Supply and Demand for Finance of Small Enterprises in Ghana

Ernest Aryeeetey
Amoah Baah-Nuakoh
Tamara Duggleby
Hemamala Hettige
William F. Steel
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FOREWORD

Overcoming the dualism of African economies is an important task for the development of the private sector. The modern sector has been the primary focus of past development efforts, and in many countries has been dominated by state ownership and regulations. But most people engage in informal activities outside the reach of regulations and of supporting institutions such as banks. For indigenous private enterprises to realize their full potential, they need to be better integrated into the formal economy and to have greater access to finance.

Since the mid-1970s, the World Bank has supported lending through the banking system to small- and medium-scale enterprises. Although surveys consistently show that small enterprises view lack of access to finance as a primary constraint, banks have generally remained reluctant to enlarge their lending to smaller enterprises, citing the risks and costs involved.

This study is unusual in its examination of both demand and supply sides of the problem. Using data from surveys and interviews, the authors investigate both the nature of demand for external finance by indigenously-owned private enterprises of different sizes and the difficulties that formal and informal financial agents face in meeting that demand. They also analyze the various sources of finance that firms presently use and make recommendations on measures that would help develop small enterprise finance as a market niche.

Kevin M. Cleaver
Director
Africa Technical Department
ABSTRACT

This study investigates the apparent contradiction between the high propensity of small- and medium-sized enterprises (SMEs) to identify finance as their primary constraint and the view of banks that SME lending remains low in part for lack of bankable demand. Surveys were conducted of relatively successful microenterprises and SMEs to assess demand and sources of finance, and formal and informal financial institutions were interviewed to analyze constraints on the supply side.

The survey results show that credit for start-up is rare and that the smaller the enterprise, the greater the equity finance share of the initial investment. Many SMEs achieve substantial growth through reinvestment of profits, making it difficult to conclude that entry and growth of SMEs depends crucially on loans. Other forms of finance, such as customers' advances and supplier's credit are at least as important as bank credit.

Nevertheless, the evidence suggests that exploitation of highly profitable opportunities by SMEs could be accelerated if they had greater access to external financing. Strong excess demand for credit is indicated by SMEs' high loan application rates and their willingness to pay above-market rates of interest.

Financial liberalization has so far had little effect on the access of SMEs to bank credit. Tight money, banks' efforts to improve portfolio performance, centralization of decision-making, and lack of competition explain why banks have shown little interest in developing SMEs as a market niche. The study suggests techniques that banks could adopt to overcome the problems of high transaction costs and risks in SME lending, drawing on the methods of informal financial agents.
ACKNOWLEDGEMENTS

This study was prepared for Ghana's National Board for Small-Scale Industries (NBSSI) under the Private Small and Medium Scale Enterprise Credit, with the cooperation of the FUSMED unit in the Bank of Ghana and the Western Africa Industry and Energy Operations Division (Africa Region) and the Industry Development Division (now Private Sector Development Department) of the World Bank. The study was managed by Drs. E. K. Abaka (NBSSI) and William F. Steel (World Bank). The authors are especially grateful for the cooperation of Mike Okoto-Donkor (FUSMED), Frederick Gyebi Acquaye (NBSSI), the staff of NBSSI and PAMSCAD, the many entrepreneurs who participated, and the managers and staff of the banks, savings and loan companies, susu collectors, and other financial agents who were interviewed. Interviewers included Patience Tetteh, Anna Armo-Himbson, Jojo Eghan, Paul Doe-Abotsi, Robertson Adjei, Eddy Akita, K. Adarkwa-Peprah, and Paul Addo. Data processing was provided by Narayana Poduval, Afua Quaigraine and Jacob Pereira-Lunghu, and word processing by Wilson Peiris, Joan Pandit and Vivian Cherian. The authors would also like to thank Irfan Aleem, Patrick Connolly, Carlos Cuevas, Arvind Gupta, Chad Leechor, Don Mead, Tom Timberg, and participants in workshops at the World Bank and NBSSI for helpful comments and suggestions.
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<td>ADB</td>
<td>Agricultural Development Bank</td>
</tr>
<tr>
<td>NHC</td>
<td>Bank of Housing and Construction</td>
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<td>BOG</td>
<td>Bank of Ghana</td>
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<tr>
<td>CDHL</td>
<td>Consolidated Discount House Limited</td>
</tr>
<tr>
<td>EDP</td>
<td>Entrepreneurship Development Program</td>
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<tr>
<td>EMPRETEC</td>
<td>Empresas Tecnologia</td>
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<tr>
<td>ERP</td>
<td>Economic Recovery Program</td>
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<td>FINSAP</td>
<td>Financial Sector Adjustment Program</td>
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<td>Forex</td>
<td>Foreign Exchange*</td>
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<td>FUSMED</td>
<td>Fund for Small and Medium Enterprise Development</td>
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<td>GCB</td>
<td>Ghana Commercial Bank</td>
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<td>Ghana Regional Appropriate Technology Industrial Service</td>
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<td>Ghana Venture Capital Company</td>
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<td>NBSSI</td>
<td>National Board for Small-Scale Industries</td>
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<tr>
<td>NIB</td>
<td>National Investment Bank</td>
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<td>NSCB</td>
<td>National Savings and Credit Bank</td>
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<td>PAMSCAD</td>
<td>Program of Action to Mitigate the Social Costs of Adjustment</td>
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<td>PFI</td>
<td>Participating Financial Institution</td>
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<td>SDH</td>
<td>Securities Discount House</td>
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<td>SME</td>
<td>Small- and Medium-Sized Enterprise</td>
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<td>SSB</td>
<td>Social Security Bank</td>
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<td>SSNIT</td>
<td>Social Security and National Insurance Trust</td>
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<td>Savings and Loan Company</td>
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* The exchange rate at the time of the survey (1991) was approximately cedis 400 per US$. 

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EXECUTIVE SUMMARY

This study investigates the apparent contradiction between the high propensity of small- and medium-sized enterprises (SMEs) to identify finance as a primary constraint and the view of banks that SME lending remains low for lack of effective demand for credit. Surveys were conducted of small enterprises (including microenterprises as well as SMEs), to assess demand and sources of finance, and of formal and informal financial institutions, to analyze constraints on the supply side.

Is Credit the Binding Constraint?

Survey results reveal the overwhelming importance of equity finance in the start-up of SMEs, the more so the smaller the enterprise. Credit for start-up is relatively rare; while external borrowing increases with firm size, internal sources of finance continue to dominate expansion. Many small entrepreneurs began with very small amounts of capital and steadily built up their enterprise with only occasional injections of external finance. The high degree of competition and the rapid growth of employment and assets in the sample firms make it difficult to conclude that entry and growth of SMEs depends crucially on loans. Many small enterprises do manage to finance rapid growth from their own resources and from non-bank sources. Efforts to promote small enterprises should pay attention to savings and trade credit as well as lending instruments.

The sample focused on firms with good growth potential. The relatively high share (44 percent) that had received at least one bank loan indicates that banks are willing to consider lending to successful small clients. Microenterprises, however, received only a small share of amounts applied for and had a relatively high rejection rate—mainly for lack of acceptable collateral.

Lack of credit may be overstated as a constraint because entrepreneurs tend not to see their internal management constraints. Furthermore, some important sources of SME financing are often not considered as loans, such as customers’ advances and supplier’s credit. More important, many firms’ financial problems would not be solved by borrowing; for example, for many microenterprises, weak demand and strong competition may be the main causes of low liquidity.

Demand for Financing

Nevertheless, lack of access to credit does curtail the exploitation of highly profitable opportunities, and growth of the SME sector could be accelerated if external financing were more readily available. High rates of application for loans among sample SMEs and their willingness to pay above-market rates of interest indicate strong excess demand.

SME demand for finance is overwhelmingly for bank loans. Informal lenders generally cannot provide enough funds and charge too much interest for SMEs, and individual equity partners are considered undesirable (equity finance institutions are more acceptable). Growing firms are more likely to demand and receive external finance than stagnant ones.
Financial Liberalization is not Enough

There was no indication that access to financing improved for SMEs after financial reforms. Indeed, a temporary worsening resulted from the tightening of monetary controls, introduction of high-yielding securities to absorb liquidity, and efforts to raise the performance of loan portfolios. In implementing reforms, banks centralized credit analysis, decision-making and loan supervision, and maintained their insistence on landed property as collateral. Despite some efforts to extend loans under the World Bank-financed SME Credit, banks have done little to improve their information base and appraisal capacity for small clients. Banks tend to underestimate bankable SME demand for credit because they have not developed techniques for overcoming high transaction costs and risks or for substituting collateral.

Appropriate Strategy to Increase SME Lending

Competition in banking, high liquidity, strong portfolios, and low yields on low-risk assets are necessary preconditions to give banks incentives to expand private sector lending, especially to SMEs. To reduce the high processing costs relative to SME loan amounts and to minimize time-consuming project appraisals, banks should focus initially on working capital loans and on character-based lending to entrepreneurs who have a track record. Working capital loans may generate additional investment because profits are likely to be ploughed back into expansion of capacity. Investment loans should be targeted toward SMEs that have already reinvested substantial internal resources but need supplementary external finance in order to "graduate" to a larger scale or higher productivity.

Risk can be reduced through close on-site monitoring. The cost of frequent monitoring can be minimized through greater decentralization of responsibilities for SME loans. Local project officers should work with the applicant to develop a business plan. Insurance schemes can offset risk if designed not to encourage wilful default or lax supervision; for example, by requiring the applicant to make a partially-refundable contribution to the insurance cost or by insuring the lender's SME portfolio rather than individual loans.

Although a substantial share of respondents owned landed property, legal documentation may not always have met banks' requirements. Others could not provide property as collateral. Hence banks need to develop alternative means of securing loans, including:

- Co-signers or personal guarantors, preferably backed by liquid assets;
- Sales contracts;
- Liens on equipment financed; and
- Substantial equity by the owner.

Decentralization of responsibility and authority can lower the costs of processing SME applications and implementing risk-reduction measures. Besides training, branch bank officers need incentives to undertake SME lending and savings mobilization (savings are more important for small investments than credit). Local units should be able to use a portion of deposits that they mobilize for SME lending. Working arrangements with NGOs may help reduce costs of screening and monitoring, and closer interaction with informal agents can utilize their superior information about small clients and their relatively low cost of frequent, small transactions.
1. INTRODUCTION

Lack of access to finance is consistently cited in surveys as a principal constraint on the development of small- and medium-scale enterprises (SMEs) in African countries. Yet few studies investigate thoroughly the nature of their demand for external finance and how effective this demand is from the viewpoint of banks and other suppliers of finance. This study examines both demand and supply sides and informal as well as formal institutions to better understand the limitations of the market for SME finance in Ghana and how the underlying problems might be addressed. While the focus is on SMEs, which are more likely candidates for formal finance than the smallest enterprises, the discussion applies to the full range of enterprises considered small relative to modern industrial plants, including microenterprises (defined here as having under ten workers).

We conclude that survey data may exaggerate credit as a binding constraint in that many SMEs reveal high growth rates—financed internally and through trade credits—despite lack of access to bank finance, while stagnant ones with poor cash flow would make poor credit risks because other constraints (particularly demand) are binding. Many small enterprises in the sample—which concentrated on relatively successful firms—were able to grow quite rapidly in terms of both assets and employment, despite limited access to external finance. On the other hand, potentially bankable demand for finance by dynamic SMEs exceeds what banks perceive. But without improved techniques to lower the transactions costs and risks of lending to SMEs, banks have little incentive or ability to develop this market.

This report presents the key findings on how the delivery of credit to the small private sector has been affected by liberalization in Ghana. In the introduction, the evolution of SMEs in Ghana, the rationale for promoting them within the context of structural adjustment, the survey methodology, and the analytical framework used to interpret the results are discussed. The perceptions of entrepreneurs on the constraints to the expansion of their enterprises are analyzed in Chapter 2. A description of how enterprises are presently financed is found in Chapter 3 and their demand for finance in Chapter 4. Conditions for the supply of SME finance are discussed in Chapter 5. Finally, recommendations for closing the gap between the demand and supply of finance to the small private sector in Ghana are made in Chapter 6. More detailed survey results are provided in Annex 1 (institutions) and Annex 2 (firms).

Evolution of SMEs in Ghana

Ghana's industrial strategy after independence in 1957 tended to favor large-scale import-substitution industries relative to small enterprises, even though the latter provided a greater share of employment. A 1963 sample survey showed that small-scale manufacturing accounted for about 17 percent of total nonagricultural employment, as against 3 percent in large-scale
manufacturing (thirty or more workers). President Nkrumah’s modernization efforts during the 1960s emphasized state and foreign investments and minimized the role of the domestic indigenous sector, both because it lacked sufficient capital for major investments and because a strong local entrepreneurial class represented a potential political threat. Large industries were given tariff protection, monopoly positions, low-cost credit, and investment incentives. From 1963 to 1970, employment in large-scale manufacturing grew at 8.4 percent per annum, despite its relatively high capital intensity, while small-scale and self-employment in manufacturing grew at 5.6 percent.

During the 1970s, deterioration in the balance of payments and overvaluation of the exchange rate curtailed capacity utilization in the import-dependent large-scale sector. At the same time, rising inflation and falling real wages drove many modern sector workers into secondary self-employment activities in an effort to maintain incomes. As the economy declined from 1970 to 1984, large-scale manufacturing employment remained stagnant, while small-scale and self-employment grew at 2.9 percent per annum and accounted for nearly ten times as many jobs as the large-scale sector, but only about a third of the value added (Steel and Webster 1991). Although incomes were generally falling and many small producers were constrained for lack of key imported inputs (screws for carpenters, yarn for weavers, ink for printers), some innovative small entrepreneurs used domestic materials to substitute for previously imported products such as soap, vehicle parts, and metal products (Anheier and Seibel 1987; Dawson 1990).

This study follows up on a previous one that investigated the behavior and constraints of small enterprises in the late 1980s, in the context of Ghana’s Economic Recovery Program (ERP) (Steel and Webster 1992). Respondents in that survey fell broadly into two groups: "stagnant producers who had not adapted to the new competitive environment (found mostly among microenterprises); and dynamic, successful adapters with good prospects (found mostly among small-scale enterprises)." The latter tended to be relatively well educated and oriented toward finding profitable market niches, rather than simply following their parents’ line of business. The study concluded that the responsiveness of these potentially dynamic SMEs was constrained in large part by their lack of access to finance for working capital and expansion.

**Rationale for Promoting SMEs in the Context of Adjustment**

The Government of Ghana views SMEs as playing several important roles in the transition from a state-led to a private-oriented development strategy:

- To help take up the slack as the state reduces the extent of its involvement in direct production;

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1/ These figures exclude household and self-employment activities, which are estimated to account for nearly 6 percent of nonagricultural employment (Ghana 1965; Steel and Webster 1991).

• To absorb employment, given the relatively labor-intensive techniques of SMEs compared to larger enterprises;

• To generate a quick production supply response because SMEs' low level of technology enables them to adapt quickly and operate with minimal dependence on weak infrastructure; and

• To develop indigenous entrepreneurial and managerial skills as a foundation for sustained industrialization.

Policy reforms under the Economic Recovery Program (ERP) have gone a long way toward improving the policy environment for SMEs. Liberalization of the exchange rate and import licensing and reduction of tariffs provide large and small enterprises with more uniform protection and access to imported inputs and export markets on similar terms. Elimination of price and distribution controls and easing of licensing requirements have reduced the obstacles, which previously made it difficult for small enterprises to "graduate" from informal status.

Nevertheless, the institutional support system remains weak. SMEs generally lack adequate access to information about markets and technology, which larger firms may be able to develop on their own, and to business services and training needed to solve problems and raise productivity. Institutions such as the Ghana Regional Appropriate Technology Industrial Services (GRATIS) and Empresas Tecnologia (EMPRETEC) are helping to fill these gaps, although their reach is limited. External support for such programs can be justified in terms of expected longer-term gains in productivity and competitiveness that will enable SMEs to play a more dynamic role in growth.

The most significant institutional weakness facing dynamic SMEs is their lack of access to external finance. Repressive financial policies in the past, especially low interest rates, and a monopolistic banking system minimized the interest of banks in developing this market. To reverse the consequences of these practices, a combination of financial liberalization and institutional reform was in order.

In view of the relatively low level of response from the private sector to early ERP reform measures that focused on the liberalization of various sectors, including the financial sector under the Financial Sector Adjustment Programme (FINSAP), direct institutional measures aimed at supporting small enterprises have also been put in place. With World Bank assistance, the Programme of Action to Mitigate the Social Costs of Adjustment (PAMSCAD) created a special fund to assist microenterprises, and the Fund for Small and Medium Enterprise Development (FUSMED) was initiated to increase the amount of credit available to SMEs through commercial and development banks. This was based on the presumption that poor availability of credit from formal sources was one of the major reasons why private sector investment had not grown as expected. A major argument was that small firms with good growth potential were being discriminated against. At the same time, however, the effectiveness of many similar SME credit schemes was being called into question (Webster 1991).
Analytical Framework

Capital needs and how these are satisfied differ according to the size and stage of development of an enterprise. While many microenterprises may find personal or family savings adequate to launch a microenterprise and profits sufficient to provide day-to-day working capital, these sources of finance may be inadequate for larger investments and operations. Thus, a shift from informal and internal sources to formal external sources would be expected as enterprises graduate to larger sizes. In other words, medium- and large-scale enterprises are more likely to be interested in actual debt finance than smaller firms. It is, however, also likely that poor access to formal loans and the non-suitability of informal loans for some firms limits the use of credit by firms wanting to expand. Within this context, therefore, the use of other financing mechanisms, including supplier’s credit, may be important.

Why has the access to loans been poor? This question is often answered within the framework of difficulties created by having a repressed financial market. When the financial system is repressed by policies that shift the allocation of investible funds from the market to the government, non-price rationing aggravates the segmentation that is often observed between formal and informal financial units. Prices and flows between units cannot play their role of linking the different segments into a more integrated system. Low mandated deposit rates inhibit formal institutions from mobilizing deposits for lending purposes. Credit rationing at low interest rates engenders practices that effectively discriminate against small enterprise borrowers, not necessarily on sound economic grounds. When formal credit sources (presumed to be cheaper) are inadequate or unavailable, small entrepreneurs are then assumed to spill over into other segments of the credit market.

