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Small Enterprise Finance under Liberalization in Ghana

Small enterprises in developing countries typically cite lack of access to finance as an important constraint on their operations. This lack of access is often associated with financial policies and bank practices that make it hard for banks to cover the high costs and risks involved in lending to small firms. This study, **Supply and Demand for Finance for Small Enterprises in Ghana**, examines the issues associated with the constraints experienced by small enterprises in Ghana.

At the time Ghana undertook its Economic Recovery Program (ERP) in the mid-1980s, its financial system was fragmented and repressed by restrictive policies that controlled interest rates, attempted to allocate credit directly by sector, and limited competition in the commercial banking system, which was dominated by the state-owned Ghana Commercial Bank. Informal financial institutions operating outside the scope of banking laws and regulations included moneylenders, rotating savings and credit associations, and savings collectors. The latter commonly assist market traders to accumulate funds through daily deposits that are returned at the end of each month (minus a small fee). There was little interaction between the formal and informal segments, apart from deposits by savings collectors in bank accounts. Also, neither segment paid much attention to small enterprises.

Ghana's ERP included the liberalization of financial markets, as well as the removal of many other restrictions on the free operation of private enterprises and markets. Nevertheless, this study, conducted in 1991-92 indicates that reforming financially repressive policies had little immediate effect on the conditions that inhibited banks from financing small enterprises, leaving their demand for credit largely unsatisfied. On the other hand, the study found that:

- Many successful small enterprises did have at least some access to bank finance;
- That other forms of external finance, such as customers' advances and supplier's credit, were at least as important as bank credit; and

- That some small firms achieved rapid growth through reinvestment of profits.

These findings are based on a survey of 133 enterprises identified as successful and therefore as potential candidates for bank financing. These enterprises ranged from micro (1 to 9 workers) to small-scale (10 to 29 workers) to medium-scale (30 to 140 workers). Interviews were also conducted with a sample of Ghana's 12 commercial and development banks, informal savings collectors and moneylenders, and semi-formal financial institutions.

Sources of Finance

Survey results reveal the overwhelming importance of *equity* finance in the start-up of small enterprises in Ghana, as in other countries_the more so the smaller the enterprise. On the other hand, *credit* for start-up is relatively rare. Banks do not normally risk lending to new investors, large or small, who do not have a track record. Many small entrepreneurs begin with very small amounts of capital from personal savings (their own and relatives' or friends') and steadily build up their enterprise by reinvesting profits. As firm size grows, the likelihood of obtaining external finance rises, although internal financing dominates even the largest size group in the survey.

Many small enterprises do manage to finance rapid growth from their own *profits* and from non-bank sources. Most important among these non-bank sources for start-up was *supplier's credit*_usually for equipment. Supplier's credit was used as frequently as bank loans for start-up (10 percent of sample firms) and more frequently for working capital (15 percent), at least by microenterprises (Table 1). Once a small enterprise was established, *advances* from customers become the most important source of finance after retained earnings, and was used by 29 percent of sample firms (more so for those with fewer than 30 workers than with more). Data from the World Bank's Regional Program in Enterprise Development (see Findings No. 9) likewise show that supplier's credit and advances are important sources of finance for small enterprises.

Table 1: Major Sources of Initial Finance and Working Capital by Firm Size (percentage of firms in each categoy listing response among top three)

	Sources of initial finance Number of workers				Sources of working capital Number of workers			
Source of finance	Total sample	1-9 Micro	10-29 Small	30-140 Medium	Total sample	1-9 Micro	10-29 Small	30-140 Mediur
Own savings	81	81	80	86	26	28	26	19
Profits	n.a.	n.a.	n.a.	n.a.	70	66	77	69
Relations	31	33	31	21	7	9	9	0
Bank loan	10	8	8	29	10	3	15	25
Overdraft	1	1	0	0	16	15	15	25
Supplier's credit	10	5	15	21	15	15	15	13
Advances	2	3	0	7	29	28	33	19
Special agency	7	11	3	0	11	13	8	6

Is Credit a Binding Constraint?

Lack of access to finance dominated respondents' perceptions of constraints on their businesses. Overall, 23 percent saw inadequate credit for working capital as their most important constraint and another 21 percent stressed lack of loans for expansion. The smaller the firm, the more likely the entrepreneur was to complain about lack of credit_and to be rejected if he or she applied.

