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Assessment of Supply-Side Financing of Lower-End Market SMEs by Rural Banks in Ghana

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Abstract

This study examined the extent of application of financing requirements of rural banks for lower-end SMEs in Ghana, using exploratory qualitative approach and structured face-to-face interview. The study reveals that the requirement from lower-end SMEs by rural banks is similar to those in the commercial banks and upper-end SME market. Furthermore, they are found to be more stringent because of the higher risk associated with the operations at that level. The authors recommend the setting up of special schemes in association with government to support SMEs in times of default.

Keywords: Supply-Side, Rural Bank, Financing, Ghana, SMEs, Lower-End-Market

Contribution/ Originality: This study adds to the limited available evidence concerning the importance of various supply-side issues of lower-end SMEs' access to external funding from Rural Banks.

1. Introduction

The prominent role of Small and Medium Scale Enterprises (SMEs) in promoting socio-economic development and its importance for sustainable competitive advantage at local, regional and national levels in developing countries has continually been recognized by researchers (Porter, 2006; Matlay and Westhead, 2005). According to Ogujiuba et al. (2004), SMEs enhance regional economic balance through industrial dispersal and general promotion of effective resource utilization, considered critical to engineering economic development and growth. Additionally, SMEs help in creating the bulk of jobs and contribute to the national revenue by way of tax revenue (Keskin, 2006; Abor and Quartey, 2010); help conserve foreign exchange and increase non-traditional exports earnings (Kayanula and Quartey, 2000; Aryeetey, 2001).

Despite this notable prospects of SMEs, a review of the literature has shown that several holdups especially lack of finance or capital affect their ability to realize their full potential (Abor and Biekpe, 2007, 2006; Quartey, 2002; Green et al., 2002; Kayanula and Quartey, 2000; Cook and Nixson, 2000; Aryeetey, 1998; Lader, 1996; Parker et al., 1995; Sowa et al., 1992). For example, in examining more than 1,600 SMEs, Carpenter and Petersen (2002) concluded that the growth of SMEs was constrained by inadequate finance. Similarly, Bruno and Tyebjee (1985) found from a study that ventures that had received external capital, achieved statistically significantly higher growth compared to ventures without external capital. Evidently, the literature demonstrates strong link between the accessibility of finance and SME growth (Demirguc-Kunt and Beck, 2008; Beck et al., 2006; Kotey, 1999).

In Ghana, SME financing has attracted great interest from both academics and policy-makers over the years because access to finance from banks remains a major challenge. According to World Bank (2006) discussion papers on SMEs finance in Ghana, the success ratio for large firms applying for bank loans was 69 percent as against 45 percent for small-scale enterprises and 34 percent for micro-enterprises. Additionally, evidence suggests commercial banks are only interested in servicing the upper end of the SME market leaving the lower end of the SMEs market (FinMark Trust, 2006; Schoombee, 2000) because they found it to be more reliable in terms of meeting the requirements of loan acquisition and repayment. This situation is very worrying since majority of the SMEs in Ghana are located at the lower end of the market and are found especially at the sub-urban and around the country side.

In recognition of this challenge, the government encourages the setting up of rural banks with the aim of extending finance to the lower end of the SME market. With the aim of closing the national financial-poverty-gaps created (BoG, 2007). Notwithstanding this effort, a study of the literature reveals two key problems of financing lower-end market SMEs in Ghana. Firstly, financing facility access-gaps between the Banks and SMEs, particularly long term finance continues to be a major constraint for growth (Abor and Biekpe, 2007; Green et al., 2006). Secondly, it is the anticipation that with a specific focus of rural banks towards SMEs financing, there disposition would be favourable. However, most of the studies regarding factors of supply side financing of SMEs largely concentrate on commercial banks to the neglect of rural banks (Beck et al., 2008, 2009; De la Torre et al., 2010; Levisky and Prascada, 1998; Haron, 1996; Binks and Ennew, 1996). Besides, studies into SMEs do not distinguish clearly between SMEs in the lower end market and those in the upper-end market. The absence of this empirical evidence is disturbing. The question is, are these supply-side factors for loan assessment by lower end SMEs from the rural banks similar to the conditions available to SMEs at the upper end market and from the commercial banks?