But do they necessarily spill over into the informal segment? When firms plan to borrow to meet working capital or fixed investment needs, their decisions will be based on the transaction costs of dealing in the various segments of the financial market. It is important to note that for both borrowers and lenders effective demand for and the supply of finance is determined by incentives, costs, risks and information (see Figure 1.1). The assumption that some entrepreneurs might use informal credit for investment in their businesses in the absence of formal credit is prompted by the consideration of the two as substitutes. The choices or decisions made by borrowers with regard to financing source will depend largely on the amount and quality of information they possess about the various sources. When the information available to borrowers is inadequate, their perception of the markets and also of the financial products may not be clear, and the use of one or the other sources may be based on considerations other than true product and price differentiation. Such considerations may include the ease with which lenders can be contacted (interpersonal relations, which are also important from lenders’ perspective).
Figure 1.1: A Framework for the Supply and Demand for Finance

<table>
<thead>
<tr>
<th>Factor</th>
<th>Lender</th>
<th>Borrower</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Incentives</td>
<td>Interest rate on loan; building client base</td>
<td>Opportunity to expand sales and capacity which is determined by market demand and competition</td>
</tr>
<tr>
<td>2. Costs</td>
<td>Time spent screening, monitoring and ensuring repayment of loans</td>
<td>Interest rate; time spent in applying for credit</td>
</tr>
<tr>
<td>3. Risks</td>
<td>Arrears or default if borrower is unable or unwilling to repay</td>
<td>Inability to repay loan may lead to bankruptcy</td>
</tr>
<tr>
<td>4. Information</td>
<td>Inadequate knowledge of customer’s reputation and business prospects; difficulty of appraising small loans accurately</td>
<td>Inadequate knowledge about dealing with banks or availability of credit; lack of adequate financial accounts on the firm; uncertainty about ability to increase sales enough to repay loan</td>
</tr>
</tbody>
</table>

For lenders faced with information asymmetry\(^3\), the issue often becomes what persuasive authority they hold in ensuring repayment. Uncertainty about contract enforcement pushes up transaction costs by raising the perceived probability and cost of default. Thus lenders may avoid lending to smaller, lesser-known clients, or impose strict collateral requirements when they do. They may perceive little incentive to tailor instruments and relationships to small clients in ways that would overcome the latter's own perceptions of the difficulty of obtaining formal finance.

In principle, the extra costs of SME lending could be offset by higher interest rates. But higher interest rates may lead to the "adverse selection" of applicants with correspondingly higher risks of failure and non-repayment (Hettige 1992). Furthermore, most banks in Ghana are reluctant to charge substantially higher rates for SMEs than for larger clients, especially for industrial investments, which they believe could not absorb such high interest costs.

Policies of liberalization have been proposed to counteract problems caused by financial repression. McKinnon (1973) and Shaw (1973) have argued that if governments were to lift all restrictions, the market could, in principle, optimally allocate funds among different categories of borrowers and thereby promote economic growth. The argument is that by relaxing interest rates to achieve positive real rates, the financial system can mobilize more deposits and increase the availability of loanable funds. Moreover, liberalized lending rates would facilitate lending to efficient private sector clients who previously lacked access because generally high

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\(^3\) For a lender, information flow is asymmetric when would-be borrowers have more information about their ability and willingness to repay loans than the lender is able to obtain and assess accurately.
information and transaction costs discouraged banks from lending to high-risk sectors under fixed interest rates. Price rationing is considered to be more efficient. There is, however, relatively little empirical evidence that higher interest rates substantially affect savings. This is in part due to the dual impact of interest rates on saving: while higher interest rates increase the benefits of saving, they also reduce the need for saving. Fry (1989) has argued that the evidence of a positive net response of savings to interest rates in developing countries is weak.

Methodology

This study was designed to address the issue of whether recent reforms undertaken in the financial sector facilitated the removal of various constraints to the flow of credit to the private sector and were adequate for meeting the financing needs of private sector investment, with emphasis on the small- and medium-scale segment. These constraints include high transaction and information costs of credit to small borrowers (from both lenders' and borrowers' perspectives) and other market imperfections that cannot be resolved solely through liberalization measures. Thus, the issues of whether the small private sector has benefited adequately from the increased finance available after reforms and how present constraints (if any) to gaining access to finance can be overcome are examined here.

A two-pronged approach was employed in the study, focusing on both supply and demand issues in relation to the financing of SMEs in Ghana. For the supply side study, interviews were conducted in September-October 1991 with formal, semi-formal and informal lending institutions. These interviews were used to discuss issues relating to the availability and terms of financing through those institutions, as well as the need and potential for generating new financial instruments, including venture capital and mutual investment funds. Disbursements under the FUSMED facility at the Bank of Ghana and the conditions for such disbursements, in relation to other small enterprise loans, by participating financial institutions (PFIs) were studied to obtain information on the terms for making SME loans. In March 1993, the various PFIs were again interviewed to determine if any changes had occurred in disbursement rates and their operational conditions in the intervening period. In the study of demand-side issues, the nature of the financial needs of SMEs and how they would like credit delivered were assessed through a field survey conducted in September 1991 and early 1992.

The survey approach was necessarily selective, given time and budget constraints. The purpose was not to achieve statistically representative results, but to understand differences between larger and smaller potential borrowers among relatively successful enterprises that would be the most likely candidates for credit. Hence, the focus was on manufacturing enterprises in urban areas that had some contact with assistance institutions such as the National Board for Small-Scale Industries (NBSSI) and were well-established or considered to have good potential for growth. Self-employment and household activities were excluded—those for which demand, rather than finance, is most likely to be the binding constraint—and the largest firm in the sample had 140 employees. The findings, therefore, relate to those SMEs most likely to have access to formal finance in a well-functioning system, and are not representative of the small enterprise sector as a whole.
Comparisons among size categories are based on employment at the time of the survey, with firms employing 1-9 workers arbitrarily termed "microenterprises," those employing 10-29 workers "small-scale enterprises," and 30-140 workers "medium-scale enterprises." Performance is measured primarily in terms of growth of employment over the five years preceding the survey (1986-1991), and secondarily by the change in profits during the last year. This report represents the best judgements of the study team regarding problems and means of meeting the financial needs of Ghana's SMEs, informed and supported by both qualitative interviews and quantitative survey results.
2. CONSTRAINTS TO SMALL PRIVATE ENTERPRISE DEVELOPMENT

The study team analyzed the data for constraints to growth of SMEs in terms of both access to resources and markets and the ability of firms to pay for and manage those resources. Growth may be constrained by inadequate access to finance, other factor markets, product markets, and licenses needed to operate legally. These constraints are determined largely by policies and institutions external to the firm. Other constraints can be considered internal to the firm, and are determined by its profitability and its ability to manage resources within the given external environment. These constraints are manifested as low competitiveness and inability to pay market prices for inputs. The analysis is based primarily on the entrepreneurs' perceptions, which may not extend to full recognition of their own shortcomings. (For further details on survey results, see Annex 2).

Access to Resources and Markets

Most respondents perceived various constraints to their expansion as external, that is, beyond their immediate control and relating to access to resources or markets.

Financial Market

Domestic Finance

The study data suggest that, from the viewpoint of the private sector, problems related to finance dominate all other constraints to expansion. The problems that received most attention from the sample in all size categories were:

(i) The absence or inadequacy of credit for working capital, which almost 40 percent of the entire sample included among their top four constraints to expansion (23 percent of respondents indicated that it was the most important constraint to expansion); and

(ii) The lack of credit for the purchase of capital equipment, as suggested by 37 percent of the entire sample (21 percent of respondents thought it was the greatest obstacle to expansion).

The suggestion that smaller enterprises have a greater problem with credit than larger firms would seem justified from the survey results: 42 percent of the microenterprises listed credit for working capital among their major constraints as against 38 percent of small-scale enterprises and 25 percent of the medium-sized firms. A similar trend occurs with credit for equipment purchase, even though larger firms have greater problems with credit for equipment than they do with working capital. The access of women entrepreneurs is limited principally
by their concentration in smaller enterprises and their lack of fully-documented property as collateral.

These results could reflect an inverse relationship between size and demand for credit, as well as access. However, the share of firms that applied (or attempted to apply) for credit rises with size (Annex Table A2.11), implying that the pattern of revealed demand is inverse to that of perceived need for external finance. Furthermore, 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 microenterprises. Hence the data imply that the smaller the firm, the more important the constraint pertaining to the lack of access to finance.

Other problems related to finance concerned the difficulty involved in dealing with banks and the inadequacy of profits to meet finance requirements. Some of the firms that cited finance as the main constraint (10 percent of the sample) were experiencing liquidity problems due to low profits and hence would not be good candidates for credit.

Foreign Exchange

Access to foreign exchange was not a problem, in view of the creation of forex bureaus throughout the country as part of the measures to liberalize the market for foreign exchange.

Other Factor Markets

Labor

The availability of both skilled and unskilled labor did not appear to be a major problem for enterprises of all sizes. For the total sample, only 7 percent of respondents indicated that they had some problems with finding skilled labor, and 2 percent had similar problems with unskilled labor. Most of those that had some problem with finding skilled labor were in the microenterprise category (9 percent of microenterprises).

Local Raw Materials

Access to local raw materials was a problem only for some microenterprises (9 percent) and medium-sized firms (6 percent). Only 5 percent of the total sample cited this as their greatest constraint to expansion. Respondents frequently said that "these days it is not too difficult to find raw materials to buy, as long as one has the money."

Equipment/Technology

Even though many firms (18 percent of the total sample) had problems with old machinery, only 2 percent of them had problems with finding replacement parts to purchase (although financing them was problem for many firms).
Infrastructure

There is a general consensus in Ghana that one of the most beneficial outcomes of the ERP has been the rehabilitation of infrastructure. However, a number of firms still have some problems with infrastructure. A general complaint is with the telecommunication system, which is found to be quite unreliable and sometimes delays transactions. This is more of a problem for medium- and small-scale enterprises than for microenterprises. The situation with energy sources is similar. Firms complain about the frequent interruption of electricity supplies. Nevertheless, this is no longer a pressing problem as less than 2 percent of the total sample had problems with irregular supply of electricity, most of them medium-scale.

Product Markets

The demand for goods in the context of trade liberalization and domestic market structure is the focus of this section. The trade liberalization policy has facilitated competing imports, but the accompanying devaluations have raised the cost of imports and thereby provided some offsetting protection, while raising the incentive to export.

Import Substitution

The increased flow of imported finished goods after trade liberalization appears to have had little overall adverse impact on private enterprise in the sample, selectively affecting the smallest more than others. Thus, less than 1 percent of the total sample thought there were too many imports coming into the system, and they were all microenterprises. For this small number, it was also their biggest constraint to expansion. Riedel et al. (1988) report that tailors in Techiman who used to make several pairs of trousers in a month could go for several weeks without any orders after trade liberalization. This was attributed to increased demand for cheaper second-hand clothes from America and Europe.

Domestic Market

Only 5 percent of the entire sample (mainly medium-sized firms) believed that low purchasing power among customers was one of their problems. Interestingly, more firms established after 1986 complained of demand problems, although this difference was not significant. It is likely that older firms with demand problems may already have exited. One would generally have expected newer firms to have less of a problem with demand since they would have been set up in response to current demand conditions. In general, firms did not believe that increased competition from other local firms was a major constraint.

Exports

Export marketing problems bothered a number of medium-scale enterprises, 12.5 percent of which included difficulties finding export markets among their top four constraints. None, however, suggested that it was the most important constraint. Among the problems that the
private sector faces in attempts to export are production difficulties, inadequate knowledge of markets, technology and product quality, and an inadequate policy and institutional framework.

Regulation

In view of the generally known cumbersome nature of the process of registering a company and obtaining a manufacturing license to commence business, the study team expected problems related to registration and other regulations to be suggested frequently by SMEs. But, interestingly, the larger firms in the sample gave no indication of being bothered by regulations and only 2 percent of the sample (all microenterprises) included "too many regulations" in their first four constraints to expansion. Similarly, less than 1 percent of the sample (all small-scale enterprises) thought rules and regulations were changed too often by government regulatory agencies. The regulations that were most disliked were those constraining labor practices (especially laying off workers) and location in urban areas (including harassment by city officials in Accra).

Profitability, Costs and Management

The firm's profitability determines its ability to bear the costs of finance, labor, raw materials, equipment/technology and infrastructure. Problems of managing cash flow and production can be considered as primarily internal to the firm.

Profitability and Finance

Even though most of the sample was experiencing rising profits, about 10 percent of the sample found profits too low to finance raw material purchases and 11 percent could not finance equipment purchase from profits. Most complaints about the inadequacy of profits for input purchase came from small enterprises. Nevertheless, only 6 percent of the sample, mainly small and microenterprises, thought that the inadequacy of profits to cover input purchase was the most significant problem.

About 60 percent of the sample firms indicated that profit levels were rising above those of the previous year. For the remainder, they were either falling or unchanging. Consistent with their higher propensity to complain about weak demand, medium-scale enterprises had the smallest proportion with rising profits. However, differences between categories were not statistically significant. The business environment did not seem to have a major effect on profitability. For example, less than 1 percent of the sample thought taxes were too high, and all of these were microenterprises.

4/ The administrative costs of expanding an existing firm are undoubtedly lower than those of launching a new one. Regulation may constitute more of a constraint on would-be investors.
Domestic Finance

Despite liberalization of the formal financial market, with its resulting increases in interest rates, not a single firm in the sample indicated that high interest rates were its most important concern. A plausible interpretation of this observation is that the relatively high inflation rates that characterized the economy for a long time (even though considerably lower since 1988) raised expectations that nominal rates of return would exceed nominal interest rates. Inflation was still at 40 percent per annum a year before this survey, when interest rates were just under 30 percent for most banks. At the time of the survey in 1991, nominal interest rates still averaged 30 percent; although the rate of inflation had come down to 18 percent, the perceptions of investors may have lagged. They may have expected inflation to return to higher levels or have had sufficiently profitable investment opportunities that would make the interest rates affordable.

Foreign Exchange

On the foreign exchange market, the rapid decline in the value of the cedi had the effect of raising the prices of inputs as well as those of finished goods. If the cost of imported inputs were a constraint, one would have expected a switch from imported inputs to locally produced inputs. However, only 3 percent of sample firms listed the price of imported inputs as being a constraint to their expansion, and less than 2 percent placed it at the top of the list of constraints. An earlier survey (Steel and Webster 1992) found that a higher proportion of firms with four to thirty workers increased their use of imported inputs after devaluation/liberalization as switched to domestic ones. A possible reason for the lack of switching by smaller firms is that they earlier paid a parallel market rate for imported inputs, which approximated the real post-liberalization rate.

Other Factors

Local Raw Materials

The prices of local raw materials were cited by 7 percent of the total sample among the top four constraints to expansion. Only 3 percent of the sample, however, listed them as the most important constraint. There were hardly any differences in perception among the different firm-size categories about the relative importance of costs of raw materials. This reflects the view that so long as inflation remains high and producers have the capacity to pass on increased costs to the consumer, they are unlikely to perceive input prices as being too high.

Labor

The cost of hiring both skilled and unskilled labor did not appear to be a major problem for firms. No firm ranked labor costs highest among various constraints in the survey. Similarly, no firm established after 1986 listed labor costs among its top four constraints, while only 2 percent of older firms did.
Equipment/Technology

While 18 percent of the sample counted old equipment among the most significant four constraints to expansion, only 9 percent gave old equipment the highest ranking and only 4 percent thought that the cost of replacement ranked in those top four constraints. Indeed, less than 1 percent ranked the cost of replacing equipment highest, and all of these were microenterprises.

Infrastructure

Transport costs appear to be a major problem for the small enterprise sector, as 13 percent of the sample listed it among their four major concerns. They saw it mainly in terms of the cost of transporting raw materials from supply points to production units. These costs have risen dramatically in the last decade with frequent increases in the price of petroleum products. In general, however, as in the case of power, these rising costs have accompanied the general rise in price levels.

Management and Space

While the entrepreneurs (especially new ones) had considerable education and prior experience, the team did not observe any correlation between their educational backgrounds or management experience and performance of their firms. Less than 1 percent cited management as a problem.\(^5\) About 17 percent of firms interviewed listed the space as a major constraint to expansion. This was particularly so for small-scale enterprises, 25 percent of which complained of having only limited space. As many as 10 percent of small firms complained that space was their most important constraint.

Growth

Small enterprises (especially micro) have been able to grow quite rapidly in terms of assets and employment, despite the perceived constraint of lack of finance. Assets of the average microenterprise in 1991 had grown by 13 percent per annum since start-up, as against 4 percent for the small- and medium-size categories, and their number of workers by 8 percent per annum, about the same as the other categories. While it is likely that they could have done much better with more finance, one cannot conclude that lack of external finance makes their operation impossible.

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\(^5\) The study team’s assessments of creditworthiness, as in Table 4.2, suggest that inadequate management capability may be a much more important constraint to expansion than many entrepreneurs recognized.
3. CHARACTERISTICS OF PRIVATE SECTOR FINANCE

Given the dominance of perceived constraints related to finance, as discussed in the preceding chapter, this chapter considers briefly the financing arrangements currently employed by private sector enterprises. The survey results point to the importance of relatively small amounts of equity finance in various stages of the development of their enterprises. They also suggest that the performance of firms does not appear to be strongly influenced by the type of finance used for starting up.

The Finance of Start-Up

The important sources of start-up capital identified in the survey were owners' savings, gifts from relations, loans from relations, bank loans, and supplier's credit (used by at least 10 percent of the sample).

Owners' Savings

As many as 67 percent of sample used their own savings as the primary source for start-up capital; for 81 percent of the sample, it featured among the three main sources (Annex Table A2.6). Overall it provided 67 percent of the amount invested.

While owners' savings dominated the financing of all sizes of enterprises, its importance as the primary source varied by size of the firm. Only 50 percent of medium-sized firms used owners' savings as the primary source as against 67 percent for small-scale enterprises and 71 percent for microenterprises. Conversely, use of formal finance rose sharply with size. This study concludes that the new entrepreneur's access to external capital may determine initial size, rather than desired size determining the amount borrowed.

Owners' savings often came from profits obtained from other businesses (45 percent) and income from local employment (26 percent; Annex Table A2.8). The share of invested savings derived from previous business profits was much higher for small (56 percent) than micro enterprises (38 percent), suggesting a pattern of "graduation" in which people use savings from employment to start on a micro scale and, if successful, use the profits to start a new business on a somewhat larger scale. Salaries from overseas and income obtained from travel abroad were also used, especially in firms established since 1986—suggesting that ease of repatriating income encourages small investments by Ghanaians abroad.

Considering that small entrepreneurs are often perceived to be reluctant to deal with banks, it is remarkable that 74 percent of the sample used banks to accumulate savings. Use of the susu system to accumulate savings was rather minimal (only 7 percent of microentrepreneurs).
Gifts from Relations

Gifts from relations ranked second after owners’ savings as a source of start-up capital, used by 18 percent of all firms but by none of the medium-sized firms. Eleven percent of microenterprises and 5 percent of small enterprises relied primarily on them for initial finance.

Loans from Relations

In some cases assistance from relations and friends is not a grant and has to be repaid in one form or the other. Such loans were used by 13 percent of the sample, and for 5 percent it was the primary source for the initial investment (none of them medium-sized firms).

