ASSESSING THE IMPACT OF TRADITIONAL BANK LOANS ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN BARINGO CENTRAL SUB-COUNTY: A THEORETICAL AND EMPIRICAL ANALYSIS

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ABSTRACT

This study investigates the impact of traditional bank loans on the financial performance of Small and Medium Enterprises (SMEs) in Baringo Central Sub-County, Kenya. Despite SMEs contributing approximately 78% to employment and over 30% to GDP (Kenyan National Bureau of Statistics, 2022), only 17% in rural areas like Baringo Central have access to formal credit (World Bank, 2023). Using a descriptive survey of 222 SME owners and managers, the findings reveal a predominantly negative perception of bank loans, with an overall mean score of 2.32 out of 5, indicating disagreement with statements about loan accessibility, affordability, and impact. Specifically, 63% of SMEs operate informally without access to formal credit (Kenyan Central Bank, 2022), and respondents generally disagreed that bank loans had improved their financial performance or growth prospects. The study concludes that rigid application procedures, high interest rates, and collateral requirements hinder SMEs' access to and effective use of bank credit, limiting their growth potential. It recommends that financial institutions and policymakers develop more flexible, tailored financial products to enhance access and foster sustainable growth in rural communities.

Keywords: SME Financing, Traditional Bank Loans, Financial Performance, Rural Kenya, Financial Inclusion.

INTRODUCTION

Small and Medium Enterprises (SMEs) are widely recognized as vital drivers of economic growth, employment creation, and poverty alleviation, particularly in developing countries like Kenya. These enterprises form the backbone of local economies, contributing significantly to income generation and community development. However, despite their importance, many SMEs face substantial challenges in accessing adequate financing, which hampers their growth and sustainability. Traditional bank loans have historically been a primary source of formal financing for SMEs, offering the potential for capital infusion necessary for expansion, operational efficiency, and innovation. Nonetheless, the impact of such loans on the financial performance of SMEs remains a subject of ongoing debate, especially in rural and semi-urban contexts where financial exclusion and collateral constraints are prevalent.

In Baringo Central Sub-County, SMEs operate within a unique socio-economic environment characterized by diverse sectors, limited financial infrastructure, and varying levels of financial literacy. While traditional bank loans could serve as a catalyst for growth, their accessibility and effectiveness in improving SME performance in this region are not well-documented. Existing literature suggests that access to formal credit can influence key financial performance indicators such as profitability, asset growth, and revenue expansion; however, empirical evidence specific to rural Kenyan SMEs is limited. This study aims to bridge this gap by assessing the impact of traditional bank loans on the financial performance of SMEs in Baringo Central, providing both a theoretical framework and empirical insights into this relationship.

The findings of this research are expected to inform policymakers, financial institutions, and SME entrepreneurs about the role of traditional bank financing in fostering sustainable growth. By understanding the extent to which bank loans influence SME performance, stakeholders can develop targeted strategies to improve access, reduce barriers, and optimize financial support mechanisms. Ultimately, this study contributes to the broader discourse on financial inclusion and SME development in Kenya, emphasizing the importance of tailored financial solutions that align with the unique needs of rural enterprises.

Statement of the Problem

Small and Medium Enterprises (SMEs) are recognized as vital contributors to Kenya's economic growth, accounting for approximately 78% of total employment and over 30% of the GDP (Kenyan National Bureau of Statistics, 2022). Despite their significance, access to formal financial services remains a major obstacle, with only about 17% of SMEs in rural areas like Baringo Central having access to formal credit (World Bank, 2023). Traditional bank loans, which could serve as a catalyst for growth, are often inaccessible due to collateral requirements, high interest rates, and limited financial literacy among rural entrepreneurs (Kinyua & Njuguna, 2021). This limited access hampers SMEs' ability to invest in expansion, technology, and operational efficiencies, ultimately affecting their financial performance. While existing literature indicates that formal credit can positively influence SME growth (Mutua & Wainaina, 2020), there is scant empirical evidence specifically addressing the impact of traditional bank loans on the financial performance of SMEs within the context of Baringo Central.

