Pokot County. The study targeted 5 micro enterprises in West Pokot County. The target population for the study was the micro enterprises managers and employees or staff members. The study targeted 10 managers and 108 employees. The target population for the study comprised of a total of 118 respondents. The sample size was 118 respondents which were composed of micro Enterprise Managers. The researcher used questionnaires and interview schedule to gather the relevant information under the area of the study. The data was analysed using both qualitative and quantitative techniques. Qualitative analysis assisted in analysing the interview schedules responses while quantitatively; descriptive statistics were employed in analysing the questionnaire data. The Regression analysis technique was used to determine the relationship between the independent variable and the dependent variable.

4. RESEARCH FINDINGS AND DISCUSSION

4.1. Effect of risk free rate on financial performance:

The study sought to examine the effect of risk free rate on financial performance of micro enterprises; the study results were as follows;

Table 4.1: Effect of risk free rate on financial performance

Statements		SD	D	U	A	SA	TOTAL	MEAN	SD
Risk free rate allows borrowers to repay both the principal and interest on time and also make savings	F	0	0	26	56	20	102	3.92	0.67
	%	0	0	26.5	54.9	18.6	100	79.4	
Less risk free rate interest rate on loan may enhance micro enterprises to drop	F	0	0	38	54	10	102	3.71	0.62
	%	0	0	37.4	53.3	9.3	100	74.2	

out of the micro finance program as they were pushed into indebtedness and could not repay the loans									
SMEs are dissatisfaction with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions	F	0	0	20	62	20	102	4.01	0.62
	%	0	0	18.8	61.3	19.9	100	80.0	
Interest rate charged has dire consequences on business operations in the form of high cost of production and prices which slow down business progress	F	0	0	28	64	10	102	3.84	0.59
	%	0	0	26.5	62.8	10.6	100	76.8	
Low interest rate charge on credits strategically boost the chances of their business growth	F	0	0	44	58	2	102	3.59	0.52
	%	0	0	42.7	56.0	1.3	100	71.8	

The study results indicated that 26.5% were undecided that risk free rate allows borrowers to repay both the principal and interest on time and also make savings, 54.9% agreed that risk free rate allows borrowers to repay both the principal and interest on time and also make savings while 18.6% strongly agreed that risk free rate allows borrowers to repay both the principal and interest on time and also make savings The study results indicated that 37.4% were undecided that less risk free rate interest rate on loan may enhance micro enterprises to drop out of the micro finance program as they were pushed into indebtedness and could not repay the loans; 53.3 agreed that less risk free rate interest rate on loan may enhance micro enterprises to drop out of the micro finance program as they were pushed into indebtedness and could not repay the loans while 9.3% strongly agreed that less risk free rate interest rate on loan may enhance micro enterprises to drop out of the micro finance program as they were pushed into indebtedness and could not repay the loans.

The study results also indicated that 18.8% were undecided that SMEs are dissatisfaction with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions; 61.3% agreed that SMEs are dissatisfaction with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions while 19.9% strongly agreed that SMEs are dissatisfaction with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions.

The study findings indicated that 26.5% were undecided that interest rate charged has dire consequences on business operations in the form of high cost of production and prices which slow down business progress; 62.8% agreed that interest rate charged has dire consequences on business operations in the form of high cost of production and prices which slow down business progress while 10.6% strongly agreed that interest rate charged has dire consequences on business operations in the form of high cost of production and prices which slow down business progress.

The study results indicated that 42.7% were undecided that low interest rate charged on credits strategically boost the chances of their business growth; 56.0% agreed that low interest rate charge on credits strategically boost the chances of their business growth while 1.3% strongly agreed that low interest rate charge on credits strategically boost the chances of their business growth.

The study results indicated that 79.4% (mean=3.92) were of the view that risk free rate allows borrowers to repay both the principal and interest on time and also make savings; 74.2% (mean=3.71) were of the view that less risk free rate interest rate on loan may enhance micro enterprises to drop out of the micro finance program as they were pushed into indebtedness and could not repay the loans whereas 80.0% (mean=4.01) were of the view that SMEs are dissatisfaction with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions; 76.8% (mean=3.84) were of the view that interest rate charged has dire consequences on business operations in the form of high cost of production and prices which slow down business progress while 71.8% (mean=3.59) were of the view that low interest rate charge on credits strategically boost the chances of their business growth.