Bank Loans

Only 10 percent of the sample had access to bank loans to finance the start of their businesses. Access to bank loans for start-up varied considerably among firms of different sizes, as 29 percent of medium-scale firms used some bank loan in start-up as against only 8 percent for both small-scale firms and microenterprises. For 21 percent of medium-scale firms, bank loans were the primary source of funds in starting business. This may be compared to 1 percent for microenterprises and 5 percent for small firms. These differences were statistically significant.

No significant differences were observed in the performance of firms that did and did not use bank loans in starting operations (Annex Table A2.7). While 8 percent of firms with rising profits had used bank loans to start up, 12 percent of those with declining profits had done the same. The same trend was observed in terms of employment growth. Banks do not seem to have succeeded in selecting firms that were likely to grow.

Supplier’s Credit

The use of supplier’s credit to start up businesses was observed for another 10 percent of the sample. These were mainly small- and medium-sized enterprises, with 21 percent and 15 percent respectively having used such a facility. In contrast, only 5 percent of microenterprises had access to supplier’s credit. Supplier’s credit was almost always a supplementary source of finance rather than the primary source. It was relatively more important for growing firms than for those with falling employment.

6/ Reference to significant differences between means is based on a t-test and that to proportions on a Chi-square test at the 90 percent level of confidence.
Financing Working Capital

Internal sources dominated the finance of working capital in most firms in the sample (Annex Table A2.10). These include retained profits (used by 70 percent of firms) and own savings (26 percent). Retained profits were the principal source for 43 percent. External finance consisted mainly of advances from customers (29 percent), overdrafts (16 percent) and supplier's credit (15 percent). In contrast with the finance of initial investments, funds from relations were irrelevant for working capital, while retained profits, customers' advances and bank overdrafts became important. Advances were more important for firms with fewer than thirty workers than for those with more, and older firms were better able to obtain overdrafts for working capital than were newer firms.

As in the case of initial finance, the use of bank loans appears to be directly related to firm size. Thus, while only 3 percent of microenterprises used bank loans for working capital, as many as 25 percent of medium-sized firms did. The disparity is, however, less visible in the use of overdrafts. Fifteen percent of both micro and small firms used overdrafts, in comparison to 25 percent of medium-sized firms. Banks appear more willing to provide short-term working capital than long-term investment finance to smaller enterprises, presumably because the short repayment period reduces risk and the absence of project appraisal lowers the transaction cost.

No clear pattern emerges when sources of working capital are analyzed within the context of firm performance, measured in terms of employment growth. For example, while one would expect growing firms to be more likely to have external finance, a greater proportion of microenterprises with falling employment (50 percent) used overdraft facilities than those with rising employment (18 percent). For small enterprises, however, more of those with rising employment figures obtained overdraft facilities.

Financing Fixed Investments

The sources of finance for additional fixed investments undertaken over the previous three to five years turned out to be quite similar to those for working capital, except for the absence of overdrafts. Internal finance sources dominated in all size categories. The proportion of those that used bank loans increases as firm size expands, (that is, 2 percent of microenterprises as against 33 percent of medium-sized enterprises). Firms with fewer than thirty workers had to seek more diversified sources of investment funds, making use of PAMSCAD facilities, advances and suppliers' credit, none of which was mentioned by medium-scale firms. Co-investors have played no significant role in the financing of fixed investments (only 1 percent of the sample), reflecting a poor perception of the desirability of equity partners.

Food processing firms relied relatively more on incomes from other activities and less on retained earnings than other subsectors as the principal source of finance for additional investment. This might indicate low profitability in that subsector. In contrast, a much higher proportion of metal products firms used retained profits, indicating higher profitability.
PAMSCAD loans have been particularly important for textile firms and new wood products firms.

Conclusions

Household savings dominate investment in small and especially micro enterprises, implying that more attention is warranted to providing better savings instruments, not just credit. While internal sources of finance continue to dominate working capital and fixed investments, external finance is quite significant and cannot be discounted. Bank loans and overdrafts are important for medium- and small-sized enterprises, customer advances and suppliers’ credit for micro and small enterprises. The question is whether the numbers can be increased to involve more of the smaller firms, given their high demand for credit and for finance generally, which we discuss in the next section.
4. THE NATURE OF THE DEMAND FOR FINANCE AMONG SMALL PRIVATE ENTERPRISES

This chapter addresses the following questions:

(i) How effective is demand for external finance among SMEs? Does firm performance suggest creditworthiness?

(ii) What are the characteristics of external finance desired by SMEs?

(iii) Is the demand for external finance backed by acceptable collateral, and what can firms offer as collateral substitutes?

The Demand for External Finance among Firms

Demand for finance may be interpreted in several ways. When entrepreneurs cite finance as a constraint when in need of cash, this may be only a perceived demand. When they express a desire for credit (not quantified) and do not act upon it, in the face of market imperfections and institutional barriers, some portion of this might represent "potential demand." The latter includes discouraged would-be applicants who would come forward if they thought their chances were better or if banks were not so hard to deal with. What is relevant to bankers is when demand is revealed, that is, entrepreneurs apply for credit at prevailing interest rates. Banks are only interested in revealed demand that is backed by bankable projects.

For purposes of analysis one needs to go beyond what is revealed and include potential demand that might come forward under improved policies and procedures. It is, however, difficult to derive a reliable estimate of such demand for credit. This analysis focuses on the extent to which entrepreneurs' perceived demand is translated into active demand that is potentially bankable. One measure of strength of demand is tenacity in making further efforts after a loan application is turned down. While the projects were not comprehensively evaluated, qualitative assessments were made of the creditworthiness of enterprises and entrepreneurs.

Directed credit schemes for small enterprises, such as those used by the government in Ghana rely on the supply-leading finance approach (Patrick 1966), which assumes that the demand for credit far exceeds supply. This approach has been criticized extensively (Adams and Graham 1981; Adams 1984). Underlying critiques of the supply-leading approach is the contention that non-existent demand would not necessarily emerge to follow supply and therefore lead to a misallocation of resources. In Ghana, a suggestion has been made in a study by IPC (1988) that what is perceived as a high unsatisfied demand for credit from small borrowers may actually be a demand for liquidity, against which a supply-leading program would have little impact in bringing about more investments.
Loan Requests by Firms

Our survey data indicate that about 67 percent of the total sample had, at various times, applied for bank loans for the present business. Some 2 percent had put in a loan application for a different business and another 17 percent had enquired from banks but had been discouraged from putting in applications (Annex Table A2.11). Only 17 percent of the sample had never applied for a bank loan. The application rate varied directly with the size of the enterprise: only 6 percent of medium sized firms had never applied for a bank loan, compared to 22 percent of microenterprises. On the average, firms had applied at least twice for bank loans. The proportion applying for bank loans corresponds to that indicating that finance was a major constraint to expansion (60 percent). Thus, perceived financial constraints have indeed been translated into revealed demand at least for the relatively dynamic firms represented in this sample.

It is also interesting that a larger proportion of firms with rising profits had applied for loans (68 percent) than those with falling profits (56 percent). Although this difference was not statistically significant, those with rising profits made significantly more applications than those with falling profits. More of them had also sought loans from informal sources, including moneylenders and susu collectors. About 63 percent of firms in the rising profit class made further attempts to borrow after an unsuccessful application for a loan, compared to 56 percent of firms in the falling profit class. Rising profit firms showed more persistence in applying for loans, with some indication that it was intended for investment to take advantage of their profitable opportunities.

Bank Response to Loan Applications

The results suggested surprisingly high access to bank finance: 44 percent of sample firms had received at least one bank loan at some time, including 50 percent of those with fewer than ten workers (Annex Table A2.11). This finding in part reflects the bias of the sample (and, presumably, the banks) toward relatively successful firms; a more representative sample found that only 18 percent of firms with fewer than ten workers had ever had a loan (Steel and Webster 1991).

Despite the apparent access to banks by sample firms, loans were neither automatic nor adequate. For firms that had put in loan applications, there is an almost 2:1 probability that the application would be rejected (for microenterprises this ratio is 3:1, although half of sample microenterprises that applied eventually got a loan). Microenterprises had to put in an average of three applications before one was successful, whereas medium-sized firms often received loans with their first applications (Annex Table A2.11).

Firms received loans for much less than they requested, with the ratio rising sharply with firm size (Table 4.1). Firms either exaggerated their requests or sharply cut back on their planned expenditures (whether investment or working capital), as the ratio between actual loans
Table 4.1: Characteristics of Loans Obtained, by Size and Age
(mean or percentage of responses)

<table>
<thead>
<tr>
<th></th>
<th>Size Categories</th>
<th>Age (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total 1-9 Micro</td>
<td>10-29 Small</td>
</tr>
<tr>
<td>Amt. applied for (£ mil.)</td>
<td>18.5 8.7</td>
<td>12.1</td>
</tr>
<tr>
<td>Amt. applied as % of desired capital</td>
<td>60.9 49.3</td>
<td>64.1 90.1</td>
</tr>
<tr>
<td>Amt. received (£ mil.)</td>
<td>6.7 0.3</td>
<td>4.6</td>
</tr>
<tr>
<td>Amt. received as percentage of applications</td>
<td>36.0 3.1 3.1</td>
<td>37.9 54.5</td>
</tr>
<tr>
<td>Amt. received as percentage of investment</td>
<td>56.1 43.0</td>
<td>55.4 100.0</td>
</tr>
<tr>
<td>Interest (monthly percent)</td>
<td>2.05 2.02</td>
<td>2.03 2.13</td>
</tr>
<tr>
<td>Maturity (months)</td>
<td>22.2 12.8</td>
<td>22.9</td>
</tr>
<tr>
<td>Asked to provide collateral (percent)</td>
<td>72.5 58.5</td>
<td>80.8 100.0</td>
</tr>
</tbody>
</table>

Source: Survey data.

and investments was similar to that reported between loan requests and desired investments. Firms with thirty or more workers evidently put in none of their own capital to supplement the loan (despite receiving only 55 percent of the amount requested). Smaller firms provided about half of the funds expended from their own sources.

At the (then) market interest rate of 30 percent, 53 percent of rising-profit firms indicated that they would be "very interested" in a loan for new investment, as against only 24 percent of falling profit firms (there was less difference in their desire for such loans for working capital: 51 percent and 48 percent, respectively). Nevertheless, a larger proportion of firms with rising profits had their applications rejected by banks, and successful ones received smaller loan amounts than the less profitable firms. Banks evidently did not base their decisions on profit performance (if firms correctly reported their status).

The relationship between loan applications and performance is reversed when the latter is measured by employment growth rather than profits. Application rates are similar for firms with rising and falling employment (for both microenterprises and small-scale enterprises). But loan applications from firms with rising employment were much more likely to be successful (about 60 percent) than those from declining firms (under 30 percent), and the amounts granted
were significantly larger. The implication is that banks place more weight on sustained growth than on recent profit trends in making loan decisions.

Among firms with fewer than thirty workers that had loan applications rejected (even if subsequently successful), lack of adequate collateral was the main reason given by banks. No medium-sized firm had been told it did not have adequate collateral. Also, no firms were told that their planned projects were unsatisfactory or that they lacked adequate experience. A poor savings record was cited in only three cases out of the sub-sample.

The study team’s assessment of projects proposed by firms indicated that about 47 percent of sample firms might be considered creditworthy, based on standard bank appraisal criteria, as shown in Table 4.2. The overall credit rating rises sharply with firm size—which also is correlated strongly with acceptability of collateral and financial management capability. Hence, a bias of lending in favor of larger firms appears to be consistent with good prudential lending practices.

There is some indication that internal management constraints may affect the creditworthiness of smaller firms. The sample firms, especially those with fewer than ten workers, were rated lower in managerial expertise than on any other criterion. The rating of

<table>
<thead>
<tr>
<th>Criterion</th>
<th>All Firms (A)</th>
<th>Number of Workers</th>
<th>Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1-9 (B)</td>
<td>10-29 (C)</td>
</tr>
<tr>
<td>Overall</td>
<td>46.6</td>
<td>34.2</td>
<td>52.5</td>
</tr>
<tr>
<td>Product marketability</td>
<td>52.3</td>
<td>40.0</td>
<td>67.5</td>
</tr>
<tr>
<td>Owner's:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prior experience</td>
<td>50.0</td>
<td>46.7</td>
<td>47.5</td>
</tr>
<tr>
<td>Education, training</td>
<td>40.8</td>
<td>41.9</td>
<td>37.5</td>
</tr>
<tr>
<td>Managerial expertise</td>
<td>21.8</td>
<td>15.8</td>
<td>27.5</td>
</tr>
<tr>
<td>Financial management</td>
<td>40.6</td>
<td>31.6</td>
<td>45.0</td>
</tr>
<tr>
<td>Collateral</td>
<td>40.2</td>
<td>21.1</td>
<td>52.5</td>
</tr>
</tbody>
</table>

Note: Interviewers were asked to rank the enterprise and the owner as "high," "moderate," or "low" in terms of various criteria of creditworthiness and management capability, from the viewpoint of a bank loan officer.
managerial expertise is not correlated with that for education and training, which showed the least difference among size groups of any of the criteria. Although these are only subjective rankings based on an interview of one to two hours, they do suggest that the smaller the enterprise, the lower the probability that a loan application will meet creditworthiness criteria.

Characteristics of External Finance Demanded by Firms

Working Capital Finance

On potential sources of working capital to finance additional raw materials needed to meet a large order, 52 percent of the sample would rely on advances from customers, including 27 percent who thought that would be the principal source (Annex Table A2.10). For another 42 percent, retained profits would be used, including 19 percent who indicated that these would be the principal source.

Although only 19 percent of microenterprises were using bank loans and overdrafts for working capital, as many as 40 percent suggested they would seek bank assistance to meet a large order. Their optimism stems from the hope that with a firm order, banks would be more sympathetic. A somewhat smaller proportion of small-scale enterprises (28 percent) planned to seek bank assistance as the principal source of additional working capital. In contrast, 59 percent of firms with thirty or more workers expected to use bank finance (47 percent as the principal source).

A number of firms with fewer than 30 workers would seek assistance from relations and use their own savings from other activities to finance a large order. No major differences can be observed in the type of finance that growing and declining firms would prefer.

Preferred Loan Conditions

Interest Rates

To estimate the range of rates acceptable to firms, the team first asked firms how useful a loan at a relatively high interest rate at the time of survey (30 percent per annum) would be for new investment and for working capital. Respondents were then asked what they thought would be an appropriate interest rate, considering their expected returns and other market conditions.

Altogether, 41 percent of the firms would find a loan at 30 percent "very useful," while another 21 percent would find it only "moderately useful" for new investment. Differences among size classes were not significant. For working capital, an even higher proportion (50 percent of the total sample) of the firms would find this type of loan "very useful," with some variation by size (60 percent in the small-scale category). Demand for working capital at that interest rate was somewhat weaker among the medium-sized firms, about half of which would
not find credit at an interest rate of 30 percent useful. In general, more older than newer firms would find the credit useful for working capital.

The average annual interest rate that businesses considered to be fair and reasonable was 19.5 percent (at least seven percentage points below minimum market rates at the time). The desired rate differed little by firm size or age (Annex Table A2.14). New firms in the food subsector were willing to pay the highest interest rate of 23 percent, while firms in the textile and wood subsectors were looking to pay no more than 18 percent.

**Maturity**

Larger firms prefer loans with longer maturities, averaging seventy months, while smaller firms would take loans maturing in about forty months (statistically significant differences). The preferred average maturity of forty-five months for the entire sample was about twenty-two months longer than the average maturity of loans actually received by small and medium-sized firms, and twenty-eight months longer than that for microenterprises (Annex Table A2.14). Food processing firms were willing to take the shortest maturities (twenty-two months), while textile firms wanted to take twice as long to repay (forty-five months).

**Frequency of Repayment**

About 57 percent of the total sample would prefer to make loan repayments on a monthly basis, while another 32 percent would like quarterly payments. Proportionately more of the firms with fewer than thirty workers were interested in monthly repayments, while the larger firms were more likely to want to make quarterly repayments.

**Preferences for Debt and Equity Finance**

In general, smaller firms in Ghana are not particularly receptive to external participation in their operations. A little over a half (56 percent) of the total sample indicated a preference for debt to equity finance; a third preferred equity finance to debt finance. Medium-sized enterprises were the most likely to accept equity finance; only 18 percent would refuse an equity partner to help finance an expansion. Newer firms tended to be more receptive to equity participation in their firms than older ones. Among firms with fewer than thirty employees, however, 40 percent would regard a local equity partner as undesirable even if they could not obtain a large enough loan for their expansion projects. Many expressed the view that they "cannot trust partners who would only put a little bit of money into an enterprise and want to control it."

Nevertheless, SMEs would be more receptive to an equity finance arrangement if it came from an institution that did not seek to control the daily operation of the establishment. Many entrepreneurs expressed a desire to have foreign firms or institutions participate in their enterprises, on the presumption that foreign participants would be better able to provide adequate
investment capital than local co-investors, while leaving their Ghanaian partners to run the business.

On the other hand, selling shares to the general public appears for the moment to be the least desirable method of finance for SMEs. Even more medium-sized firms (53 percent) than smaller firms (41 percent) rejected the sale of shares—although another 41 percent of those medium-sized firms thought the sale of shares to the general public would be "very desirable." Here again, newer firms were more receptive to this alternative form of finance.

Is there a Demand for Informal Finance?

One would generally expect that, under competitive conditions, firms that fail to secure formal loans would spill over into informal sources of finance. The results, however, indicate very little use of informal finance by SMEs (apart from start-up capital from family and friends), reflecting the highly segmented nature of the financial market in Ghana.

Only 8 percent of the sample had ever sought a loan from a moneylender and 3 percent had approached a susu operator for a similar facility (Annex Table A2.16). Considering the relatively large number of rejected bank loan applications, these results indicate little spillover into informal segments of the financial market. Proportionately more medium-sized firms than smaller enterprises had sought informal finance, primarily from moneylenders, who have the capacity to meet large emergency needs. Smaller firms are more likely to use susu operators, if need be.

Many firms viewed borrowing from informal commercial sources as a measure of last resort rather than a preferred means of regular finance, thus making spillovers minimal. Most of the study sample (including all of the medium- and small-sized firms) that sought credit from moneylenders attempted to obtain a bank loan first. The two reasons for going to the bank first were a high perceived chance of success and the lower interest rate. Those that did not first apply to a bank considered their chances of receiving bank loans low or did not have a bank account. Since loan applications to informal sources were almost always successful, the reluctance of SMEs to use informal finance indicates that its terms were unattractive for small manufacturing business.

Collateral and Collateral Substitutes among SMEs

The availability of collateral plays a significant role in the readiness of banks to meet the demand of the private sector. Banks have usually been criticized for paying too much attention to the availability of what they see as acceptable collateral in their loan decisions. Unless banks vary interest rates widely to cover differential risks, they must seek other methods to offset risk. Collateral both provides an incentive to repay and offsets losses in case of default. Thus, collateral was required of nearly three-quarters of the sample firms that received loans. It would appear, however, that banks have not been overly rigid in their demand for collateral, with proportionately fewer microenterprises (59 percent) than small- (81 percent) and medium-scale (100 percent) enterprises required to support their applications with suitable collateral.
Seventy percent of successful loan applicants provided landed property as collateral, mainly farmland (Annex Table A2.15). For another 13 percent, banks asked for a guarantor, especially in the case of microentrepreneurs (27 percent). This finding suggests that a guarantor system might be developed as an acceptable alternative to some banks, at least.