Nevertheless, firms in the sample had doubled the real value of their assets in just over 8 years on the average. Growth in capital was highest for microenterprises at 13 percent per annum, as against 4 percent for small- and medium-scale enterprises (SMEs). Employment grew at 7 to 9 percent per annum across size categories. These relatively high rates of growth are not necessarily typical of small enterprises as a whole, since the sampling focused on firms considered to be potentially successful (60 percent reported rising profits).

The high growth rates of small enterprises and their important use of non-bank finance make it difficult to conclude that lack of access to bank loans has *prevented* them from entering and growing in response to the ERP_although they might well have grown faster with easier access. Furthermore, 44 percent of the entrepreneurs had obtained at least one bank loan and 74 percent had saved in a bank. So, many of them did have some access to bank services, even if their credit demand was not adequately satisfied.

Half of the microenterprises in the sample that had received a loan were clients of the Program of Action to Mitigate the Social Costs of Adjustment (PAMSCAD), whose loans are administered by a commercial bank. While this program has demonstrated that special efforts can broaden access to finance and help establish viable enterprises, its repayment rates have remained too low to demonstrate to banks that microenterprise lending is profitable.

Lack of credit may be overstated as a constraint because entrepreneurs tend not to view their own management weaknesses as limiting their ability to use credit effectively. Furthermore, the financial problems of some firms would not be solved by borrowing. For example, for many microenterprises, weak demand and strong competition may be the main causes of a tight cash flow situation.

Demand for Financing

Nevertheless, the study concluded that the ability of many small enterprises to exploit highly profitable opportunities would be enhanced if external financing were more accessible. High rates of application for loans among sample firms and their willingness to pay above-market rates of interest indicate strong excess demand. Two-thirds of respondents had applied for at least one bank loan for their present business (of which 44 percent had their applications approved, though usually for less than requested). Another 17 percent had inquired but been discouraged by the bank from applying. About half said they would take a loan for working capital at 30 percent per annum interest (the average rate on their most recent loans was 25 percent).

While demand for working capital was widespread throughout the sample, demand for credit for investment purposes depended on firm performance. The proportion of firms with rising profits or employment that wanted an investment loan at 30 percent was double that for firms with falling profits or employment.

Respondents' demand for finance was overwhelmingly for bank loans. Despite their complaints about insufficient finance from banks, only 8 percent of respondents had ever approached an informal moneylender. Most informal lenders are oriented toward small consumer and trading loans and cannot provide the amount of funds demanded by SMEs or accommodate the low interest rates that they can afford. While informal savings collectors help small market traders accumulate funds, their low capital base and lack of access to bank credit limit their ability to lend.

Respondents generally were not receptive to equity partners, fearing loss of control over their businesses. Nevertheless, a third would consider equity investment, particularly among larger and newer firms and preferably by institutional investors rather than individuals.

Issues for Lenders

Despite strong demand for finance from small enterprises, banks may perceive a lack of effective demand by clients they consider creditworthy. Difficulties of small enterprise lending from the banks' perspective include:

- *Information and risks*: Statistically, small enterprises tend to have high failure rates. Hence, lenders need to be selective. It is difficult, however, to assess accurately the viability of a small enterprise, the abilities of the entrepreneur, and the likelihood that the client will repay_which are the most important criteria of creditworthiness applied by the banks. Banks have to depend heavily on an entrepreneur's track record. In that respect, sample firms were twice as likely to have received a bank loan if their employment had been growing over 5 years, than if they were declining.
- *Collateral*: Banks consistently require collateral to enforce repayment, to offset losses in case of default, and to help screen applicants. Three-quarters of sample firms that received loans had

to provide collateral, usually farm land (the main exceptions were microenterprises under the PAMSCAD program). The result is that smaller firms tend to get screened out, since they are least likely to be able to provide acceptable collateral. Although most respondents owned property, the difficulties of proving legal, enforceable title to land may render it unacceptable to banks as collateral.

- *Costs*: Because small firms often lack good financial accounts and may have difficulty filling out bank forms correctly, the cost of processing and monitoring small loans exceeds that of loans to large enterprises_on a per-loan basis, let alone per dollar lent. Banks estimated that it took an average of 24 staff-days to gather information and process an application for a small enterprise as against 16 days for a large-scale firm.