These study findings indicated that majority of the respondents were of the view that SMEs are dissatisfied with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions.

This shows that the loan processing procedure might be too long and even to access the credit takes a much longer period. In this case the money anticipated surpasses the needs of the SMEs due to the duration it takes to get the credit.

These study findings are in line with results by Mochona (2010) who noted that only a few of the women clients reported increased incomes from their micro enterprise activities. It was also noted that dissatisfaction with the loan processing procedure and time taken to secure the loan. Most present and ex-clients faced major risks in running their businesses and therefore dropped out of the micro finance program as they were pushed into indebtedness and could not repay the loans. Although savings were made regularly, majority of the women clients of Gasha Microfinance Institution were unable to build key assets since the savings were dismal.

Table 4.2: Regression Model Analysis

ANOVA						
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	F	Sig.
1	.946[a]	0.896	0.895	0.09437	958.443	.000[a]
a. Predictors: (Constant), E, B, D, C						

The study results indicated that the regression model was significant at p=0.000 and that 89.6 percent of the data was used to compute the regression model. This implies that the regression model was correctly computed and therefore it was fit for the study.

Table 4.3: Relationship between Study Variables

Coefficients[a]					
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.015	0.082		0.180	0.857
Risk free rate	0.217	0.034	0.367	6.420	0.000
a. Dependent Variable: financial performance					

The regression equation was modelled as follows; $Y= ß_0 + ß_1X_1+ e$. The regression equation computed was; Y = 0.015 + 0.367 + 0.500 Y (Financial performance) = 0.015 + 0.367 (Risk free rate) The regression equation indicated that term structure was the most important variable to financial performance contributing 50.0 per cent followed by maturity premium which contributed 49.0 per cent to financial performance and risk free rate contributed 36.7% The study results revealed that there was a significant relationship between risk free rate and financial performance (p=0.000); there was a significant relationship between term structure and financial performance (p=0.000).

5. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings:

The study results indicated that 79.4% (mean=3.92) were of the view that risk free rate allows borrowers to repay both the principal and interest on time and also make savings; 74.2% (mean=3.71) were of the view that less risk free rate interest rate on loan may enhance micro enterprises to drop out of the micro finance program as they were pushed into indebtedness and could not repay the loans whereas 80.0% (mean=4.01) were of the view that SMEs are dissatisfaction with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions.

The study findings indicated that 76.8% (mean=3.84) were of the opinion that high interest rates curb inflation but also slow down the economy whereas low interest rates stimulate the economy thus lead to inflation; 84.4% (mean=4.22) were of the opinion that low inflation is a unique problem for micro enterprises and it remains that bottom interest rates could have the desired effect while 82.4% (mean=4.12) of the respondents were of the opinion that high interest rates lead people not to borrow loans out from the bank because it is more difficult to pay the loans back and thus introducing inflation in the economy.

5.2 Conclusion:

The study concluded that SMEs are dissatisfied with the loan processing procedure and time taken to secure the loan after risk free rate are induced by banks and lending institutions. This shows that the loan processing procedure might be too long and even to access the credit takes a much longer period. In this case the money anticipated surpasses the needs of the SMEs due to the duration it takes to get the credit. The study concluded that low inflation is a unique problem for micro enterprises and it remains that bottom interest rates could have the desired effect.The study concluded that maturity matching between debts on loans with high interest rate plays an important role in deciding the length of the debt maturity. This implies that maturity matching between debt and the life of assets plays an important role in deciding the length of the debt maturity. Short-term debt is positively correlated with firm's growth opportunities. Short-term debt is the best financing tool because it is perceived to be cheaper.

5.3 Recommendations:

The findings of the paper imply that the government should formulate policies that compel commercial banks to relax their restrictive regulations and operations which may discourage borrowing and offer more credit facilities for SMEs. The government should empower the SMEs to access and get credits from the commercial banks through formal and informal entrepreneurship education for SMEs to develop their managerial capabilities, accounting skills and overall, be more credit worthy.

5.4 Areas for further research:

Areas for further research are suggested below: Effect of managerial competence, information availability and other factors that affect the general performance of SMEs.

There is need to research further on the external factors that have an impact on the access to credit by the Small and Medium Enterprises like the adequacy of the financial systems, regional imbalances in the economy among others.

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