Sample firms had a surprisingly high ability to offer property as collateral. Only 26 percent of the sample could not offer any collateral at the time of the survey. Microenterprises were least likely to be able to offer property as collateral (37 percent), while only 15 percent and 6 percent of small-scale and medium-sized applicants, respectively, could not offer any collateral. Newer firms were also less likely than older firms to have any collateral. In all size categories, a house was the form of property most commonly available (43 percent). Many successful applicants indicated that banks preferred farmlands to houses, but only 13 percent of the sample could offer farmlands.

As an alternative to houses and farmlands, most SME owners without landed property suggested that banks take a lien on their equipment (63 percent). This was greatly favored by medium-sized enterprises. For another 13 percent of the sample, the best alternative would be the savings account of a guarantor; some 13 percent could only offer personal guarantees by associates.

Smaller firms find it more difficult to provide acceptable collateral—although a substantial share do have some property. To increase the access of smaller firms, more attention will have to be devoted to making possible substitutes more acceptable. One issue is how to make the guarantee of a local chief or a family head more acceptable.

Conclusions

The revealed demand for finance (actively sought) is for normal working capital and growth requirements. It is not intended to solve only temporary liquidity problems. Growing firms appear more likely to use external finance—though it is difficult to determine whether finance induces growth or the opposite (or both). Even though SMEs that seek informal credit initially attempt to obtain formal loans, this demand is not considered as a spillover since the volume of SME informal loans is very small. There is little competition between formal and informal finance.

Using the criteria that banks generally apply, smaller firms are found to be less creditworthy than larger enterprises. Improving their management capabilities would make them stronger candidates, but they may become creditworthy only if banks introduce more flexible lending technologies and less rigid criteria.

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\(\text{8/}\) Uncertainties associated with title to property may render some of the properties unacceptable to banks as collateral, if clear legal documentation of ownership cannot be provided.
5. THE SUPPLY OF FINANCE TO THE PRIVATE SECTOR

This chapter considers supply conditions, focusing on constraints to SME finance in Ghana and the potential for effectively meeting the present demand. First, it briefly describes the structure of the financial system (both formal and informal segments) following liberalization and then evaluates what problems both segments have in lending to SMEs. (For a more complete discussion, see Annex 1.)

The Structure of the Financial System following Liberalization

Formal Banking Institutions

The formal segment of the financial system consists mainly of banking institutions, with some not-very-strong non-bank financial institutions. The thirteen commercial, savings, development and merchant banks lend mainly to major corporations and the import-export trade. While liberalization of financial markets has increased competition, the new ("merchant") banks have likewise specialized in the trade and investment needs of larger commercial customers. Following the restructuring of the banking system under FINSAP, the development banks have recently incorporated major elements of commercial banking into their operations, diversifying their loan portfolios and moving gradually in the direction of "universal banking."

The 124 unit rural banks have the clearest mandate for lending at the small-scale level. They were set up ostensibly to mobilize deposits from rural areas and channel these into productive activities in those areas. Unfortunately, their performance has been generally disappointing, mainly as a result of poor portfolio management and ineffective savings mobilization, resulting in perpetual capital adequacy problems and the failure to meet obligations to customers in some cases.

Structure of Bank Liabilities and Assets

Up to 1983, about 70 percent of the banking system’s deposit base originated from demand deposits only. By 1991, following reforms, demand deposits still accounted for 57 percent of the aggregate deposit base. With savings deposits accounting for most of the rest, roughly two-thirds of bank liabilities are usually taken up by demand and savings deposits. Time deposits and other long-term liabilities have never been a significant feature of bank liabilities in Ghana. The fact that savings deposits in Ghana are operated almost like demand deposits in several banks ensures the dominance of short-term liabilities in the structure of banks.

Since banks have to match the maturity structure of their assets with the existing maturities of their liabilities, they believe that they could be forced into insolvency if they allocated credit to meet medium- and long-term revealed demand. They are consequently obliged to maintain a sizeable proportion of assets in highly liquid form, self-liquidating assets with acceptable collateral, and almost risk-free assets. Not eager to undertake high-risk or term
lending, commercial banks are, not surprisingly, burdened with excess liquidity. The irony of the situation is that short-term working capital would be ideal for most small enterprises.

**Informal and Semi-Formal Financial Institutions**

"Informal" financial institutions or sources include saving and lending activities that operate outside the scope of the banking law and other financial sector regulations of government. These include moneylenders, *susu* collectors, *susu* groups or ROSCAs, and different kinds of mutual assistance groups that collect or lend money.\(^2\) "Semi-formal" financial institutions are subject to some registration or other regulations but are small freestanding units that are not integrated with the formal banking system. These include credit unions, *susu* companies, and savings and loan companies (S&Ls).

The types of informal savings facilities available in both rural and urban areas are largely the same, with minor variations. The *susu* system of regular small contributions is the most common informal savings facility—both the individual collector arrangement often found at market places, and the rotating groups found at the workplace and to a lesser extent in markets and shops. There are quite a number of mutual assistance groups that mobilize savings, mainly as a means for achieving such socio-economic goals as village development. It has been estimated that savings mobilized informally in urban areas constitute about 45 percent of total financial savings mobilized in those areas (Aryeetey and Gockel 1991). A substantial share of these funds are held as short-term deposits in commercial banks, establishing a rudimentary linkage between formal and informal finance. In rural areas, savings mobilization by *susu* collectors is no less important and indeed may be the only accessible means of accumulating funds for investment for some clients. It is reported from Yendi, a small town of 33,000 people, that one collector collected €1.6 million in a month while another at Savelugu, which has 19,000 people, collected €1.8 million in 1988 (IPC 1988).

On the lending side, the major actors are mainly moneylenders, some *susu* collectors, and the new *susu* and savings and loan companies. The 1951 Moneylenders Ordinance states that "any person who lends a sum of money at interest or who lends a sum of money in consideration of a larger sum being repaid shall be presumed to be a moneylender." Moneylending as a principal occupation appears to have diminished over time, although most communities have successful traders or people with surplus funds that they are willing to lend short-term at relatively high rates of interest.

Informal sources are less significant as lenders for business than they are for consumption purposes. This is partially attributable to the nature of their liabilities, which are of a very short-term nature, and because people save with them mainly to accumulate a lump sum to purchase

\[9/\] Gifts and loans from relatives and friends are not included in the discussion of informal financial markets because they do not represent an institution that is a meaningful target for policy, nor are they a form of financial intermediation in the usual sense. Although relatives and friends are without doubt an important source of finance, these funds are often in the form of gifts (intended or unintended) and an expression of social obligations rather than profit-seeking.
a consumption item or for working capital. Individual susu collectors have the detailed day-to-day knowledge of their clients that would make for cost-effective microenterprise lending, but their lack of access to short-term credit inhibits them from doing more than extending limited advances to a few clients.

**Lending to SMEs by the Financial System Before and After Liberalization**

Some trends in lending to SMEs before the liberalization of the financial system are considered here, after which the effects of the SME credit program alongside the removal of various controls on credit allocation are discussed. This discussion is based mainly on interviews with personnel of various FUSMED participating financial institutions in October 1991 and again in March 1993.

**Formal Financial Institutions**

Before liberalization, the Bank of Ghana prescribed sectoral credit ceilings to be applied by all banks in lending to various sectors, including SMEs. Ceilings were in the form of permissible percentage increases over each bank's outstanding credit to the sector at the end of the previous year. The summation of these sectoral ceilings resulted in a "global credit ceiling" for each bank. All sectoral credit ceilings have been removed since 1988. In practice, the ceilings had little effect on redirecting actual bank lending toward the priority sectors. Between 1981 and 1988, total credit to commerce and finance (non-priority) exceeded the ceiling (by as much as 94 percent in 1983), but the ceilings were seldom reached for the priority sectors.

Even though the small business sector has always been described as a priority sector by government, between 1985 and 1990 the share of indigenous manufacturing sole proprietorships (which constitute most of this sample) in total domestic credit dropped steadily, with the exception of 1986, when the three development banks were recapitalized with external assistance. The share of the manufacturing sector in all loans allocated to indigenous sole proprietorships also dropped, as did the share of indigenous sole proprietorships (an indicator of small size) in total manufacturing sector loans.

Following liberalization, the Fund for Small- and Medium-Sized Enterprise Development (FUSMED) was introduced with World Bank assistance. It was designed to promote financial deepening by encouraging banks to originate more and better loans to bankable SMEs. The project has a credit line of $25 million through the Bank of Ghana for on-lending at a cost reflecting the rate on 180-day deposits mobilized by the banks. Other components of the project include training and technical assistance to improve banks' skills in project appraisal, monitoring and supervision of SME loans.

The problems faced by banks with SME lending under the scheme were studied under the following themes:

(i) Creditworthiness criteria;
(ii) Cost of funds to banks;
The findings are discussed in detail in Annex 1.

**Creditworthiness Criteria**

Analysis of various lenders’ criteria suggests that banks used basically the same criteria in appraising large and small enterprise loans. Similarly, the criteria for new and older firms did not differ greatly. Even though banks insist that they consider the viability of projects as the most important criterion in assessing applications, our SME respondents indicated that their loan applications were usually not rejected on that account. Banks rank experience in a business higher when appraising a new firm, in view of the lack of information on the firm. They also rank character/reputation lower for new businesses, since they often have no basis for establishing it. Although collateral is not ranked highly, it features in the requirements of all banks. Some banks do not require collateral for large established firms. The presence of collateral in all responses suggests that it may be used as a substitute for effective appraisal of the entrepreneur and project.

**Cost of Funds to Banks**

The cost to banks of mobilizing funds directly (mainly through savings accounts) was estimated at 15.5 percent in early 1992. The FUSMED reference rate of 20.5 percent at the time was a substantial 5 percentage points above the cost of directly mobilized funds. Although the cost of funds had been rising, average term lending rates of up to 26 percent at the time provided sufficient spread. Thus, there was little incentive to draw funds from FUSMED, which also involved higher transaction costs to comply with documentation requirements. The average cost of funds and interest rates fell in 1992, but the FUSMED rate lagged behind. For January to March 1993, the FUSMED reference rate was 16.8 percent, deposit rates averaged 15 percent, and term lending rates of banks averaged 24 percent.

**Transaction Costs**

The study team investigated whether lending to SMEs in Ghana was more expensive than lending to larger enterprises in terms of loan screening, loan monitoring and contract enforcement. Banks estimated that screening to gather information about the applicant and project, review the feasibility study, do the credit analysis and make the decision took an average of sixteen man-days for a large-scale application and twenty-four man-days for a small-scale application. They attributed the longer time for SMEs to the time it took to assemble all the required information. Similar results obtained for loan monitoring and contract enforcement suggest that
the transaction costs for SME lending were higher than those for large enterprises per loan (let alone per cedi lent).\textsuperscript{10}

\textit{Lending Risk to Banks}

In assessing the risks involved in lending, bankers ranked "default by borrower" as the most important for both SMEs and larger businesses. The reasons differ, however: SMEs are expected to default as a result of unexpectedly poor returns on investments, whereas larger businesses are thought more likely to default wilfully. Following FINSAP and bank restructuring, banks have taken steps to reduce the risk of default through improved project appraisal techniques and increased supervision of loans. But when supervision is done by head office-based credit departments, as was observed in five out of seven banks, transport costs become prohibitively high relative to small loans. Other measures that banks mention for reducing risks include the diversification of their loan portfolios, thereby reducing the concentration on sectors that are subject to foreign exchange risks.

Many bankers believed that the risks involved in lending to SMEs could be best reduced through guarantee or loan insurance schemes. In such schemes, they would like to see clear and specific documentation requirements for the lender to make a claim and quick payment of properly documented claims. Many would like to see borrower participation in entrepreneurship development training, while others suggested that technical assistance in developing small business banking centers might be useful. While a number of bankers thought that assistance with project supervision by an outside agency might be useful, some did not want to pay for such a service or to abdicate their responsibility for supervision. Building computer-assisted analysis capability in banks was also highly recommended by bankers.

\textit{Capacity to Lend}

The team studied lending capacity in terms of technical training of bank personnel for appraising projects, bank management practices, internal organization of banks, manpower utilization and requirements, and incentive systems. Most banks were not completely satisfied with the capacity of their credit operations staff to make key judgements on project viability and cash flow expectations. They would like to see skills upgraded in the areas of cost analysis and project sensitivity analysis. For SME lending, some banks would like to have their staff receive further training in balance sheet analysis and how to use the information for sound project analysis. They also require training in the area of technical feasibility of SME projects. While some credit officers have received training in traditional approaches to balance sheet analysis, development of financial pro forma and simple financial ratios, most of them have not been exposed to tools for assessing applications when the available financial data are scanty.

\footnote{10/ A study by Aryeetey and Seini (1992) on the transaction costs of lending, covering sixty bank branches in Ghana, suggested that there was no statistically significant difference in the cost of administering loans to smaller and larger enterprises.}
At the branch level, many bank managers have not been specifically trained to do forward planning using financial projections and other tools. They lack the training, guidance and independence to develop innovative financial products that would suit growing SMEs. They also lack training in credit analysis and credit supervision.

The internal organization of most banks is such that SMEs applying for loans deal with branch staff who have little say in the decision, whereas major decisions are taken at the head offices by officials who know little about the entrepreneurs. Branch office personnel only monitor loan account performance and report at regular intervals to the head office. This arrangement ensures that many potential SME borrowers do not get the chance to interact with the few trained project personnel before applications are made. There is a high probability that many potentially good projects are turned down because distant credit officers lack enough documented information to form views on projects and, especially, on the entrepreneurs.

Other problems with the management of credit include the poor incentive structure within some of the state-owned banks. Remuneration and other benefits and privileges are not necessarily based on performance but more on length of service. Some of the staff interviewed indicated that they would appreciate performance bonuses for good loan administration, as happens in some industrial countries.

Informal Sector Lending to SMEs

The operations of ten informal and semi-formal lenders, made up of susu collectors, moneylenders and susu or savings and loan companies were studied. As seen from the demand side analysis, credit from such sources is hardly used by SMEs were studied. The principal reasons for this are the relatively high interest rates, short repayment periods, and limited lending capacity of individual lending units. While the average loan size of the sample of lenders was C350,000 in 1991, the concerned SMEs had applied for an average of C20 million with their most recent loan applications from banks.

Despite the poor attraction of informal credit for SMEs, the study estimated that the total volume of informal lending (for all purposes) had expanded by about 10 percent in real terms since liberalization policies began. This expansion is attributed to growth in the personal incomes of lenders, accumulated from activities not directly related to lending. For instance, moneylenders can lend more because their transport or trading business is doing well following trade liberalization. Similarly, susu collectors have been able to expand lending because more market women are making deposits with the expansion of petty trading activities.

The development of susu companies since 1985 represents the most radical shift in the scope of informal financial operations. Unlike other informal agents who are generally oriented either toward saving or toward credit, but not both, susu companies were set up with the intention of directly intermediating funds. They are registered businesses that operate on similar principles to susu collectors. The difference is that the saver is "guaranteed" credit. Instead of deposits being returned to the saver at the end of each month, the saver accumulates deposits for at least six months with the company, at the end of which the savings may be withdrawn in
addition to an equivalent amount of loan. In the absence of any prudential regulations governing their operations, however, some of these companies attempted to meet credit demands of existing clients by mobilizing new clients in a sort of "pyramid scheme." The difficulty in matching savings mobilization with credit in a system that does not attempt to keep reserves resulted in liquidity problems (sometimes compounded by misuse of deposited funds), making it difficult to return deposits to savers and resulting in the collapse of most of these companies.

To remedy the situation, the Bank of Ghana issued regulations governing savings and loan companies, and legislation on non-bank financial institutions was passed. Only two institutions have been licensed so far under these regulations, including a savings and loan that operates as a limited-service bank serving market traders and savings collectors. At the same time, other informal financial institutions are emerging, including purchase finance houses (which help finance consumer durables and equipment for small enterprises) and savings and investment operations that focus on microenterprises, compete with moneylenders and also mobilize savings. In addition, some business associations have indicated a desire to establish small financial institutions to serve their members (for example, the Council of Indigenous Business Associations and the Greater Accra Susu Collectors’ Cooperative Society). It remains to be seen how such institutions can be accommodated within the new regulations, especially if they are unable to meet the minimum capital requirement for non-bank financial institutions (€100 million, or $125,000 at the 1994 rate of exchange).

The high cost of informal credit in some cases is not due to the cost of mobilizing funds by susu collectors, which is negative. Moneylenders, however, tend to have a much higher cost of funds, measured as the opportunity cost of earnings from trading, transport, and other businesses. This makes them unwilling to expand lending relative to their other activities or to lend for long terms.

The transaction costs of informal lenders are generally low, estimated at 2 percent of the loan amount for S&Ls and considerably less for the others. It is interesting that informal lenders believe that the risks associated with SME lending have gone down considerably following the liberal policies of government. They believe that earlier defaults in the 1980s were due to the absence of production materials for their microentrepreneur clients. Thus, poor returns and external factors forced them to default. This corroborates the perception of bankers that default by microbusinesses is generally not wilful. In that case, improving the access of small enterprises to factor and product markets should enhance their creditworthiness.

Conclusions

The main finding from this study of the financial sector following liberalization is that the liberalization of the system and the institution of an SME credit program have by themselves not been sufficient to generate substantially more lending to SMEs. The decline in the share of formal credit received by small manufacturing enterprises has continued, except during a period in which yields on government paper fell, liquidity was high, and the entry and growth of new banks induced some to expand private sector lending to attract new clients.
Two sets of forces have worked unintended against SME lending since liberalization. One is the set of financial sector reforms that led to the tightening of monetary controls and the introduction of high-yielding securities to absorb liquidity. The other is the pressure to restructure, cut back on operational costs and improve the quality of loan portfolios. In tightening up their procedures to improve performance, banks centralized credit analysis, decision-making and supervision of loans. They have not sought acceptable substitutes to landed property as collateral, and their information base on projects and clients has not improved.

Despite SMEs' strong interest in credit, commercial banks' profit orientation may deter them from supplying credit to SMEs because of the higher transaction costs and risks involved. First, SMEs' loan requirements are small, so the costs of processing the loans tend to be high relative to the loan amounts. Second, it is difficult for financial institutions to obtain the information necessary to assess the risks of new, unproven ventures, especially because the success of small firms often depends heavily on the abilities of the entrepreneur. Third, the probability of failure for new small ventures is considered to be high.