The Present Study

To fill this lacuna in the literature, we sought to find out whether the supply-side factors available to lower-end market SMEs for accessing credit from rural banks is similar to upper-end market SMEs from the commercial banks and the extent of the application of these conditions. This study is very important because it afford policy makers the opportunity to know what other challenges SMEs in the lower-end market face differently in credit accessibility, therefore informing more rigorous policy formulation.

2. Literature Review- Supply Side Factors of Financing SMEs

The economics literature on business financing has recognised several main hindrances that may prevent small and medium enterprises from procuring adequate finance.

Angela Motsa and Associates (2004) in a review of literature indicates that SMEs struggle to access loans because they are developing in an economy dominated by large organizations. These organizations remain more attractive to banks than SMEs.

Another key supply side constraint is the multiple definitions of SMEs. The term “SMEs” has received multiple definitions and according to Abor and Quartey (2010); Ubabuko et al. (2010); Kayanula and Quartey (2000) and Ganbold (2008) the lack of unique or single uniform acceptable definition leads banks to develop their own definition, leading to multiple eligibility criteria for access to finance.

Another view point is information asymmetry. Angela Motsa and Associates (2004: 45) emphases “the quality of communication and the level of understanding of their businesses by bank officials” as key to SMEs accessing external financial supports for their business. According to Ganbold (2008) the main cause of information asymmetry that constrains SME access to finance may include high cost of obtaining credit information on SMEs, inconsistent SMEs financial statement and audits and access to third party information by providers in the market place. Additionally, Banks and SMEs do not know much about each other (Deakins et al. 2008; Burns, 2007; Wattanapruttipaisan, 2003). This ultimately would limit the effective structure of banks’ credit offerings to them (RAM Consultancy Services Sdn Bhd, 2005).

According to Pandula (2011) and Carreira (2010) banks may prefer certain sectors having lower risks/defaults, high growth rate, and high cash-flows. Therefore, if SME’s choice of an industry does not fall within the bank’s financing priorities, the bank has no option than to reject the applications to un-zoned industries (Pandula, 2011; Carreira, 2010; Burns, 2007). In support of this view, Deakins et al. (2008) subsequently argued that SMEs in competitive sectors and rural communities may find it harder accessing finance from banks due to some restricted internal regulations of the banks. (Pollard, 2003; Russo and Rossi, 2001).

Another very important factor is perception about SMEs. Though the SME sector is perceived attractive with good prospects (Beck et al., 2008), it is however considered a risky and high default sector (Tetteh and Frempong, 2009; Burns, 2007). Banks are risk averse; they try to avoid bad debts and lend on SMEs’ business prospects (Burns, 2007). Contrary to this view a study by Amonoo et al. (2003) indicates a higher default rates in large firms compared to SMEs. The study revealed 76.5%, 70.9% and 66.2% loan recovery rate for small firms, medium firms and large firms respectively.

Additional aspect is the ability of the bank to mobilise more savings for capitalisation. Evidence shows that there may be low public confidence in saving with the banks during transitional periods of an economy; likewise rural communities, where the majority prefer traditional financial institutions and

home savings. This can make the banks’ deposit base very weak and in short-terms only. To serve the public, the Banks have to fall on international supports which may have conditions and limitations, hence make the Banks’ facilities difficult to access (RAM Consultancy Services Sdn Bhd, 2005). As proposed by Obamuyi (2007), banks are challenged by capital constraint model in relation to capital inadequacy and maintaining minimum capital requirement. Besides, bank capital channel model indicates how interest rates affect the banks' cost of finance, hence the profitability and capital requirement thereby reducing the supply of their credit facilities to SMEs.

Lending decisions are highly influenced by the policies and procedures laid down by banks (Burns, 2007). Banks have standard financial models, which are commonly based on collateral, credit rating/scoring and relationship lending. However, most SMEs, especially those in developing countries, fail to meet the collateral lending models for lack of relevant fixed assets (Deakins et al., 2008; RAM Consultancy Services Sdn Bhd, 2005; Wattanapruttipaisan, 2003; Schoombee, 2000). Niewenhuizen and Kroon (2003) argue that existing criteria for and methods of evaluation of loans discriminate against SME entrepreneurs and do not identify potentially successful owners of SMEs, instead they focus on potentially successful enterprises.