Historically, banks in Ghana had little incentive to try to overcome these difficulties and increase lending to local small enterprises. Their orientation has been mainly toward short-term commercial transactions_in part because their deposit base is primarily short-term.

The Impact of Liberalized Financial Policies

Financial liberalization measures in the late 1980s included the removal of restrictions on interest rates, the elimination of credit ceilings, and opening up the banking system to more competition. While these measures positively affected incentives to lend, other measures taken to stabilize the economy and strengthen the banking system had a short-run negative impact on credit availability to small enterprises. Tight monetary policies resulted in higher interest rates on government paper than on loans to long-standing commercial clients, leading in turn to non-competitive higher rates to new, smaller borrowers. Efforts to improve portfolio performance led banks to centralize decision-making and maintain their insistence on landed property as collateral¯often a stumbling block for small entrepreneurs.

The lack of interest of most banks in developing smaller enterprises as clients, particularly in the face of high yields available to banks by purchasing government-backed bills and bonds, shows that liberalization of financial policies by itself is not sufficient to improve access of small firms to formal finance. Competition among banks, high liquidity in the sector, strong portfolios, and low yields on competing low-risk assets are necessary preconditions to give banks incentives to expand private sector lending, especially to small enterprises. During a period of falling interest rates on government paper, some of Ghana's newer, small banks did indeed show growing interest in developing small business clients, and a new private savings and loan institution caters explicitly to small traders and businesses in some busy urban markets. But to boost such positive developments, additional measures may be needed to address the problems of poor information and high costs and risks involved in small enterprise lending.

Strategies to Increase Small Firms' Access to Credit

- To reduce the high processing costs relative to small loan amounts and to minimize time-consuming project appraisals, banks should focus initially on working capital credit as against investment loans. Working capital loans may indirectly generate investment by successful firms, which are likely to plow back profits into expansion of capacity. Investment lending should be concentrated on SMEs that have already reinvested substantial internal resources but need supplementary external finance in order to move to a larger scale or higher productivity.
- Risk can be controlled through character-based lending to entrepreneurs who have a good track record and close on-site monitoring. The cost of frequent monitoring can be minimized through

greater decentralization of responsibilities for small loans_provided local branch officers are adequately trained.

- To expand small enterprise lending, banks need to develop alternatives to property as collateral to secure loans, such as personal guarantors, sales contracts, and liens on equipment financed. All of these, however, may depend on improvements in the ability of the legal system to enforce commercial contracts.
- Besides training, local branch bank officers need incentives to undertake small enterprise lending and savings mobilization. Working arrangements with non-governmental organizations may help reduce costs of screening and monitoring. Banks and informal financial agents may be able to enter into relationships that take advantage of the latter's superior information about small clients and their relatively low cost of frequent, small transactions.

Past and Future Role of the World Bank

A World Bank-financed SME Credit project was introduced in Ghana to encourage banks to originate more and better quality loans to viable SMEs. The project financed training and technical assistance to improve banks' skills in project appraisal, monitoring and supervision of SME loans. While the funds were disbursed satisfactorily, the banks tended to use them more to provide term loans to preferred customers than to develop outreach to new small clients. Centralization of bank operations and decision-making while banks were restructuring their portfolios worked against the decentralization of authority to facilitate developing and supervising small loans. Arrears problems resulted, in part, from the failure of banks to establish the intensive monitoring and incentives for staff that are important tools to achieve high repayment rates by small borrowers.

Participating banks are, however, gradually giving more authority to branch managers and seeking ways to streamline procedures for small clients. While the project has made some inroads, the institutional impediments to SME lending remain high, and access appears to be opening up only gradually. Efforts are now being made to improve the incentives and skills of bank staff in dealing with small clients and to make the credit line available to selected non-bank financial institutions with a proven record of providing and recovering credit to small enterprises.

Substantial widening of access to credit by small enterprises is most likely to come from new banks and non-bank financial institutions that are tailoring their operations to develop new, smaller clients. An important role for the World Bank is to support the establishment of the basic conditions that encourage innovations to better serve this market niche. Stable economic policies and healthy bank portfolios, supported by a strong supervision system, are necessary before banks will readily take on the risks they perceive in small enterprise lending.

Perhaps most important is healthy competition, from informal and semi-formal financial institutions as well as from new banks, that makes small enterprises with high growth potential sought-after as clients, and thereby induces lenders to develop techniques to reduce the costs and better control the risks involved.

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