To raise effective demand as seen by banks under present practices, SMEs would generally have to improve their capitalization and their management capabilities, produce solid documentation for property offered as collateral (backed by improvements in the legal system to make it enforceable), and demonstrate steady growth. At the same time, to expand the supply of credit to SMEs, banks would need stronger incentives, better-adapted techniques, and more decentralized procedures.
6. TOWARD IMPROVED AND EFFECTIVE SME FINANCE: CONCLUSIONS AND RECOMMENDATIONS

It was noted earlier that there was a 2:1 probability that an SME application for a bank loan would be rejected, and a 3:1 probability for microenterprises. While bankers attribute high rejection rates to the absence of viable or bankable projects, entrepreneurs indicated it was because they were not seen to have good collateral. This evaluation suggests that there may be fewer creditworthy projects than entrepreneurs believe, but considerably more than banks think, especially if appropriate appraisal, supervision and security methods were used. The issue is what can be done to improve the number of good projects while assisting banks to view them as such. As regards informal finance, the study finds that while SMEs enjoy considerable goodwill, the market situation is presently not suited to the type of finance required by SMEs.

Lessons from the Study

Priority should be given to increasing access to working capital. The sample firms in this study had relatively stronger demand for working capital than for investment finance. The evidence suggests that, if firms can make a profit on their current operations (which working capital would assist), they can reinvest their own earnings in order to grow. Furthermore, given the difficulty and high transaction costs of project appraisal of small investments, a working capital emphasis would be appropriate to keep down the costs of lending, especially for microenterprises—banks can look mainly at the entrepreneur’s track record, rather than try to assess a new project.

Many small entrepreneurs have grown about as far as they can on their own resources and need significant external finance in order to "graduate" to a new level. That is the appropriate point of intervention for SME investment loans, rather than new start-ups. Indeed, interviews with graduates of the Entrepreneurship Development Programme (EDP) suggest that first-time entrepreneurs may sometimes be unrealistic about what level they can operate at, and banks may be justified in being skeptical about giving large investment loans to such entrepreneurs. It may be pointed out that while some special schemes, such as PAMSCAD, have indeed successfully increased the access of microentrepreneurs to credit, they have not apparently been able to select more frequently those who are more likely to grow rapidly and be profitable.

While banks may be right that under their existing procedures, there are not that many bankable SMEs coming forward, a change in procedures may yield a greater volume of bankable SME loans. The extent of change may be profound, in that there has to be substantial authority and incentive at the branch level. The suggestions given below for closing the gap between the demand and supply of finance to SMEs concentrate on what the financial system might do. Additional suggestions are made for entrepreneurs to improve the quality of their proposals for credit.
Adapting the Financial System to SME Finance

On the supply side, the study focuses, first, generally on a structural approach to SME lending that banks might consider and then discuss possibilities for improving on assessments of creditworthiness, risk reduction and transaction cost reduction. These suggestions are based mainly on best practices in providing finance to small-scale enterprises in other innovative financial institutions in Africa and the Caribbean (Duggleby 1992). This summary introduces common lessons learned about how to screen borrowers and projects and to minimize the risks and costs involved, in order to achieve sustainable rates of recovery and return on investment.

Structural Approach to SME Lending

Banks might consider an arrangement for local units to use a portion of the deposits they mobilize to make loans under a certain amount to small businesses; a portion of the profits on these loans could accrue to the staff of the local unit as a bonus. By the same token, local units may be penalized by reducing the portion of mobilized funds that they can use in this way, if they make a loss. Making profits thus ensures an increase in the portion of funds loanable to small business.

Creditworthiness Criteria

Institutions that successfully finance small enterprises evaluate creditworthiness by the same criteria that other financial institutions apply to larger enterprises, but they differ in relative emphasis and flexibility. In general, the four principal criteria (in order of importance for small enterprise finance) are:

(i) **Character of the entrepreneur**, including: personal references; motivation; timely settling of past financial obligations; and a record of fair dealings with customers, suppliers, employees and the community at large.

(ii) **Experience** in business (preferably the type being financed).

(iii) **Project viability**, particularly adequate cash flow to pay loan obligations.

(iv) **Security** to ensure repayment or to serve as a fall-back in case of default.

The relative emphasis on these criteria may vary according to the type of enterprise and the experience of the institution. Microenterprise finance generally requires primary emphasis on personal character and experience and much less on project viability and security. In the formative years of an institution, it may need to emphasize security and project analysis to help ensure a good repayment record until it has built up better knowledge of the client base and profitable investments.
Project and Character Analysis

To analyze SME projects effectively, institutions must develop reliable information about the sectors and markets in which they operate. These might include undertaking an in-depth analysis that includes:

- Development of a *business plan* by the project officer and the applicant that includes figures on demand, unit costs, prices, anticipated income stream, and a reasonable rationale for deriving these figures.

- Careful *risk analysis* by the project officer on site, involving examination of the market and market share for the product or service, sampling of costs and prices, business history, observation of its operation, and character assessment of the entrepreneur through interviews with employees, suppliers and key informants in the community.

- *Evidence of growth* in the last year, through increased turnover, net income, or market share.

Security

Landed property is unsuitable as a general collateral requirement for SME lending, both because so few entrepreneurs have a clear title to land and because the costs of enforcing collateral are high for lack of an adequate and efficient legal system. Alternative means of securing loans and investments include:

- Co-signers or personal guarantors, preferably backed by liquid assets;
- Contract to supply products;
- Lien on the equipment financed;
- Substantial equity by the entrepreneur;
- Loan risk insurance.

The credit policy of some successful SME lenders has been to emphasize borrower character and reputation more than traditional forms of security. They accept less than conventional levels of collateral if the borrower can secure the moral guarantee of one or more members of the institution’s management committee. This approach would be recommended in small towns where members would know most entrepreneurs. Some institutions are willing to substitute personal equity and other indicators of strong motivation, as well as experience and a willingness to learn new technical and managerial skills, for tangible security. In others, one or two co-signers with liquid pledged assets are required. When a loan shows signs of repayment difficulty, simultaneous visits are paid to both borrower and co-signers who help pressure borrowers to pay. This practice has significantly increased collections. Some institutions compensate for problems in marketing and product distribution by requiring at least one purchase contract before granting a loan.
Risk Reduction

In addition to applying creditworthiness criteria and using innovative methods of securing loans, successful SME lending institutions use a number of strategies to reduce risk. An important limitation in assessing risk is the lack of good information, particularly credit rating systems. Hence, institutions need to build up their own information base.

Many institutions concentrate on existing businesses to maximize the availability of information on which to assess the applicant's character and ability. Although this approach works against the objective of reaching new entrepreneurs, it may be initially necessary for an institution to reach self-sustainability and to gain sufficient experience before taking on riskier first-time investors.

To build a client's track record, institutions sometimes restrict the size of initial loans and proceed step-by-step with gradually larger loans for longer terms. With good repayment performance, the borrower's subsequent loan size and repayment period are calculated according to the cash flow needs of the enterprise.

Institutions also need to build expertise in the activities that they typically finance. They might establish a data bank giving key information on input costs, supply constraints and markets for various subsectors in production and processing. This would allow them to identify specific risks inherent in sectoral lending and either avoid unacceptable risks or take steps to reduce them.

Close monitoring and quick follow-up in the event of problems are often critical for successful SME finance programs. If such monitoring is done by head office personnel, transaction costs become prohibitive. On the other hand, when local bank personnel stop by borrowers frequently, they very early develop a sense of likely outcomes. Successful institutions typically combine regular site visits and a computerized accounting system. Some attribute their high recovery rates to tough repayment and recovery policies. Clients overdue by more than ten days receive a visit from a legal officer; after sixty days, action is initiated to seize the security.

Commercial bank managers often suggest that a credit guarantee scheme would be an important condition for them to undertake the higher risks involved in increased small enterprise lending. However, there is a limit to how successful credit guarantee schemes will be, and many do not have a strong record of success. There is even some possibility that the availability of a guarantee might weaken the intensity of post-loan supervision and recovery efforts, which appear to be critical for high small loan recovery rates.

Banks, together with insurance companies, might consider the development of risk insurance schemes for loans taken. This might require the borrower to share the cost of a policy to insure (guarantee) a bank loan, with an appropriate repayment structure to ensure that payment of both interest and insurance premium does not overly burden the borrower and that timely repayment is rewarded by partial refund of premiums paid.
Transaction Costs

A major portion of transaction costs involves obtaining information and processing it for decision-making purposes. These can be reduced by applying the following broad principles:

- Decentralization of decision-making and responsibility for supervision to the local level ensures that information is relevant, timely, easy to obtain and relatively cheap, while transport expenses are kept low.

- Increased application of character-based creditworthiness criteria relative to project-based criteria for small enterprises helps to reduce screening costs through minimal information requirements and the use of information that is readily available. (*Susu* collectors provide an appropriate model in this respect, given their low additional information costs when lending to a deposit client).

- Using information possessed by informal lenders may be inexpensive and very useful. Closer interaction between formal financial institutions and informal agents in deposit mobilization and lending has great prospects in facilitating transaction cost reduction while expanding the lending base and reducing the risk borne by banks.

- The use of other NGOs in screening and preparing SME loan applications can generate information and monitoring at low cost to the lender. Institutions such as Women’s World Banking Ghana and the Association of Small Businesses might be encouraged and assisted to do this.

To achieve the regular follow-up and quick response necessary for successful small lending, some institutions have introduced computerized systems to monitor repayment performance and supervision.

Assisting Firms to Propose Bankable Projects

On the demand side, while constraints stemming the education and technical training of entrepreneurs did not appear to be binding, it was obvious that not many entrepreneurs possess the requisite financial management skills for growing enterprises. Most entrepreneurs in the sample indicated that if given the chance to participate in any short training programme, they would be interested in learning some financial management. They need skills in bookkeeping and the management of production records. Good records and well-kept books facilitate firm management, financial planning and the borrowing process. The conclusion is that entrepreneurship development programs, such as those run by NBSSI and EMPRETEC, should target existing firms with growth potential and help entrepreneurs to identify constraints, develop achievable business goals, and present appropriately-scaled project proposals to banks.
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ANNEX 1. RESULTS OF SURVEY ON SUPPLY OF FINANCE FOR SMALL ENTERPRISES

1. INTRODUCTION

Ghana’s Economic Recovery Program (ERP), launched in 1983, provided new opportunities and challenges to its indigenous private sector. Liberalization of markets opened up access to imports and other resources to Ghanaian entrepreneurs, most of whom operate small- and medium-scale enterprises (SMEs) that had been largely excluded from previous systems of direct control and allocation.

Lack of access to finance has been identified as an important constraint on the ability of SMEs in Ghana to fulfill their potential for dynamic growth under the ERP (Steel and Webster 1992). Since 1983, financial liberalization was also pursued in Ghana initially as a part of structural adjustment reforms and subsequently under the financial sector adjustment program (FINSAP). FINSAP addressed a majority of the issues which contributed to the neglect of SMEs by banks. These issues included policies of direct controls over interest rates and the allocation of credit, the historical orientation of banks toward import-export trade and large firms, the lack of competition among banks, and the presence of a large share of non-performing assets in the banking system. Although financial liberalization has created some necessary conditions for increased SME lending, the effect so far has been limited.

The limited impact of financial liberalization on SME lending is due to several factors. First, until 1992, tight monetary policies aimed at reducing inflation resulted in exceptionally high returns on government paper (Treasury and Bank of Ghana bills and bonds), which absorbed much of the liquidity in the system and made lending to the private sector relatively unattractive. Second, in restructuring weak bank portfolios and management systems, banks have tended to centralize their decision-making, whereas effective SME lending requires a decentralized approach. Banks are only beginning to put in place the decentralized management and information systems that would be needed. Third, the short-term nature of banks’ deposit structures and their inability to undertake maturity transformation reinforces their reluctance to make long-term investment loans. Fourth, in trying to work with SMEs, banks also face high transaction costs and risks and have inadequate information. Informal financial agents may have better information and lower costs, but do not appear to be important sources of business finance (other than for petty trade).

2. STUDY OBJECTIVES AND METHODOLOGY

This survey was undertaken mainly to investigate the extent of "bankable" demand for credit among viable SMEs, to assess the current capacity of the financial system to meet such demand, and to find out how this capacity might be enhanced. The specific objectives are to:
• Analyze lending capacity and constraints to extending bank credit to viable SMEs;
• Ascertained how these have been influenced by financial policy reforms;
• Suggest effective mechanisms for managing risks and reducing transaction costs;
• Identify ways to strengthen intermediate financial instruments and semi-formal institutions which could effectively meet the demand for finance among Ghana's dynamic SMEs;
• Develop a framework for improving the capability to structure, monitor and evaluate SME projects for lending.

During September 1991, intensive interviews were held with the nine principal formal financial sector lenders who participate in the Private Small and Medium Scale Enterprise Credit (SME Credit). Interviews were held with both the management and the credit operations staff on the following issues:

• Willingness to work with SMEs;
• Creditworthiness criteria and risk factors in loan decision-making, and their order of importance;
• Differentiation between small- and large-scale enterprises; and capacity to analyze and supervise loans.

Ten informal and semi-formal lenders were interviewed to assess the extent of their lending to SMEs, the impact of financial liberalization, their perception of the risks involved, and their capacity to lend. The interviews focused on the following issues: background and characteristics of the lender; type of lending operation and characteristics of loans; volume of SME lending; perception of cost of SME lending as against other lending; perception of risk and attitude toward collateral; and capacity to lend.

3. FINANCIAL LIBERALIZATION: IMPLICATIONS FOR THE FORMAL FINANCIAL SECTOR

The Financial Sector Adjustment Program

FINSAP was necessitated by difficulties in mobilizing domestic financial resources and supporting investment. These difficulties stemmed from the financial sector's inability to finance investment at a time when the commercial banking system held excess reserves; the holding of many non-performing loans by the banks; the relatively high costs of operations of banks; and the absence of a well-functioning capital market. The FINSAP package addressed issues of interest rate controls, competition in the financial market, credit allocation, the efficiency of
banking operations, the Bank of Ghana's supervision of the commercial banks, and development of capital markets. This annex discusses the ways in which liberalization has affected the structure and the functioning of the financial market, banking practices and performance.

Under the previous financial regime, interest rate controls and ceilings on deposit rates were imposed in order to keep borrowing costs low to investors (and to the government). Nominal lending rates in Ghana had remained below 19 percent for at least five years preceding the ERP in 1983, and deposit rates varied only slightly despite high inflation. With financial liberalization, interest rates were permitted to rise to align them with inflation rates and achieve positive real rates surpassing 30 percent in 1988 and 1989 when the inflation rate fell below 30 percent.

Sectoral credit ceilings, which had proven ineffective in channeling credit to priority sectors, were gradually phased out after 1987, with the agricultural credit target removed in November 1990. Global ceilings were retained for each bank until late 1991. However, as of 1992, the Bank of Ghana still exerted indirect restraints on credit expansion through benchmark indicators intended as guidelines through weekly reporting requirements.

The Structure of the Formal Financial Sector

The Banking Sector

Composition

The formal banking sector in Ghana comprises the Central Bank of Ghana (BOG) which supervises the operations of the banking sector, and twelve other banks, which for the most part engage in low-risk, short-term lending to existing customers in the private and public sectors. These banks include eight government-owned institutions, two majority privately-owned commercial banks, and two private merchant banks.

Ghana Commercial Bank (GCB), and two expatriate-owned banks (Barclays Bank and Standard Chartered Ltd.) provide the traditional commercial banking services, especially to major corporations and large-scale exporters. The GCB is the largest commercial bank operating in Ghana since 1953. It also provides some development lending in the form of medium-term project loans for business expansion under SME credits and donor-provided agricultural funds. Over 90 percent of the assets in the commercial banking sector are controlled by GCB, Barclays, Standard Chartered and Social Security Bank (SSB). With their relatively large branch network and a substantial deposit base among working people, GCB and SSB hold a major portion of the deposit liabilities too (over 50 percent). The SSB, opened in 1977, is wholly owned and administered by the Social Security and National Insurance Trust (SSNIT) and operates like any other commercial bank, with some emphasis on consumer lending facilities for workers.

Several other banks were established to provide more specialized banking services in specific sectors of the economy. The Agricultural Development Bank (ADB) caters to the credit needs of agriculture and related activities; the National Investment Bank (NIB) serves industry;
the Bank for Housing and Construction (BHC) provides deposit and lending facilities for housing, construction, and other service-oriented sectors. These banks were established as development finance institutions, but with liberalization and the new Banking Law (1989), they have introduced commercial banking services and operate on a commercial basis. Although these banks have attempted to diversify their portfolios in response to the lifting of sectoral ceilings and the pressure to spread risks, they still tend to concentrate on the areas they know best.

Competition in the banking sector has increased with aggressive marketing efforts adopted by newly established, predominantly foreign-owned banks. They have tried to adapt financial products to customers' needs, and there is some evidence that borrowers are beginning to "shop" the banks to find the best bargains. ECOBANK Ltd. and Continental Acceptances Ltd. were established in 1990, and proposals for two more private banks, Meridien Bank and Citibank, were being processed at the time of the survey. As a result, as much as 50 percent of the savings base in large banks comes from customers who deposit in multiple banks.

Financial sector liberalization has somewhat increased the availability of new financial instruments. Merchant Bank (Ghana) Ltd., partially owned by the government, provides a variety of financial instruments, including trade finance, supplier and other documentary credits, bill discounting and acceptances, export finance, working capital finance and project finance. Through its subsidiaries, it also provides brokerage and stock advisory services and manages investment funds for institutional and individual clients. Similar instruments are also being offered by new private banks to the top end of the business market. Merchant Bank is also seeking to make long-term project finance available on a selective basis to medium-scale industries that are highly profitable and uniquely positioned in the domestic or export markets.

Two small government-owned banks and rural banks complement the activities of other banks. The National Savings and Credit Bank (NSCB) was established in 1972, converting the Post Office Savings Bank system to play a more effective role in mobilizing savings; it was also given authority to lend. The Ghana Co-operative Bank is a development finance institution that began operations in 1975. Both these banks provide predominantly short-term credit facilities to customers, including smallholder agriculturalists and small retail and trading activities. To help mobilize resources and extend credit locally, 124 rural banks were established as unit banks, with initial capital from BOG while management and ownership were given to the local communities. Despite their large network, they did not contribute effectively to increased deposits or lending. Many of them became financially weak and are being closed or restructured under the bank restructuring program adopted as part of the Rural Finance Project.

Deposit Structure

The composition of the deposit liabilities of banks in Ghana did not change much with financial liberalization. The liability structure of the banks remained predominantly short term. The share of demand deposits in total deposits fell slightly from 66 percent in 1983 to 57 percent in 1991. Meanwhile, growth of deposits has also been restrained by four principal factors: lingering lack of confidence stemming from the freezing and investigation of many bank

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accounts in 1981-1982; the time involved in making bank transactions; the persistent high rate of inflation; and attractive yields on government paper as an alternative. The latter two conditions changed significantly late in 1991 as the inflation rate and T-bill rates fell, and deposits are reported to have grown substantially as a result. Bankers estimate that in 1992 75 percent of the national savings base was held within the banking system, compared to 55 percent previously.