One other core problem, as identified by Newman (2005) and Wattanapruttipaisan (2003) is low comparative returns and high costs of serving the SMEs. Knott (2004) argues most banks perhaps use Pareto Principle, "80/20 rule" the secret of achieving more profit (80 percent) from less effort (20 percent). Servicing the sector is not always considered rewarding. Some banks consider returns on SMEs' credit facilities low but with high fixed costs for processing them. Hence, returns are not in the number of clients served, but the value each can accrue to the bank (Newman, 2006; Wattanapruttipaisan, 2003).

To ensure uniformity and control, some Banks centralised the facility appraisal and approval at the head office. This makes the relationship lending models ineffective at the branch levels; leading to high rejection rates, delay in processing with respect to collateral and other documentations. This practice among banks creates barriers for SMEs, except the branch managers have an influence on the approval process at the head office. Banks with weak credit skills and practices for evaluating SMEs may find it difficult applying certain lending models as well (Deakins et al., 2008; RAM Consultancy Services Sdn Bhd, 2005; Wattanapruttipaisan, 2003).

Another notable problem is management weakness (Wattanapruttipaisan, 2003). The scarcity of management talent, prevalent in most countries in Africa, has a magnified impact on SMEs. Lack of support services or their relatively higher unit cost can hamper SMEs' efforts to improve their management, because consulting firms are often not equipped with appropriate cost-effective management solutions for SMEs. Besides, despite the numerous institutions providing training and advisory services, there is still a skills gap in the SME sector as a whole (Kayanula and Quartey, 2000).

Finally, SMEs are also faced with financial sector policy distortion. Ganbold (2008) highlighted the problem of crowding out of SMEs resulting from excessive public sector borrowing. Additionally, most state owned enterprises especially those into building of infrastructure, enjoyed preferential treatment to access to credit at the expense of SMEs. Other financial sector policy distortions include legal regulatory framework, weak judicial and legal system and lack of property rights.

3. Methodology

Study Area

The research was conducted on two Rural Banks, thus Rural Bank A and Rural Bank B located in the capital of Ho municipality, Ghana. The choice of the banks was deemed appropriate because they are established to serve the SMEs (BoG, 2007).

Research Approach

Exploratory case study approach was adopted. The preference for this technique is to seek understanding of the issue at stake and capture the richness of the information from the rural banks (Gable, 1994). Two cases were used for the study with the aim to show numerous sources of evidence (Yin, 2009) and raise the level of confidence in the robustness of the information gathered (Zaidah, 2007).

Sampling Technique

Two (2) managers, one from each rural bank were sampled using purposive sampling technique. This approach was adopted by the researchers because they believe the managers can provide specific in-depth and comprehensive information about their operations, which the researchers require for the study (Saunders et al., 2012; Bernard, 2002; Curtis et al., 2000).

Instrumentation

Data was collected through the use of face-to-face structured interview. This means was considered suitable because it offers the respondents standardised question that is relatively quick and easy to compare and analyse (Saunders et al., 2012). It also allows the respondents to relax and carefully provide objective opinions on the topic (Norton, 1990). The instrument was divided into two sections. The first section focused on facilities provided to SMEs thus financial allocation, charges (cost of capital), disbursement plan and client base of the rural banks. The aim is to determine the extent of commitment of the banks towards it clients'. The second section captures the obstacles to lending and accessing these facilities from the supply-side perspective. This section is divided into three: public sector constraints, private banking sector constraints and structure constraints. Since the first section of the questionnaire required secondary data from the banks, it was e-mailed 25 clear working days to the management to get them prepared. The face to face meeting took place on 11th July 2013 for rural bank A and on 15th July, 2013 for rural bank B. The responses were recorded using data blank sheets for both sections. On the average each interview lasted for 32.21 minutes.

Data Analysis

Two main methods were used for data analysis. Frequency distribution table was used for section A, because it enabled easy summary of the categorical data collected; and relatively easy to interpret and in comparing percentages (Easton and McColl, 2011; Saunders et al., 2012; Creswell, 2003). The qualitative data in the section B was analyzed using data reduction and categorization process (Saunders et al., 2012) based on the research objectives.