This knowledge gap poses a challenge for policymakers and financial institutions aiming to promote inclusive financial development in rural Kenya. Without concrete data on how traditional bank loans influence key financial metrics such as profitability, asset growth, and revenue, efforts to improve access and support for SMEs may lack direction. Recent statistics underscore the urgency of this issue, as 63% of SMEs in rural Kenya operate informally without access to formal credit, limiting their growth prospects (Kenyan Central Bank, 2022). Consequently, there is a pressing need for empirical research to assess whether traditional bank loans significantly enhance the financial performance of SMEs in Baringo Central, guiding targeted interventions to foster sustainable growth and financial inclusion in the region.

LITERATURE REVIEW

Traditional bank loans and financial performance of SMEs

Research on the effects of traditional bank loans on the financial performance of SMEs has yielded mixed findings across different regions, with most studies emphasizing a positive relationship. In the USA, Berger and Udell (2006) demonstrated that access to bank loans significantly boosts SME profitability, primarily through increased operational capacity and revenue growth, based on regression analyses of urban firm data. Similarly, Cole et al. (2016) found that favorable loan terms enhance financial stability, though their urban-centric approach and reliance on self-reported interview data may limit the applicability of their findings to rural contexts. Chen et al. (2019) further showed that bank-financed SMEs experienced improved liquidity over time, yet their focus on urban firms in developed economies raises questions about the relevance to less-developed rural areas.

Comparable patterns emerge in Canadian studies, such as those by Afolabi et al. (2021), who identified a positive association between bank loans and profitability in urban SMEs through regression analysis. Wong et al. (2018) reinforced these findings, emphasizing the role of flexible loan conditions in enhancing financial performance. Dyer et al. (2019) added longitudinal evidence, revealing that SMEs with bank financing tend to have better liquidity ratios over extended periods. However, the urban bias persists, as rural SMEs often face different challenges, including higher financing costs and limited access, which these studies do not adequately address.

In Western Europe, research by Eikelenboom and de Jong (2018) confirmed a strong positive correlation between bank financing and SME profitability in urban Dutch regions. Cosh et al. (2020) highlighted that bank loans improve liquidity management, enabling SMEs to navigate economic uncertainties. Nonetheless, their urban-focused mixed-methods approach, incorporating subjective interview data, may not capture the realities of rural SMEs, which often encounter more severe financial barriers. Brixy et al. (2018) corroborated these findings with a longitudinal study in Germany, but again, the urban concentration limits broader applicability.

Studies in Eastern Europe and Asia also reflect similar trends, with Kallio et al. (2020) and Kauffmann et al. (2021) demonstrating that bank loans contribute to higher profitability and growth among urban SMEs. However, rural SMEs in these regions often face significant barriers, such as inadequate financial infrastructure and stringent lending criteria, which are underrepresented in the existing literature. Liu et al. (2020) in China and Chan et al. (2022) in Southeast Asia found that while bank financing improves liquidity and growth, challenges like high interest rates and limited access persist, especially in rural settings.

In the African context, Abor and Quartey (2010) observed a positive relationship between bank loans and profitability among Ghanaian urban SMEs, but noted that rural businesses face substantial hurdles in accessing credit. Similarly, Njeru and Mwangi (2018) reported that high borrowing costs and strict conditions hinder rural SMEs in South Africa from fully benefiting from bank financing. Osei et al. (2020) highlighted that rural SMEs in Nigeria encounter difficulties in securing loans due to collateral requirements and perceived risks, limiting the impact of bank loans on their financial performance.

Within Kenya, recent studies such as that by Owino et al. (2020) and Karanja and Waweru (2021) suggest that access to traditional bank loans generally correlates with improved liquidity and growth among urban SMEs. However, these studies also point out disparities in access, with rural SMEs often excluded from formal financial services due to infrastructural and collateral challenges. Moreover, the predominantly cross-sectional methodologies employed, such as surveys and regression analyses, limit insights into the long-term effects of bank loans. Future research should incorporate longitudinal designs and diverse geographic samples, including rural areas like Baringo Central, to better understand the nuanced impacts of bank financing on SME performance across different environments.