Depositors' interest in time deposits heightened with the drop in rates on government paper. Commercial banks began exploring deposit instruments that would attract longer-term deposits. Some examples are high-rate fixed-deposit instruments that would allow business customers withdrawal privileges to meet cash flow needs, and Bearer's Certificates for ninety-one days to a year. Nevertheless, most banks remain wary of locking themselves into high interest rates beyond a year as long as economic growth remains weak, and at the time of the survey were paying from 3 percent to 5 percent on demand deposits above C10 million, perhaps to retard the shift into longer-term accounts.

**Lending Structure**

The short-term nature of the deposit base of the banking sector has repercussions on its lending structure. Except for the development finance institutions, banks' portfolios are dominated by short-term credits to existing commercial customers (overdrafts, working capital, documentary and trade credits). These are interspersed with some expansion loans to established medium-to-large-scale customers. Lending to the private sector has been constrained both directly by the credit absorbed by state enterprises and indirectly by government borrowing from the banking system. From 1984 to 1988, total loans and advances of the commercial banking system had grown much more rapidly than its holdings of central government domestic debt. With the rediscount rate on T-bills rising from 19.9 percent in 1989 to 27.3 percent in 1990 and 32.0 percent by mid-1991, this trend was reversed. With the lowering of rates on government paper by the end of 1991, it was expected that term lending would become a more attractive investment for banks. No clear increase materialized early in 1992, which may have reflected in part the uncertainty surrounding the general elections and in part the fact that banks did not see an adequate supply of viable projects.

**Interest Rates**

Following the gradual relaxation of lending and deposit rate controls since 1987, and full liberalization in 1989, banks are free to set their own rate structures. The anticipated effect of rate liberalization was that savings and lending rates would rise to very high levels initially and then fall in response to increased competition among banks and lowered inflation. Nevertheless, bank lending and deposit rates remained high through 1991, sustained by the exceptionally high yields on Treasury and BOG monetary instruments introduced to absorb excess liquidity and thereby slow the inflation rate. By mid-1991, the rates on these instruments had risen as high as 34 percent, higher than the lending rate to the private sector. The result was a crowding out of funds available to private sector borrowers. By early 1992, the month-to-month annual inflation rate had fallen to 10 percent and the yield on T-bills was reduced to 16 percent-13
percent. But in 1993, a resurgence of government deficit spending and inflation again drove the rates on government paper above 30 percent.

Nominal lending rates of commercial banks rose to 30 percent in 1991, and the negative real lending rate (-104 percent in 1983) first became positive in 1985 (11 percent), then remained only marginally negative until 1989, when positive rates were again achieved. At the end of 1991, when the annual inflation rate fell to 14 percent, the central bank reduced its rate and encouraged commercial banks to reduce their lending rates to an average of 19 percent. Lending rates have responded to movements in the T-bill rate, but with some lag. Although the maximum lending rate matched the jump of nearly five percentage points in the T-bill rediscount rate, when the rediscount rate fell by fourteen percentage points, the minimum lending rates fell by only seven to nine percentage points and the maximum rates had fallen only slightly by February 1992. Thus, lending rates in early 1992 were high relative to both the T-bill rate and the rate of inflation.

Both commercial and development banks maintain that they set lending rate structures primarily according to market competition and the average cost of funds, with transaction costs mentioned as a third consideration. However, GCB appears to place slightly more emphasis on transaction costs than upon competition, and it tends to be a market reference point for other banks in setting rates. In addition to the base lending rates (26-32 percent in September, 1991), loan commitment and servicing fees (amounting to about 3 percent) may also be added and often come as an unanticipated financial burden to the borrower.

Despite the removal of sectoral requirements, most banks have continued to price loans differentially by sector, with a relatively low rate for agriculture and a high rate for construction. Bank managers indicated that most banks calculate transaction costs by prorating standard overhead costs, not by estimating actual costs of discrete steps in extending and servicing particular types of loans. As a result, banks were unable to give details on why they thought an SME loan cost more to transact than a credit to a larger enterprise. Therefore, most banks were not pricing loans to large businesses differently from those to SMEs. The differential for three banks doing so was a rate of 1-2 percent higher charged to SMEs, to compensate for the perceived higher risk involved and the higher cost of servicing. For similar reasons, a 1-2 percent higher rate was charged by two of these banks to new businesses than to existing clients. Meanwhile, some banks trying to avoid costly SME loan defaults down the road charged a lower rate on SMEs loans (2 percent differential), believing that there is a threshold of affordability for SMEs.

**Non-Bank Financial Institutions**

Ghana's financial market is served by several non-banking institutions which are not regulated by banking law. These include the Ghana Stock Exchange, several insurance companies, SSNIT, two discount houses, and a building society. The capital market in Ghana is still at a preliminary stage and is not able to mobilize significant amounts of long-term resources. The reorganized Ghana Stock Exchange began trading in November 1990, handling active trading for some twenty-five to thirty listed companies which are primarily public limited
companies. Despite the substantial volume of trading initially, its trading volume dropped as a result of rapid increases in the yields of short- and medium-term paper issued by the BOG and the government.

The two discount houses, Consolidated Discount House Limited (CDHL), Securities Discount House (SDH) were established in 1987 and 1990, respectively, to promote the development of a money market. CDHL is essentially a short-term financing institution, and is required to hold at least 70 percent of its assets in short-term paper. It is also allowed to accept short-term deposits from financial institutions. SDH was set up in June 1991 to provide a secondary market for commercial paper issued by larger public and private companies.

The insurance market consists of about twenty insurance companies (both life and non-life insurance) and SSNIT, which deals with social security. The latter accepts contributions from both employers and employees. Until 1986, it was required to invest in special government stocks, but it is now free to choose the composition of its assets. As a result of the high yields offered in 1991, it shifted a substantial part of its portfolio to short-term bills.

Two pioneer venture capital facilities were being structured at the time of the survey to enter the financial market in 1992. ECObANK intended to capitalize an $18 million regional venture capital fund that will invest directly in high-return manufacturing and mining industries in Ghana and several surrounding markets. The fund is expected to serve the top of the market in terms of profitability and market position, and will also provide restructuring and management technical assistance. Continental Acceptances Limited proposed to launch the Ghana Venture Capital Company (GVCC) to invest directly in Ghanaian SMEs. GVCC's management will actively supervise investments through strategic planning and management assistance to each invested company.

The Institutional Framework

In the late 1980s, many Ghanaian banks in Ghana faced severe financial difficulties that threatened the stability of the entire financial system. Contributing factors included under-capitalization, inadequate bank regulation and supervision, insufficient credit analysis, inappropriate sectoral policies, weak accounting and management systems, and rapid depreciation of the currency. The government initiated a restructuring and institutional strengthening program that included rationalizing the branch network, reducing surplus staff, streamlining operational costs, and strengthening loan collection, as well as adopting performance indicators and complying with prevailing regulations in terms of capital, reserves and liquidity.

Regulation and Bank Supervision

Prior to the financial sector reform program of 1985, enforcement of banking regulations was ineffective and supervision was weak. The focus was on the bank's condition at a given point in time, rather than on strengthening management systems. The number of staff in the BOG's Examination Department was insufficient, and they did not have the skills needed to carry out comprehensive examination procedures. Regulation was extended to semi-formal (and,

Under the credit line for FINSAP, measures have been gradually introduced to improve supervision and help the banking sector to regain stability. Technical advice was sought to strengthen the supervision function of the Bank of Ghana. Reforms included reviewing management structure, staffing, training and compensation issues; amending the Banking Law to require that each bank be examined annually; and introducing standard accounting and auditing principles. However, restructuring requirements for better credit analysis, portfolio management and capital adequacy have made most banks more reluctant to take risks, and lending remains highly selective.

Management and Training

Under FINSAP, technical assistance was provided to BOG to develop training programs to introduce more modern banking methods and technology, upgrade auditing and accounting skills of existing personnel, and develop new talent. It recruited a senior training specialist who formulated a training program for the banking sector. A professional banking college is being established to support training in urgently needed areas such as credit analysis, risk management, finance, financial management of financial institutions, money and capital markets, foreign exchange marketing, and basic management skills. Under FINSAP II (launched in 1989), funding is provided for BOG and some commercial banks to enhance management capabilities through organizational restructuring and purchasing of computers. It also provides resources for a diagnostic study of the insurance industry, training and technical assistance for the new National Insurance Commission, and further development of the Ghana Stock Exchange.

Legal Framework

There has been little change in the legal framework regarding property rights and contract enforcement during the period of financial reform. Continuing problems with legal enforcement of tangible security through the court system are causing the banks to wait from six (for registered documents) to twenty-four months to redeem real property. Enforcement problems stem from unclear titles, lengthy court procedures, and the reluctance of judges to evict people from their homes. Bankers also point to possible collusion in delaying judgment. Even enforcement of liens on equipment takes an average of six to twelve months.

Despite the difficulties presented by the legal environment, banks continue to emphasize collateral (preferably tangible security) in extending credit, for lack of alternative means of securing loans in an environment where poor information, lack of familiarity with new borrowers, and other factors combined to increase lending risk. Collateral requirements under the SME Credit range from 60-150 percent of the loan amount. The threatened loss of collateral exerts effective psychological pressure on borrowers. Other alternatives to hard collateral adopted by some banks are deposits (blocked accounts) by small customers, personal guarantees backed by blocked deposits of a guarantor, or a joint guarantee by a Board of Directors. The
latter has been very effective for enforcement. The absence of procedures for the hypothecation of trade assets makes it difficult for lenders to take and enforce liens on working assets.

4. Financial Liberalization: Implications for the Informal Financial Sector

The Structure of the Informal Financial Sector

The informal financial sector encompasses all financial transactions taking place outside of formal financial institutions, and embraces a wide spectrum of activity. Some of these are not described here due to the unclear and ambiguous nature of their transactions, especially those between friends and relations. Until 1985, there was a virtually complete separation between informal institutions engaged in savings mobilization and those engaged in credit, indicating an absence of financial intermediation within the informal sector. Dominant on the savings side were different versions of the susu system, while the operations of moneylenders dominated the lending side.

The Susu System

The susu system of saving has two versions: rotating savings through susu clubs; and individual susu collectors who operate a deposit facility for any number of people. The second is believed to have developed out of the first. The typical Ghanaian susu club consists of members who agree to make regular contributions to a fund which is given, in whole or in part, to each contributor in rotation" (Ardener 1964). The individual susu collector—sometimes described as a "mobile banker"—visits savers at shops, work places, market stalls and homes at agreed times each day and collects a specific amount determined by the saver in consultation with the collector. After an agreed period of time—usually on the last day of each month—the deposits are returned, less a day's deposit as commission. Many market women and traders find the individual version more convenient in achieving their limited savings targets of obtaining a lump sum at regular intervals to meet working capital and other financing needs.

Moneylenders

The regular moneylenders are scattered throughout the country in both rural and urban areas and consist of those licensed under the Money Lenders Ordinance (1951) and those who do business without official authority. Official data in the Greater Accra Region indicate a decline in the number of licensed moneylenders since the beginning of the 1980s. In 1972 and 1977, there were thirty-three and twenty-five respectively, but since 1982 there have been under ten. By 1988, only four moneylenders were licensed to operate in Accra, and by October 1989 only two. It is likely that the decline is not peculiar to the Greater Accra Region. The decline in the number of licensed moneylenders may be attributed to some "going underground" to avoid public officials scrutinizing their activities, and perhaps to the emergence of other forms, for
example, savings and loan (S&L) companies. It is likely, however, that the decline in the number of traditional moneylenders and the rise of new types may have been induced by the difficulties the national economy went through in the 1970s and 1980s.

Traditional moneylending is usually undertaken by older people (average age: sixty-one) who may have spent many years accumulating wealth from other activities. Moneylenders in large centers tend to have some education, whereas rural lenders are almost always illiterate. Most moneylenders have another business alongside that of lending. The practice of investing one's own accumulated savings and profits distinguishes this form of lending from that of S&L companies and susu collectors, who lend out the savings of others.

Borrowing from traditional moneylenders is not usually done by persons desiring to carry out long-term investment. Because of the high interest rates involved, the demand for credit from moneylenders comes mainly from persons with no other options to meet an emergency situation. These include farmers, market women, traders, public servants, self-employed craftsmen, and even big businessmen.

Susu and Savings and Loan Companies

As the economy grew, there was pressure on the informal sector to provide residual finance to businesses that were not accommodated by the financial system. With inflation declining in the late 1980s, borrowers found it difficult to pay the high interest rates charged by traditional moneylenders. A new form of the susu collector system, known as susu companies, began emerging from 1985 to fill this void. They operate similarly to susu collectors, but instead of returning deposits to the saver at the end of a month, susu companies accumulate them for a period of at least six months, at the end of which the saver may obtain a loan that is proportional to the amount saved, in addition to withdrawing the savings. Depositors sought out those collectors who were most likely to give out loans, encouraging some susu collectors to restructure their operations into susu or hire-purchase companies. Thus, liberalization was associated with substantial increases among informal and semi-formal financial institutions.

Unfortunately, in their eagerness to attract depositors, many susu companies failed to follow sound financial management practices. Problems of imprudent investments and non-repayment of loans led to some failures and public dissatisfaction. The Bank of Ghana issued a regulation in 1990 that S&L companies must register with the Bank and deposit an amount of $5 million before opening. By September 1991, only fifteen companies had applied to be registered, and of these only two had actually been registered. According to the Bank of Ghana, the delay stemmed from their inability to satisfy the requirement of permanent premises with safe deposit facilities. However, it is not very clear as to what institutions the regulation applies to. It defines "savings and loan companies" broadly enough to cover susu collectors and moneylenders, who do not generally go by that name.

Most susu companies follow no prudential regulations nor any other financial regulations in their operations. Although they are not registered with BOG, many are registered under the Companies Act either as finance companies or as trading companies. City authorities do not
restrain them from operating in city markets as long as they pay the taxes and rates levied on them. Given the modus operandi and scope of informal financial transactions, it is not clear how the central bank can effectively influence their behavior, and there is a risk that tighter enforcement could stifle the informal financial sector.

A more recent development is the emergence of S&L companies operating more along banking lines and catering to informal clients such as market traders, susu collectors, and microenterprises. In addition, purchase finance houses, which provide loans for consumer durables and equipment for small enterprises, sometimes take in savings and thereby become de facto financial intermediaries. While these institutions can fill an important gap between informal and formal financial systems, their status is somewhat uncertain under the new act governing non-bank financial institutions, which includes a relatively high minimum capital requirement of C100 million, ($125,000 at the 1994 rate of exchange).

**Deposit Structure**

In 1988 it was estimated (by IPC) that only 20 percent of household savings in Ghana was held in financial form. With increasing stability following liberalization, and growing confidence in the banking system which had earlier been undermined by various government interventions, holdings of total financial assets (with banks and susu collectors) appear to have increased. Despite bankers' suggestions that their share as well as the level of savings is increasing, there is no indication from informal collectors that their deposits are diminishing. Bankers are generally unaware that a portion of their increased deposits has been mobilized by susu collectors.

Deposits of rotating susu clubs are owned by a wide spectrum of low-income depositors, especially urban artisanal employees, junior public servants and some traders (Miracle and others 1980). Bortei-Doku and Agyei (1992) observed that average monthly deposits by junior public servants in 1991 usually averaged about C4000. Among traders, the deposits are often much larger, averaging C10,000 each month—consistent with average, daily deposits to susu collectors in 1989 of C500 in urban areas (C100 in rural areas). Most depositors in S&L companies are traders and SMEs. S&L collapses and defaults in paying back deposits have made this facility less popular for SMEs than in the late 1980s. For those saving with susu companies, monthly deposits averaged C50,000.

**Lending Structure**

The main institutional lenders are: rotating susu clubs, susu collectors and moneylenders. Lending within rotating susu clubs may be taken for granted as a result of the system's structure. Each time a person saves, or makes a contribution to the pool, another is being lent money. The loan period becomes shorter for each successive borrower. Generally, interest is not paid under this rotating scheme.

Most people who save with the susu collectors indicated that motivation for it initially comes from the forced savings accumulation, followed by access to credit. Loans (usually
considered as advances) by susu collectors are currently small relative to deposits and are very short term (usually one to three months), but there appears to be an important demand for access to such credit. Often, no interest is charged, apart from the monthly commission. When interest was levied, rates varied between 5 and 50 percent per month, with an average of 13.3 percent per month. Susu collectors are limited in the amount of credit they can give not only by the size of the assets they control but, more important, by the short-term nature of deposits with them. Lending for them is risky, because susu collectors who lack the liquidity to repay their depositors at the end of the month will lose their business. Financial liberalization has not affected their lending because it has not given them increased access to bank credit, as a fallback against unpaid loans catching them short of the amounts needed for month-end payments to depositors.

Traditional moneylenders do not mobilize deposits and therefore cannot expand their lending base, which is usually obtained from surpluses in other economic activities. The limited supply of lending capital (often held by a monopolist lender) has to be allocated among different borrowers within a restricted geographical area that enables the lender to constantly monitor loan repayments. In this situation, low "bidders" such as enterprises, are priced out of the market through relatively high interest rates offered by consumers.

**Interest Rates**

The fact that deposits with susu collectors have continued to attract zero interest and even pay a commission in the face of high inflation and formal rates shows that financial liberalization had not affected informal deposit rates at the time of the survey. Nevertheless, the potential exists that high, stable formal sector deposit rates could attract some deposits from informal channels.

Informal lending rates and terms vary among moneylenders and depend on the personal standing of the borrower. Rates also vary with debt maturity. The two main forms of interest in vogue are described by moneylenders as "short-term" and "long-term" interest rates. The short-term interest rate is applied to loans for periods of less than one month. Here, the borrower pays the principal and the interest a month after the agreement at rates that vary from 20-50 percent and average around 30 percent. If the borrower cannot repay on schedule, he is expected at least to pay the interest and rollover the balance as a new credit. Thus, a short-term credit can be turned into a long-term one. The long-term interest rate covers several months and may run into a year. The principal and interest are lumped together and paid in installments over a period of time. The interest rate usually varies between 50 percent and 100 percent per annum, and payments are normally on a monthly basis.

Four components of the interest rate charged by money lenders are: the opportunity cost of funds, a premium for risk, a premium to cover transaction cost, and an element of monopoly profit. The high interest charged by them can be attributed to several reasons, which include: the speed with which funds can be mobilized from moneylenders; borrowers' poor information about the market; the high-risk premium charged because moneylenders overestimate the risk
element in giving credit; and, the fact that the interest rate covers all fees and charges, whereas the formal sector may levy them separately.

Informal lending rates appear to have dropped from an average of over 100 percent per annum in 1985 to an average of 50 percent observed at the time of this study. Although this may in part reflect the reduction in annual inflation over the period, it also represents an increase in the supply of funds from moneylenders stemming from their trading activities, which benefited from the liberalization of trade.