4. Results and Discussions

Financial allocations, charges, disbursement plan and the clients' base by both rural banks across three year period (2011, 2012 & 2013) are illustrated in Table 1. Evidence from the table shows that the facility allocation to SMEs by rural bank A is 70% of total loan compared to 15% of rural bank B, indicating their commitment levels per time. The larger allocation by rural bank A compared to rural bank B can be narrowed down to its large client base which averages around 14,441 compared to 502 respectively. Furthermore, the allocation towards SMEs has seen a steady increment over the three years considered for the study. However, actual disbursement has fallen short of the banks' projected targets over the three years. On the average rural bank A disbursed 82.33% of its allocated funds across the 3years compared to an average disbursement of 86.67% by rural bank B.

Worthy of note is interest charges or cost of capital to SMEs which is higher for clients of both banks. Thus, averaging 23.81% and 20.44% for both rural bank A and rural bank B respectively. Remarkably, cost of capital keeps rising across the three years. These imply that SMEs face more severe credit conditions and it suggests a heightened perception by lenders of risk for SME loans due to poor repayment culture among some customers and adverse macro-economic climate in the country. Ironically, the high cost of capital may also be a panacea for high default rate. This phenomenon may end up constraining the growth of SMEs. The high cost of credit may also explain the limited demand for credit facility by SMEs from the banks. These high rates leave them with little recourse but to dig deeper into their personal savings or turn to family and friends to raise funds for day-to-day operations. This is consistent with the literature on the pecking-order theory, that the SMEs prefer internal funding to external ones (Abor and Biekpe, 2009; Brealey et al., 2009; Pike and Neale, 2009; Lucey, 2006) if they consider the cost of borrowing to be too high.

Table 1: Financial Allocations, Charges, Disbursement Plan and the Clients' Base of Rural Banks
Source: Field survey, July 2013

	Rural Bank A			**Rural Bank B**		
	2011	**2012**	**2013**	**2011**	**2012**	**2013**
Allocation/Targeted Disbursements	GH¢800,000 $315,607	GH¢900,000 $355,058	GH¢950,000 $374,783	GH¢150,000 $59,176	GH¢200,000 $78,902	GH¢220,000 $86,792
Actual Disbursements to SMEs' Clients	GH¢700,000 $276,156	GH¢780,090 $307,752	GH¢770,200 $303,850	GH¢120,500 $47,538	GH¢207,730 $71,951	GH¢197,950 $78,093
Percentage of SMEs' loans to total loans	70%	70%	70%	15%	15%	15%
Processing fees	4%	4%	4%	3%	3%	3%
Interest rates per annum	23.50%	23.75%	24.20%	20.00%	20.12%	21.20%
Size of SMEs clients	14,400	14,447	14,475	490	501	517

Average Currency conversion rate between 2011 to 2013: $1.00 = GH¢2.5348 as on 24/04/2013
(GH¢ = Ghanaian Cedi; $= U.S.D)

Analysis of Supply-Side Constraints

The goal of this section is to identify supply-side constraints SMEs encounter in an attempt to secure loans from rural banks. The results were reported by categorising the constraints into three dimensions: public sector constraints, private banking sector constraints and structure constraints.

Public Sector Constraint.

Question: *Indicate* public sector constrains that limit SMEs from accessing loans. The responses of both managers is summarised in the Table 2.

Table 2. ***Summary of Public Sector Constraints***

Type of Rural Bank	**Response**
Rural Bank A	• Crowding out effect
Rural Bank B	• Crowding out effect

Source: Field survey, July 2013

This finding is consistent with the work of Ganbold (2008). The crowding out effect may be due to large loan demand by private individuals and larger organizations possibly due to the low rate of interest offered by rural banks compared to commercial banks. The other clients aside the SMEs also provide the rural banks a safer bet than investing in unknown business. Interestingly, the borrowing of one cedi more from rural banks by individuals would leave one cedi less for the SMEs. This is likely to affect their growth and eventually their expected impact on the local economy in which they operate.

Private Banking Sector Constraints

Question: *Indicate private banking sector constraints* that limit SMEs from accessing loans. The responses of both managers is summarised in the Table 3.