RESEARCH METHODOLOGY

The research adopts a descriptive research design, which is suitable for profiling and understanding the various financing techniques employed by SMEs in Baringo Central Sub-County, including traditional bank loans, fintech solutions, crowdfunding, and government initiatives. This approach enables the researcher to systematically document the current state of SME financing and financial performance without manipulating variables, providing an objective snapshot of the phenomena under investigation. Descriptive studies are widely used in social sciences and business research for their ability to characterize populations, behaviors, and trends through structured surveys and questionnaires, contributing to a comprehensive understanding of the subject matter (Johnson et al., 2022).

The study focuses on a well-defined target population comprising 498 SME owners and managers across five wards within Baringo Central. These participants represent diverse sectors such as agriculture, trade, manufacturing, services, financial services, and tourism. SME owners and managers are chosen because they are the primary decision-makers regarding financing choices, making their insights critical for understanding how traditional bank loans influence financial performance. Their firsthand knowledge of financial challenges and opportunities provides reliable data on the adoption and impact of different financing strategies, aligning with prior research emphasizing the importance of decision-makers' perspectives in financial studies (Nganga & Njagi, 2022).

To ensure representativeness and accuracy, the study employs stratified random sampling, dividing the population into sectors or strata. This method guarantees proportional representation from each sector, reducing sampling bias and allowing sector-specific analysis. The sample size is determined using Yamane’s formula at a 95% confidence level and a 5% margin of error, resulting in a sample of 222 SMEs. The sample size was obtained using the formular below:-

$$n = \frac{N}{1+N(e^2)}$$

Where:

n is the sample size,

N is the total population of SMEs in Baringo Central Sub-County, and

e is the margin of error (0.05 for a 95% confidence level).

N=498/1+498(0.05^2)

N=498/2.245 = 222

This formula helps ensure that the sample size is large enough to yield statistically significant results, yet manageable within the study's resource constraints. Stratified sampling enhances the precision of estimates by minimizing within-group variability and increasing the reliability of the findings, which is supported by methodological standards in social science research (Krejcie & Morgan, 2020; Lohr, 2010).

Data collection is primarily conducted through structured questionnaires, which gather quantitative information on financing techniques and financial performance metrics such as profitability, revenue growth, and asset levels. The questionnaires include both closed-ended Likert-scale questions and open-ended items to capture detailed insights. Prior to full deployment, a pilot test is conducted to refine the instrument, ensuring clarity, relevance, and validity. This approach aligns with best practices in survey research, emphasizing the importance of pre-testing instruments to improve reliability and validity (Creswell & Clark, 2010; Saunders, Lewis, & Thornhill, 2019). The questionnaires are administered in person, facilitating clarification and improving response accuracy.

Data analysis involves a combination of descriptive statistics, inferential statistics, and regression models. Descriptive analysis summarizes key variables, providing an overview of the data distribution and central tendencies. Multiple regression analysis evaluates the relationship between traditional bank loans (independent variable) and financial performance (dependent variable), controlling for other factors such as SME size and age. Additionally, the study employs diagnostic tests including normality, multicollinearity, homogeneity, and linearity to ensure the robustness of the data before analysis. Ethical considerations, including informed consent, confidentiality, voluntary participation, and cultural sensitivity, are strictly observed throughout the process, with ethical approval obtained from relevant review boards to uphold research integrity (Bryman, 2016; Creswell & Creswell, 2018).

RESEARCH RESULTS AND DISCUSSION

Traditional Bank Loans

The use of traditional bank loans as a financing option was assessed based on the perceptions of SME owners and managers. Respondents indicated their level of agreement with five statements related to the application and impact of traditional bank loans on their businesses. Overall, the responses showed a consistent tendency to disagree with several aspects of traditional bank loans (mean=2.32, standard deviation=1.05). Specifically, respondents generally disagreed that they had applied for traditional bank loans within the past year (mean=2.49, SD=1.011). They also expressed disagreement with the notion that the loan approval process is efficient and straightforward (mean=2.34, SD=1.124). Furthermore, they did not find the interest rates on these loans to be affordable for their businesses (mean=2.30, SD=1.058). Additionally, respondents disagreed that access to traditional loans had positively impacted their businesses (mean=2.30, SD=1.008), and they also did not believe that such loans had improved their growth prospects (mean=2.18, SD=1.055).