Contract Enforcement

Most informal lenders claim they do not have much problem with the enforcement of loan contracts. They usually ask for collateral that they can sell immediately to redeem debt (that is, pawnbroking), such as jewelry. The most acceptable guarantors are persons in responsible positions who would not like to be embarrassed by being known in their communities to be in financial difficulty. Default rates for individual moneylenders and susu collectors are relatively low; under 10 percent in most cases.

Only duly registered moneylenders or S&L companies can seek redress from the courts in case of contract breaches; the others rely on "societal pressures." The actual risk exposure of a hire-purchase or S&L company is also very low in the case of loans to purchase equipment. Clients are made to follow a savings plan that guarantees they pre-pay up to 50 percent of the value of the equipment plus interest, and the companies put up the remaining 50 percent with a lien on the equipment. Through daily repayments, the company is able to monitor the cash flow of the borrower; if default should become imminent, the equipment is impounded without difficulty.

In sum, informal savings and lending appear to have been relatively unaffected by financial liberalization and monetary policies. Informal finance depends more on the real economy, with deposits growing with incomes and lending growing as trading profits give moneylenders additional funds. The rapid growth of susu reflects substantial excess demand for credit in the informal sector, but this relatively new institution has so far not proven widely effective in satisfying it. Although most informal loans and advances go to traders and consumers, some SMEs borrow (mainly from moneylenders) and more would participate if a regular flow of credit were assured. Susu collectors presently place a substantial share of their deposits in banks but receive no credit in return. Only with some credit access would they be able to significantly expand their own lending to informal clients, including SMEs.

5. Formal and Informal Lending to SMEs

The extent to which liberalization, financial sector restructuring and introduction of the World Bank-financed Private Small and Medium Scale Enterprise Credit (SME Credit) have created suitable conditions for SME lending by formal and informal financial institutions is described in this section. It describes ways in which lending procedures and operations have
changed since financial liberalization, and indicates what is needed to facilitate more SME lending.

**General Impact of Liberalization**

The main finding of the survey is that liberalization and the SME Credit by themselves have not been sufficient to create a conducive environment for SME lending. Structural adjustment policies changed the incentive structure and opened up new opportunities for SMEs. Nevertheless, the availability of credit has been hampered by some of the financial policy reforms, tightening of monetary controls, introduction of high-yielding securities to absorb liquidity, and restructuring measures that have centralized decision-making within banks and made them more reluctant to take long-term risks. These factors have in fact rendered credit analysis and supervision more difficult and costly.

According to banks, global and sectoral lending ceilings in force before 1989 constrained their lending to SMEs. With those ceilings lifted and interest rates freed, five of the nine banks interviewed reported that SME lending had increased by about 10-20 percent. Nevertheless, the share of indigenous manufacturing sole proprietorships in total bank lending to the private sector, which may be used as a proxy for the SME credit share, dropped from 1.6 percent in 1987 to 1.1 percent in 1990. On average, no more than about 15 percent of banks' loan portfolio is made up of credits to SMEs.

Increases in lending to SMEs were attributed by bankers mainly to the presence of some attractive lending opportunities at reasonably manageable levels of risk and to the availability of outside credit funds at a reference rate which makes it possible for banks to cover their costs and realize a satisfactory return. A third incentive is maintenance of its small depositor base by making some SME loans. SME lending generally is limited to working capital or expansion needs of existing clients. With deposits apparently increasing faster than loans, there is some possibility that a situation of excess liquidity will re-emerge if banks remain reluctant to expand SME and term lending.

**SME Credit Project**

The SME Credit project was designed to promote financial deepening by encouraging banks to originate more and better quality loans to viable SMEs. The project features a credit line of $25 million through the BOG for on-lending at a cost reflecting the average cost of 180-day deposits mobilized by the banks. In addition, the project finances training and technical assistance to improve banks' skills in project appraisal, monitoring and supervision of SME loans and to assist in problem identification and resolution. It was anticipated that the training and additional experience gained with SME lending would encourage banks to expand lending to SMEs over the longer term and to develop them as creditworthy banking customers.

Banks have not embraced SMEs as a prime credit market. They appear to use the SME Credit largely to provide loan funds to preferred SME clients when they lack (or prefer not to use) their own funds, rather than generating new lending to SMEs on the basis of attractive
features of this market segment. Since the elimination of credit ceilings, there is no special incentive to use SME Credit funds (which were provided outside the ceilings), hence banks now generally prefer to use their own funds, which are mobilized at a lower cost, when they do lend to SMEs.

Approved and pending loans reflect financing for a wide variety of SMEs, in the manufacturing of consumer and industrial products, agro-processing and services. Credits have been used for working capital, importation of equipment and raw materials, and construction or furnishing of expansions for hotels and schools. While the majority of clients are in greater Accra, the balance is distributed geographically in the West, Central and Eastern Regions of Ghana. Loans approved range from as low as $9000 for working capital for a stationery printer, to as high as $500,000 for equipment import for a lumber products industry, and $750,000 for working capital for a paper sack manufacturer.

In the process of restructuring, bank operations and decision-making have become more centralized. In addition, adherence to performance indicators such as the ratio of operating costs to total assets, arrears as a percentage of outstanding portfolio, and the ratio of actual loan collections to scheduled collections have made the banks reluctant to encourage new or small borrowers. Most banks have not invested in improved project analysis and loan supervision closer to business sites as measures to reduce the risk of default. They seem generally uninterested in adapting financial products to meet the needs of viable SMEs. The tendency is to try to mould a customer to the existing set of financial products. As a result, SMEs have had a difficult time obtaining even overdrafts and short-term working capital finance to meet orders, let alone funds for expansion.

There is, however, some indication that conditions are improving. Since September 1991, GCB has been decentralizing its lending system to give more authority to regional and branch managers. All loan applications are now routinely routed through the branches, and credit analysis is done by a credit officer installed at each regional office and some branch offices. GCB and NSCB are considering ways to streamline loan processing procedures to reduce the costs of SME lending.

In summary, financial liberalization has removed many of the constraints that gave banks little incentive to lend to SMEs. With banks free to set interest rates, increasing competition among banks and lower rates on safe government instruments had induced some banks to think more about SME lending as a possible profitable market niche. On the whole, however, banks remain highly risk-averse, given political and economic uncertainties and the emphasis on continuing to strengthen their portfolios. However, their management structures and staff capabilities are not well suited to decentralized SME lending on a large scale. The type of training currently envisaged also seems ineffective in dealing with small-scale clients. Hence, access appears to be opening up only very gradually and mainly for well-established SME clients rather than new firms.
Creditworthiness Criteria

Bank managers ranked various creditworthiness criteria which are used in appraising a credit to a SME as against a large enterprise, and a new business as against an existing one. The overall rankings are as follows in order of priority:

(i) Viability of the business and ability to repay out of cash flow;
(ii) Character of the borrower and reputation in the business;
(iii) Experience in the business being financed;
(iv) Amount and type of collateral as loan security.

The prominence given to non-collateral criteria reflects a concern that the project will not be able to pay for itself on a cash basis, due to non-viability, management mistakes, or unanticipated changes in the market.

Lenders' responses also indicate that banks do not apply significantly different (non-collateral) creditworthiness criteria or rankings when analyzing a loan request from SMEs and large enterprises or lending to new and existing enterprises. The viability of the enterprise is the most important concern, regardless of the stage of establishment of the business. Nevertheless, collateral is a criterion for every loan, whether the enterprise is small or large, new or established, as a fall-back in case other elements of the credit transaction fail to perform as expected. In contrast to other creditworthiness criteria, collateral is ranked higher for new businesses, and some banks do not require collateral for loans to established large-scale customers.

Cost of Funds to Banks

Liberalization of interest rates initially increased the cost of mobilizing additional funds (mainly through savings accounts) to relatively high levels in 1991, which gradually became lower (15.5 percent) early in 1992. Although figures were not available on the average cost of funds, it is certainly lower than the costs indicated here, because of the large proportion of demand deposits that bear little or no interest. The rate for SME Credit funds is set with reference to savings deposit rates in the preceding period. Because interest rates were declining from mid-1991, the SME Credit rate of 20.5 percent early in 1992 was five percentage points above the current cost to banks of mobilizing their own additional funds. The reference period was subsequently shortened to make the reference rate more sensitive to the market, but the rate used remains above the average banks actually pay on new deposits.

The movement in lending rates has more than compensated for the increased cost of funds, resulting in higher spreads for most lenders. At average term lending rates of 20 percent to 26 percent for manufacturing in February 1992, banks were realizing spreads of 5 percent to 10 percent. Banks indicated that a total spread of 8 percent to 10 percent would be needed to
interest them in SME lending due to the higher costs and risks of such lending. With lending rates to small industries and SMEs around 25 percent to 26 percent early in 1992, the spread was not sufficient to make SME Credit funds at 20.5 percent attractive. Banks were reluctant to raise rates higher for SMEs because they did not feel that most SMEs could absorb interest costs above 25 percent without endangering their viability. To the extent that they engaged in SME lending, banks generally preferred to use their own funds or seek other donor credit lines with lower rates.

**Transaction Costs in Bank Lending to SMEs**

The main transaction costs of lending to SMEs are incurred in gathering information, processing, including monitoring and loan supervision, and collection and enforcement.

**Information Costs**

The costs involved in gathering the information necessary to assess the borrower’s creditworthiness and the project’s viability constitute the largest single cost component in SME lending. The lack of a credit reference bureau and poor inter-bank cooperation makes it particularly difficult to obtain this information for SMEs and new borrowers in Ghana. Financial liberalization and the SME Credit project have helped to strengthen the emphasis on sound project analysis and borrower character appraisal; however, they have also increased information costs (by about 15 percent) due to the requirement of technical information. The average SME borrower is not technically or financially equipped to provide such information. Six of nine banks interviewed indicated that most SME projects arrive without feasibility studies, audited accounts, or documentation of collateral because SME borrowers typically cannot afford management consulting services. Therefore, some of the verification task often devolve on bank credit operations staff, thus increasing the transaction costs.

Information costs of SME lending may also be high because they: are physically far from the headquarters or branch offices; cannot provide well-organized financial information in terms of standard accounting and auditing practices; do not use modern management techniques in business planning, hence the accuracy of their projections cannot be verified; and are unable to provide the information needed to assess local supplies of raw materials and local markets, which SMEs tend to use and serve.

**Processing Costs**

Total processing cost is defined here to include verification of information, loan processing, structuring the loan recommendation, getting a loan decision, and loan supervision. It does not include the cost of collection and enforcement. The most time-consuming processing tasks are feasibility study review and credit analysis. At the nine banks interviewed, the cost (in terms of time requirement) for these two steps accounted for an average of 53 percent of total processing time for a large enterprise loan and 63 percent for an SME. The extra cost for SMEs is mainly to wait for and verify borrower-supplied feasibility information. There is evidence that lenders who are more experienced with SME lending expend fewer man-days in loan processing.

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as a percentage of total time expended on a project. The percentage of total man-days expended in taking these steps ranged from 50 percent to 56 percent among more experienced SME lenders, as contrasted with 69 percent to 86 percent for lenders who have done very little actual lending to SMEs.

The effect of liberalization and financial restructuring has generally been to increase the loan processing time required and hence the cost of SME lending, reflecting in part the centralization of loan processing and supervision under the restructuring requirements.

Loan structuring and recommendation costs are similar for large enterprises and SMEs (9 percent and 10 percent of processing time, respectively). This element of processing cost has not changed significantly under liberalization or the SME Credit. The cost to secure the decision to make a loan varies widely depending on the size of the project and whether it has to go through a Loan Committee. The average share of cost for a loan decision is 22 percent for a larger enterprise and 13 percent for an SME if a Loan Committee is not involved. This portion of processing cost has generally not increased under the SME Credit.

Time expended in loan monitoring and supervision does not vary significantly by size of enterprise or bank experience in SME lending. Most lenders visit businesses with non-problem loans four days per year at most, for both large and SME businesses, whether this responsibility is decentralized or supervised out of headquarters. For both large projects and SMEs, supervision accounted for less than a fifth of total man-days spent per project (18 percent and 17 percent, respectively). This pattern reflects not so much the low level of importance placed upon supervision as the difficulty in making regular supervision visits, especially from centralized operations.

**Collection and Enforcement Costs**

Difficulties in enforcing collateral through the legal system have forced SME lenders to carefully document it up front. The added costs are passed on to the borrower in the form of a valuation fee on collateral securities and a legal department documentation fee, which add an estimated 1.5 percent to the borrower’s cost. Elapsed time to document collateral can range from one to three weeks if the borrower produces documentation on collateral with the application. This time period has not changed with restructuring and the advent of the SME Credit Program. In most banking systems, loan collection and enforcement of collateral are done by headquarters and are costly steps for lenders, due to the distances between headquarters and project sites and the lengthy process for enforcing collateral through the courts. Even then, it does not typically fully compensate the institution for its loan loss upon property sale. Active lenders in Ghana have increased their emphasis on sounder project appraisal so as to reduce the need for enforcement later.

Liberalization and the SME Credit have had no perceivable direct effect on easing collection and enforcement for SME loans where tangible security is involved. But indirectly, the SME Credit has made conditions more favorable for SME lending by spurring banks to employ more realistic forms of loan security, in the absence of tangible security among most
SMEs. These securities include blocked accounts, letters of undertaking, and pledges of other financial instruments.

**Lending Risk to Banks**

Bankers' responses did not reveal significant differences in ranking risks by size of enterprise. Non-wilful default by the borrower (due to cash flow problems) was frequently ranked as the primary concern in risk assessment. While SMEs were seen as generally more vulnerable to non-willful default, larger enterprises were considered more likely to engage in wilful default. The quality of project analysis is the determining factor in identifying project-related problems early on. Banks that have decentralized some of the responsibility for project review and analysis to branch offices rank the risk of project non-viability significantly lower, suggesting the high confidence they have in the quality and accuracy of judgments when project analysis is done closer to the business site.

Market liberalization and the introduction of the SME Credit have not significantly decreased risk aversion of lending to SMEs or altered the relative importance of risk factors, nor have they substantially reduced dependence on collateral. Financial sector restructuring has tended to increase general risk aversion among the banks.

**Risk Reduction Measures**

Financial restructuring has stimulated banks to strengthen measures that reduce the risk of borrower default and project non-viability, such as: more thorough project analysis; more frequent on-site monitoring; and more consistent loan account monitoring by branch office staff. Still, taking collateral remains a major tool of risk reduction. Credit supervision too, can be used as an effective risk reduction measure, if banks are well organized and staff trained to do it properly.

The most active SME lenders indicated that liberalization and the availability of the SME credit have encouraged greater bank supervision of loans. Several banks have also encouraged portfolio diversification as a risk (especially foreign exchange risk) reduction tool. Banks were of the view that collateral requirements could be relaxed if a sound loan insurance or guarantee scheme were available to provide risk coverage. However, past experience of most banks with the Bank of Ghana Guarantee Fund prompted banks to indicate that such a scheme should contain clear and specific documentation requirements for the lender to make a claim, and that quick payment should be made on properly documented claims if the scheme is to be effective.

According to lenders, other incentives or forms of assistance most helpful in reducing the risk of SME lending, are: borrower participation in entrepreneurship development training; technical assistance in developing small business banking centers; assistance with project supervision by an outside agency; and aid in building computer-assisted analysis capability.

Although supervision by an outside agency was viewed positively by several banks, some were doubtful whether it might create a public image that the bank could not adequately monitor
There were also banks which were hesitant to bear the cost of such an agency. Some bankers expressed a desire for bankers’ seminars as a forum for lenders to share problems and discuss techniques for dealing with them. These seminars are seen both as a form of banker-to-banker assistance and as a means to induce bankers to cooperate more closely in providing information (opinions) on borrowers and projects. Such seminars could also serve as a useful channel for providing training to bankers.

The feasibility of building computer-assisted project analysis would depend on the volume of SME lending, which presently is not large enough to justify setting up an internal computer unit in each bank. An outside computer analysis center might make sense if it could be supported by banks jointly or by an outside funder. A similar constraint of inadequate amount of existing SME lending activity at present discourages the establishment of separate SME divisions in each bank.

**Capacity to Lend**

Lack of bank capability to extend and service SME loans is a function of the following:

- Level of technical expertise and training;
- Internal organization of lending institutions;
- Manpower and division of roles in the credit process;
- Incentive systems for building sound SME portfolios.

**Technical Capacity and Training**

Most banks were not comfortable with the judgement capacity of their credit operations staff in determining the viability of a project or its repayment capabilities. They expressed the need for further staff training to improve the quality and accuracy of project analysis, especially in terms of cost analysis and project sensitivity analysis. Testing project resilience to changes in market share, cost and prices is especially important because of the poor quality of available information. Other areas in which training and assistance were requested were in determining loan transaction costs using the itemized cost method for discrete steps in the credit process, marketing financial services in an increasingly competitive environment, doing computer analysis, and diversifying bank portfolios.

Traditional bank training programs for credit officers do not provide adequate tools to compensate for lack of reliable information on markets, costs, prices, and borrower reputation and capability. Most credit officers in Ghana’s banks have little understanding of how a small business is managed. They lack training in loan recovery management: how to recognize a potential problem loan, develop a strategy for servicing it, and take steps to work out problems (through rescheduling, restructuring, increased frequency of supervision) before it defaults. Even when credit officers have received training, applying it within the institution has been
difficult due to the established procedures and lack of reinforcement at the management level for the adoption of new techniques. Frequent personnel shifts within the organization have also limited the application of task-specific training.

Similarly, branch managers are unable to assist headquarters in improving the quality and recovery of loans because they lack training in project analysis and credit supervision. They have not been brought fully into the banking system to understand its functioning and objectives and share in the rewards of good loan performance.

On their part, bank managers also need training in forward planning using financial projections and other planning tools. These skills are needed to make operations with local businesses a "profit center" within the bank. They also need assistance with the technical requirements of decentralizing, notably delegating more authority for project analysis and credit supervision to branch offices. Constrained by credit controls until recently, bank managers have not been trained or encouraged to develop innovative financial products to do profitable business with fast-growing enterprises.

Internal Organization

In the majority of the banks interviewed, internal organization and bank procedures were not geared to working effectively with SMEs, whose locations are often distant from bank headquarters or regional offices; on whom information is difficult and costly to obtain; and whose scale of operations cannot absorb costly delays in processing loans. All banks interviewed process and supervise SME loans largely from headquarters, as part of a unit handling all types of credits. In most, branch officers only monitor loan account performance and report monthly to headquarters. In a few, however, branch managers receive projects, review the feasibility, and prepare a report to headquarters; they also play a significant role in credit supervision. Interviews with these banks, and experience elsewhere with bank lending to SMEs, indicate that lenders using more decentralized systems for loan processing and supervision have less fear of default, more confidence in their project analysis judgments, better-performing loans, and more flexibility in identifying problems and working out a potential default than do banks using more centralized systems.