Table 3. ***Summary of Private Banking Sector Constraints***

Type of Rural Bank	Response
Both Rural Banks	• Excessive security and guarantee requirement
	• High non-performing loans
Rural Bank A	• Complexity of documentation
Rural Bank B	• None

Source: Field survey, July 2013

When both managers were probe further as to why demand for excessive security guarantee, they indicated lending to small enterprise is characterized by greater risk and the excessive collateral is one effective way of mitigating their risk. It is worthy to note that, while collateral is typically an obligatory condition for granting a loan, it is a fact that small businesses often have difficulty providing sufficient and good quality collateral to the banks (Azende, 2012). Extreme application of collateral demand would only worsen the predicament of the managers of the SMEs. Furthermore, these severe collateral requirements can add a potential cost to borrowers if they do not make their best effort with the loans acquired (Kihimbo et al., 2012).To ensure SMEs are not hindered by this condition, it is paramount rural banks devise alternate means for securitizing their loans to SMEs.

The subject of non-performing loan to SMEs can be associated with the unfavourable economic situation pertaining in the country. The problem of non-performing loans would lead to excessive debts of SMEs since their operational efficiency would fall (Michael et al, 2006) which will eventually impacts business investment and erodes banks' profitability. It is also likely to affect the psychology of bankers in respect of their disposition of funds towards credit delivery and credit allocation (Batra, 2003). This phenomenon also brings to light the monitoring process of the banks in question. Supervision helps in keeping a good loan good. Robinson (1962) and Anjichi (1994) asserted many of the anguish and frustrations of slow and distresses credits can be avoided by good loan supervision. Furthermore, it also shows that the banks expose themselves to clients of industries which are finding it difficult to survive.

A further probe to ascertain reasons behind the challenges of complexity of documentation reveals that, most clients lack the knowledge regarding the required documents and sometimes entrepreneurs submit their proposals without attaching the very or every required document. Furthermore, in Ghana, most of the lower-end SMEs are located in the rural areas; they operate without trade license therefore cannot fulfil the criteria of other documents like business deed, bank statements, VAT registration certificate, etc. As a consequence, financial institutions do not find them eligible for sanctioning loan. In this circumstance, it takes longer time for arranging the needed documents that leads to the deviation from serving their original purpose.

Structure Constraints

Question: *Indicate structure constraints* that limit SMEs from accessing loans. The responses of both managers is summarised in the Table 4.

Inadequate managerial skills as identified by both managers concur with the findings of Anheier and Seibel (1987) and Aryeetey et al (1994). According Abor and Quartey (2010) small and medium enterprises find it difficult to attract motivated managers, since they can hardly compete with larger firms. The scarcity of management talent though very real is mostly execrated in Ghana by the inability and sometimes unpreparedness of SMEs to employ competent support units due to issues of affordability. The low levels of managerial skills does impact the financial literacy of SME owners thereby preventing SMEs from adequately assessing and understanding different financing options, and from navigating complex loan application procedures.

Financial information is the key to access better financial services. However, small enterprises do not maintain the structured financial information that is required by the rural banks to appraise their proposals was another response by managers of the two banks. In Ghana very few SMEs maintain their records through formal financial statements and for those who present formal accounts most do not adequately maintain their accounts as per the financial institutions' requirement.

Table 4. ***Summary of Structure Constraints***

Type of Rural Bank	Response
Both Rural Banks	• Inadequate managerial skills • Unstructured financial information • Long loan processing procedure • Loan size.
Rural Bank A	• Delays in dispute resolution or long legal arbitration • Multiple definitions of SMEs
Rural Bank B	• Lack of adequate information

Source: Field survey, July 2013

The fact that SMEs' accounting and financial statements are often not transparent makes them risky borrowers and thus less attractive to lenders. Hiring an accountant or engaging the service of independent and capable accounting firms is as close to impossible for an SME, mainly because of affordability.

Also significant is the issue of long loan processing procedure. Loans are needed at a specific time. Which implies the loans must be disbursed to SMEs when needed. Managers of both banks indicated that clients normally truncate their demand for the credit if the process becomes longer than expected. This problem can be linked to the inability of the SMEs to submit complete documents for credit assessment. Another worthy point raised by both banks managers is the size of loan. Though banks prefer advancing bigger loan size because their transaction cost are lower, the managers of both banks intimated the amount they lend out to SMEs is based largely on the borrower's repayment capacity which is consistent with the work of Struck and Glassman(1983). This action is likely to prevent SMEs from diverting portions of the borrowed money into non-business purpose (Chirwa, 1997) and it would also make available credit to other SMEs.