Table 1 Descriptive Statistics for the Traditional Bank Loans Variable

			Skewness		Kurtosis	
Questionnaire Item	***M***	***SD***	**Statistic**	**SE**	**Statistic**	**SE**
I have applied for traditional bank loans in the last 12 months	2.49	1.011	.870	.167	.066	.333
The approval process for traditional bank loans is straightforward and efficient	2.34	1.124	.737	.167	-.294	.333
The interest rates on traditional bank loans are affordable for my SME	2.30	1.058	.908	.167	.289	.333
Access to traditional bank loans has positively impacted my SMEs financial performance	2.30	1.008	.918	.167	.438	.333
Traditional bank loans have significantly improved my SMEs growth prospects	2.18	1.055	.925	.167	.237	.333
Overall response score	**2.32**	**1.050**	**.869**	**.167**	**.225**	**.333**

These findings suggest that SME owners and managers in Baringo Central sub-county hold a negative perception of traditional bank loans, particularly regarding their accessibility, affordability, and their impact on financial performance and business growth. Essentially, the results indicate that SMEs view traditional bank loans as characterized by rigid application procedures, unfavorable lending terms, and limited returns on debt financing. However, it is also important to recognize that the responsible use of bank loans may be influenced by certain socio-demographic factors of SME owners and managers.

These results align with previous research highlighting the numerous challenges SMEs face when seeking traditional bank financing. For example, the perception of strict application processes and demanding lending conditions corroborates findings by Chan et al. (2022), who identified similar issues such as stringent eligibility criteria and limited access to financial products for SMEs in Southeast Asia. Likewise, studies by Kira and He (2023) have emphasized that collateral requirements and rigid loan conditions serve as significant barriers for many SMEs attempting to access traditional bank credit. Similarly, Abey and Quartey (2010) in the Ghanaian context acknowledged that less favorable loan terms constrain SMEs' ability to secure financing.

Furthermore, these descriptive results reinforce previous studies conducted within Kenya that examined the relationship between traditional bank loans and SME performance, which reported comparable challenges. For instance, Njeru and Morangi (2018) pointed out that high borrowing costs and strict loan conditions deter SMEs from seeking such funding. Likewise, Owino et al. (2020), through a mixed-methods approach, highlighted obstacles like high interest rates and inflexible repayment terms that could adversely affect SME financial performance. Additionally, Karanja and Waweru (2021), in a longitudinal study, observed that many rural SMEs in Kenya struggled to access credit, revealing a disparity between urban and rural enterprise financing opportunities. Overall, this study accurately reflects the limited and often costly use of traditional bank loans among SMEs in Baringo Central, showing that despite their potential to provide liquidity, these loans are difficult to obtain and may entail high costs.

Conclusion

The adoption of traditional bank loans by SMEs in Baringo Central sub-county to fund their business operations remains limited. Owners and managers of these small and medium-sized enterprises tend to view these loans unfavorably, primarily due to the perception that the application procedures are overly rigid and bureaucratic. Additionally, the lending terms imposed by banks are perceived as highly stringent, making it difficult for SMEs to qualify for and access these financial products. As a result, these loans are neither easily obtainable nor affordable for most SMEs in the area. Furthermore, despite the availability of such loans, their impact on the financial performance of SMEs appears to be minimal. This is largely because the perceived poor returns on debt financing such as high interest rates and inflexible repayment conditions limit the benefits that SMEs can derive from borrowing. Consequently, traditional bank loans are not viewed as a highly effective or attractive financing option for SMEs in Baringo Central, leading to their low utilization and limited influence on business growth and financial improvement within this community.

Recommendations

Based on the study's findings and conclusions regarding financing methods and the financial performance of SMEs in Baringo Central Sub-County, it is recommended that financial institutions and policymakers collaborate to create more flexible and accessible banking solutions specifically designed for rural SMEs. This could involve streamlining application processes, reducing the collateral requirements, and offering tailored loan products that address the unique needs and challenges faced by rural entrepreneurs. By making these financial services more attainable and less burdensome, it is likely that the uptake of bank loans among SMEs will increase. In turn, this could lead to improved financial performance for these enterprises, fostering sustainable growth and development within the community. Such efforts would not only enhance access to finance but also contribute to strengthening the overall economic resilience of rural SMEs in the region.

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