In every, country laws are made to safeguard the legal rights and interests of parties and facilitate impartial and prompt resolution of financial disputes. However, managers of rural bank A also indicated delays in dispute resolution or long legal arbitration as another factor impeding loan accessibility by SME clients. Improving the legal framework will go a long way in building confidence in the rural banks about their ability to retrieve the money in terms of default.

Another limiting factor indicated by the manager of rural bank A is multiple definitions of SMEs, leading to multiple eligibility criteria which is consistent with the work of Ganbold (2008).Consequently this phenomenon would push for banks negotiating the cost of capital separately with each SME aside the general prevailing cost of capital. As Cook and Nixson (2005) argued, the use of variety of dimension such as value of fixed assets of the enterprise, enterprise turnover and the number of employees hampered any attempts to undertake serious empirical work on measuring the characteristics of small and medium enterprises and explaining the behaviour of these enterprises.

Lack of adequate information was identified by the manager of rural bank B as another limiting factor on SMEs funding which is consistent with the work of Sharpe (1990). As Cook and Nixson (2000) posit, credit is provided in the context of information asymmetry on both sides. Rural banks cannot just lend unless SMEs are able to convince them by providing appropriate and inadequate information.

Finally, both managers were asked if there is less emphases on this requirement to lower end SMEs compared to upper-end SMEs. They indicated, requirement for lower-end SMEs is more stringent. When quiz further on why? They indicated their area of business is more risky. In order to secure, recover their loans and also prevent insolvency they have no other option than to tighten the access requirements.

5. Conclusion and Recommendations

The role of lower-end SMEs in rural economies of developing countries is considered crucial because they serve as a good source of employment, sustainable income generating avenue and help to diversify the national economy. Yet, in Ghana lower-end SMEs appear to suffer more regarding external financing. Furthermore nothing is known about whether lower-end SMEs face the same credit requirement compared with the ones in the upper-end market. This study was therefore set out to unravel whether the supply side constrained identified in the literature is the same compared for both categories of SMEs.

With respect to allocation, it is evident that the proportion of rural bank A is greater than rural bank B. However, the disbursements of the banks are far below the projected allocation towards their clients'; 82.33% for rural bank A and 86.67 for rural bank B. However, the interest charges for the two rural banks were found to be too high.

Conceivably, the authors held the view that rural banks disposition towards lower-end SMEs would be better mainly because they are to make loan acquisition by this agency simple. However, analysis of the views of managers of both rural banks highlighted a lot of similarities in the supply-side requirements by rural banks from clients of lower-end SMEs for the acquisition of loans. Managers of both banks mentioned crowding out effect as the main public sector constraint that limits SMEs loan acquisition. In addition, excessive security and guarantee requirement, high non-performing loans and complexity of documentations were the critical private sector banking constraints identified. Finally, inadequate managerial skills, unstructured financial information, delays in dispute resolution, multiple definition of SMEs and adequate information loan size are among the structure constraints that confront SMEs which are consistent with previous studies regarding commercial banks. Quite apart from that, it is also clear that the requirements by rural banks are even more stringent compared to commercial banks because the lower-end of SME market is perceived more risky with higher default rate. This is not out of place, as every business worth its sort seeks to make profit and thus they need to be sure of recouping their monies when they lend them out to small businesses.

The findings point out that the rural banks inability to grant loans to SMEs is due to some problems associated with the SMEs themselves. The phenomenon is a disincentive for the goals of establishing these rural banks; more importantly the growth of SMEs. To remedy this challenge we recommend special credit guarantee schemes with government support to sustain the SMEs. Again, corporate loan security with insurance companies will help manage the risks and default rates. These policy interventions would compensate for weaknesses in collateral demand and other demands by the rural banks. Also rural banks must establish special units within their organization that would assist SMEs in structuring their financial information's at no cost.

6. Limitation

Since the research sample is relatively small, the authors recommend caution in the interpretation and generalization of the findings of the study. Further work involving a larger sample would be useful to contextualize the financing requirement of rural banks towards lower-end SMEs.

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