Manpower Utilization and Requirements

In the present organizational structures of six of the nine banks interviewed, the tasks of SME feasibility study, credit analysis, loan structuring, and getting the credit decision are carried out by a credit officer at headquarters who is often already overextended. A credit officer usually handles as many as six to ten new project appraisals monthly plus ten to fifteen project supervisions, across all types of credits (SMEs, large-scale industry, trade). Because of the distances between bank operations and business sites, increased project workloads, and shortage of manpower, even a minimum level of credit supervision is difficult for active lenders under the SME Credit. A few lenders indicated that management reporting requirements imposed
by the SME Credit are affecting capacity to handle new credit appraisals and supervise existing ones. In practice, many banks have been neglecting the requirements.

**Incentive Systems**

A contributing factor to the lack of capacity to the serve the financing needs of SMEs is the failure of most institutions to provide incentives to generate and manage good portfolios based on realistic performance standards. Regardless of how they perform, staff can expect only a salary and grade promotion and cannot look forward to other rewards, such as profit sharing or salary bonus incentives packages, which have been successfully administered by banks in developed countries. As a result, they have no performance-based incentive to analyze and supervise projects adequately. The heavy workloads of credit officers further lower motivation levels and productivity.

**Growth of Informal Financial Sector Lending to SMEs**

The use of informal credit by SMEs is not common, despite their need for working capital and equipment loans. The principal explanation is that the high interest, short repayment period, small size, and other characteristics of informal loans are not particularly suitable for SME investment and working capital needs. Since SME access to lending by formal institutions has not increased significantly after liberalization, the pressure on the informal sector to compete more effectively in providing SME finance is not present. The changes in lending activities of the informal sector are mostly due to other macro policy changes in Ghana.

The supply of informal funds has increased since 1985, and their lending rates have declined since 1989. These changes may be attributed to the growth in the number of persons involved in the savings and loan business since 1985 and increasing competition among them; the expansion in their lending base without raising their cost of funds; and the channeling of profits from trading activities (under liberalization) into moneylending operations. Most informal lenders apparently cannot meet the financing requirements of larger SMEs, whose demands for several million cedis remain beyond their capacity. The average loan size of informal lenders is presently C50,000; the survey data showed that SMEs applied, on the average, for C20 million from banks in their last loan applications.

**Informal Sector Cost of Funds and Capacity to Lend**

The cost of funds to susu collectors is actually negative in nominal terms, since depositors pay a commission of one day's deposit per month (see Aryeetey and Steel 1992 for the calculation of the implied rate). This cost has remained unaffected by variations in the rate of inflation and interest rates. Thus, they have tremendous incentive to lend increased deposit collections at prevailing interest rates of about 25 percent. However, the susu collectors interviewed expressed reluctance to expand lending without a fall-back mechanism to meet their obligations to refund depositors' balances at the end of each month. As such, the bulk of their loans are very short term, and hence are unsuitable for SMEs.
The susu companies have a cost of funds similar to that of susu collectors (slightly higher in cash terms because they hire collectors), but they are better designed for lending beyond one month because they require depositors to accumulate funds for at least six months to qualify for loans. Unfortunately, mismanagement of funds and failure to screen loans adequately led to the failure of many susu companies. It remains to be seen whether the newer savings and loan companies, being operated like banks but using techniques of susu collectors, can fill the gap.

On the rare occasions when SMEs borrow from informal sources, moneylenders appear to be the most likely source. Moneylenders face a much higher cost of funds than susu collectors or companies because they use funds generated from other activities (usually trade). The high opportunity cost of these funds generally limits their willingness to lend for long terms and to greatly expand lending relative to their other activities.

Transaction Costs for Informal Lenders

Screening Costs

In view of the small size of the projects that informal lenders typically finance, screening procedures are simple and consist of an assessment of creditworthiness, project viability and value of collateral. More than 50 percent of the lenders interviewed indicated that evaluating expected return on the project was the most important creditworthiness criterion. In addition, they also do a mental assessment of the information about new clients provided by the recommender (often an old client) and a mental appraisal of the reliability of the person introducing the new client. To evaluate project viability, they may visit the project site and assess it based on intuition derived from "knowing the market." Finally, they make a casual assessment of the value of collateral put up by the client.

Most informal lenders have no explicit way of working out the costs involved in screening. It is difficult to estimate these costs due to the lack of direct information on the costs of various actions taken and, in many cases, the virtual absence of observable steps in loan application processing. Due to their simple operational style (from market stalls or homes), proximity to borrowers or project sites (reducing transport costs), and the virtual absence of paper work, the marginal screening cost is unlikely to exceed C2,000. This would be equivalent to 0.6 percent of the average loan amount of C350,000. The total screening cost for S&L companies is likely to be somewhat higher than that for traditional moneylenders in view of the higher overhead expenses involved in managing a group of collectors and paying rent and taxes.

Loan Monitoring Costs

Of the ten informal lenders studied, seven paid regular visits to the project sites of clients for deposit mobilization, loan monitoring and sometimes for contract enforcement. For S&L companies, the associated costs (total salary payments, transport expenses and other office maintenance expenses) have been apportioned equally between the first two functions since these are the primary reasons for site visits. The estimated monitoring costs is about 2 percent of the
total loan amount. For traditional moneylenders, monitoring and collection costs are minimal since debtors go to the lender at the agreed time to repay debts.

**Contract Enforcement Costs**

Enforcement costs are low for informal lenders because default or delinquency rates are very low, given the intensive monitoring (at least by regular lenders) and virtually automatic rollover of principal if interest payments are maintained (for moneylenders). In the relatively few cases where informal lenders have had to pursue borrowers, they have gone to the borrowers’ homes or project sites to deliver verbal notices of intention to confiscate collateral, sometimes accompanied by state security personnel to issue threats to the borrower. Their costs include the transport expenses involved as well as payments made to the person assisting them.

**Risk Perception in Informal Lending to SMEs**

The perception of the risk involved in lending to small enterprises by informal lenders varies considerably. While six out of ten lenders did not think that lending to SMEs was any more risky than lending to a large enterprise, the remaining four discerned a higher level of risk. Informal lenders suggest that SME borrowers default mainly due to the unavailability of production materials. With improved availability of most materials following the removal of trade restrictions, production and the ability to repay loans have improved, and the associated risk is generally perceived to have gone down since 1985.

For *susu* collectors and well-managed S&L companies, risk in lending to SMEs is controlled through constant monitoring of the project in the course of daily collections, enabling them to detect cash flow problems early and take steps to avoid eventual default. Furthermore, their daily interaction with depositors provides a good opportunity for quick but thorough screening of all loan applications, thus avoiding risky loans. Traditional moneylenders emphasize easy access to collateral as the means for reducing risk.
ANNEX 2. RESULTS OF FIRM-LEVEL SURVEY
ON SME DEMAND FOR FINANCE

1. INTRODUCTION

Studies of small- and medium-scale enterprises (SMEs) in Ghana and other countries consistently find that a large proportion of entrepreneurs identify inadequate access to finance as a paramount concern. The principal purpose of this survey was to gather further information on the nature of SMEs' demand for finance in relation to indicators of firm performance. Small entrepreneurs are often distrustful of banks, skeptical about their chances of getting credit, and reluctant to undergo the application process. If banks or other financial institutions are indeed going to develop this market, there is a need to document the extent and characteristics of SMEs' demand for finance, including their relative preferences for semi-formal and formal financial instruments and their willingness to pay a higher cost for convenience. From the viewpoint of banks, key concerns are whether creditworthiness can be based on simple indicators of likely success and the extent to which small enterprises can provide the collateral needed to offset the risks involved in lending to them.

In this context, the data were analyzed to shed light on the following central questions on financing the establishment and growth of small businesses: First, how do small entrepreneurs accumulate the savings that they invest, and to what extent do they make use of banks and informal savings mechanisms? Second, is success in operating a business related to verifiable indicators such as education and prior experience? Third, how actively do they seek external finance and what terms are they seeking? And fourth, how credible is their demand in terms of firm performance, ability to provide security, and management capability?

2. METHODOLOGY

Firm-level interviews were conducted during September 1991 and early 1992 with 133 existing small and medium enterprises in five locations: Accra, Tema, Koforidua, Kumasi and Takoradi. These entrepreneurs included 59 who had participated in NBSSI's EDPs. An additional 29 interviews were conducted with EDP participants who had not yet started a business. Teams of two interviewers recorded answers on a form with pre-coded responses (standardized after an initial pilot survey).

An effort was made to select enterprises that were perceived as successful or having some growth potential, particularly among the clients of NBSSI and the Programme of Action to Mitigate the Social Costs of Adjustment (PAMSCAD). The sample represents the type of SMEs likely to demand external finance, not a random drawing from the population of SMEs. Given the concern with improving the access of SMEs to formal bank credit, the sample was biased toward urban areas, where bank branches are located. Most sample firms came from the four

73
subsectors commonly found to account for the bulk of SMEs: food, textiles, wood products, and metal products.

The hypothesis was that firm size would be positively related to use of bank accounts and to other characteristics likely to lead to greater success in obtaining loans, such as the entrepreneur's qualifications and availability of collateral. Hence, much of the analysis consists of comparison of responses by firm size. Initially, the data were examined in detailed groupings according to the total number of workers, 1-4, 5-9, 10-19, 20-29, 20-49, and 50-140 (the last being the largest firm size in the sample). This analysis suggested that the following 3 groups would provide clarity in presentation without unduly obscuring the variations by firm size:

- 1-9 workers, termed "microenterprises;"\(^1\)
- 10-29 workers, termed "small;"
- 30-140 workers, termed "medium."

To obtain a sufficient number of observations for statistical analysis within the small enterprise category and to analyze the impact of reforms on firms that were small when they took effect, some of the analysis covers all firms with 5-29 workers as of 1986. The terms "SMEs" is used to refer generally to the range of firms in the sample, in contrast to large firms (typically employing several hundred workers).

A further hypothesis was that success in obtaining a loan would be correlated with enterprise growth, both because lenders would take growth as a positive indicator of ability to repay and because the loan would ease the financial constraint on growth. It was expected that new firms would have a harder time obtaining loans because they lack a track record. Hence, the analysis was also conducted in terms of firm growth and age, as well as by examining differences between firms that received and were denied loans. Growth was measured both in terms of employment over the five-year period 1986-91 and profits over the past year. "New" firms were defined as those that were established in 1986 or later, that is, after structural adjustment reforms were well established and import licensing had been replaced by an auction system.

Where possible, a Chi-square test for significant difference was used to compare the observed distribution of responses among subgroups with the expected distribution based on the average response for the entire sample. References in the text to significant or non-significant differences are based on the Chi-square test at the 0.10 level of probability.

\(^1\) Although the term "microenterprise" is sometimes limited to firms with fewer than 5 workers, the firms with 5-9 workers in the sample appeared to have more in common with those under 5 than with those up to 29 workers. Furthermore, about half the workers in these firms were part-time workers, apprentices, and owners, who are not always fully counted in criteria for grouping firms. The microenterprises in the survey should be distinguished from self-employment and household enterprises. They represented productive units outside the home, employing at least one wage worker in all but seven cases.
3. The Sample

The distribution of sample firms by employment size and subsector is given in Table A2.1. Over half the firms are in the microenterprise group with 1-9 workers (most of them with 6 or fewer). The metal products subsector is over represented in the sample compared to its share of total SME employment, reflecting good opportunities in the context of growing construction demand. The sample includes nine non-manufacturing firms, mainly in business services, which are omitted for some of the analysis (e.g., comparing "old" and "new" firms).

Table A2.1: Distribution of Firms by Size and Product Group
(number of firms in sample)

<table>
<thead>
<tr>
<th>Number of workers</th>
<th>1-9 Micro</th>
<th>10-29 Small</th>
<th>30-140 Medium</th>
<th>Total Number</th>
<th>(Percentage)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>14</td>
<td>7</td>
<td>1</td>
<td>22</td>
<td>(16.5)</td>
</tr>
<tr>
<td>Textiles</td>
<td>17</td>
<td>6</td>
<td>3</td>
<td>26</td>
<td>(19.6)</td>
</tr>
<tr>
<td>Wood</td>
<td>12</td>
<td>11</td>
<td>1</td>
<td>24</td>
<td>(18.1)</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>8</td>
<td>(6.0)</td>
</tr>
<tr>
<td>Ceramics</td>
<td>4</td>
<td>5</td>
<td>3</td>
<td>12</td>
<td>(9.0)</td>
</tr>
<tr>
<td>Metal products</td>
<td>20</td>
<td>7</td>
<td>6</td>
<td>33</td>
<td>(24.8)</td>
</tr>
<tr>
<td>Other</td>
<td>6</td>
<td>2</td>
<td>0</td>
<td>8</td>
<td>(6.0)</td>
</tr>
<tr>
<td>Total number</td>
<td>76</td>
<td>40</td>
<td>17</td>
<td>133</td>
<td>(100.0)</td>
</tr>
<tr>
<td>(Percentage)</td>
<td>(57.1)</td>
<td>(30.1)</td>
<td>(12.8)</td>
<td>(100.0)</td>
<td>(100.0)</td>
</tr>
</tbody>
</table>

Table A2.2 summarizes firm characteristics of age, labor force, sales, initial and current value of assets in relation to the size and age of firms, as well as derived ratios and growth rates as indicators of overall firm performance. The following discussion highlights some of the data in these tables.

The average age of the firms in the sample increases directly with size, from 6 years for microenterprises (1-9 workers) to over 15 years for medium sized firms (over 30 workers). These differences (which are statistically significant) are consistent with previous observations that turnover rates tend to be higher among smaller firms.
Table A2.2: Indicators of Firm Performance by Size and Age
(means of responses)

<table>
<thead>
<tr>
<th></th>
<th>Total sample</th>
<th>All sample firms: Number of workers</th>
<th>5-29 workers: Age of firm</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1-9 Micro</td>
<td>10-29 Small</td>
</tr>
<tr>
<td>Firm age</td>
<td>8.4</td>
<td>6.1</td>
<td>10.3</td>
</tr>
<tr>
<td>Labor: a/</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total 1991</td>
<td>15.0</td>
<td>4.6</td>
<td>14.7</td>
</tr>
<tr>
<td>Of which, apprentices</td>
<td>1.7</td>
<td>1.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Start-up</td>
<td>6.0</td>
<td>3.0</td>
<td>7.2</td>
</tr>
<tr>
<td>1980</td>
<td>22.1</td>
<td>8.7</td>
<td>10.6</td>
</tr>
<tr>
<td>1986</td>
<td>16.1</td>
<td>3.6</td>
<td>12.6</td>
</tr>
<tr>
<td>Peak</td>
<td>19.6</td>
<td>6.0</td>
<td>20.3</td>
</tr>
<tr>
<td>Monthly sales (£'000)</td>
<td>2737</td>
<td>413</td>
<td>1547</td>
</tr>
<tr>
<td>Cost of assets if new (£'000)</td>
<td>30766</td>
<td>1913</td>
<td>23970</td>
</tr>
<tr>
<td>Ratio full-time/other workers</td>
<td>3.8</td>
<td>1.6</td>
<td>3.1</td>
</tr>
<tr>
<td>Male/female worker ratio</td>
<td>3.1</td>
<td>3.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Employment ratios:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1986/1980</td>
<td>0.72</td>
<td>0.41</td>
<td>1.19</td>
</tr>
<tr>
<td>1991/1986</td>
<td>0.93</td>
<td>1.28</td>
<td>1.17</td>
</tr>
<tr>
<td>Peak/start-up</td>
<td>3.27</td>
<td>2.00</td>
<td>2.80</td>
</tr>
<tr>
<td>1991/start-up</td>
<td>2.49</td>
<td>1.57</td>
<td>2.02</td>
</tr>
<tr>
<td>1991/peak</td>
<td>0.76</td>
<td>0.77</td>
<td>0.72</td>
</tr>
<tr>
<td>Current/initial assets</td>
<td>2.04</td>
<td>2.11</td>
<td>1.50</td>
</tr>
<tr>
<td>Average growth/year since start-up (percent):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Labor</td>
<td>11.5</td>
<td>7.7</td>
<td>7.1</td>
</tr>
<tr>
<td>Assets</td>
<td>8.9</td>
<td>13.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Sales per worker (£'000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>182</td>
<td>89</td>
<td>105</td>
</tr>
<tr>
<td>Full-time</td>
<td>226</td>
<td>151</td>
<td>129</td>
</tr>
<tr>
<td>Assets per worker (current cost, £'000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At start-up</td>
<td>22505</td>
<td>307</td>
<td>2205</td>
</tr>
<tr>
<td>1991</td>
<td>2047</td>
<td>414</td>
<td>1633</td>
</tr>
</tbody>
</table>

a/ Average of those firms reporting (including those that indicated "none," but excluding non-responses).
Labor and Capital

The average size of sample firms is 15 workers (including owners)--two-and-a-half times their average start-up size. On the average, firms had 3.8 full-time wage workers for every apprentice and part-time worker. While the use of part-time workers rises in proportion to firm size (and the differences are significant), the number of apprentices does not. Microenterprises average one apprentice, small and medium firms just over two (with no significant difference between the latter). Contrary to what might be expected, the medium-sized firms--which involve relatively little family and apprentice labor--are more likely to employ women than the micro and especially the small enterprises (even though a relatively low proportion of medium-sized firms are owned by women).

Medium-scale firms show a greater gain in average employment than the smaller size categories, reaching a peak of 4.5 times their average initial size of 17.6 workers, equivalent to an average growth in employment from start-up to 1991 of 8.6 percent a year. Micro and small enterprises peaked at only 2.0 and 2.8 times their initial employment and grew at an annual average of 7.7 percent and 7.1 percent, respectively. The evidence suggests that there is substantial "graduation" from one size category to another, and that the potential for employment growth rises with firm size.

It is apparent that these firms have been able to grow quite rapidly in terms of employment, whether or not their demand for external finance has been met. Their assets also had doubled in real terms since start-up, on the average. Although microenterprises begin with very small investments, they add to their assets much more rapidly than firms in the larger size categories, more than doubling their equipment in just 6 years (an annual average of 13 percent, compared to about 4 percent for small- and medium-sized firms). This result is surprising in view of the common presumption that growth of microenterprises is constrained by lack of access to finance, and it suggests substantial reinvestment of earnings.

The cost of equipment per job rises sharply with size, from £0.3 million ($770) for microenterprises to £5.9 million ($14,800) for medium-scale firms. Nevertheless, rapid accumulation of assets in microenterprises and growth of employment in medium-sized establishments combine to narrow this gap in labor intensity over time. Furthermore, sales per worker (a rough approximation of productivity) does not differ as strongly with size as might be expected from the differences in capital intensity. Sales per worker (including owners) in microenterprises is about 85 percent that in small-scale firms.2/

Entrepreneurs

Table A2.3 presents the gender, age, training and education of the principal entrepreneur, disaggregated by the age and size of firms. Women constituted 20 percent of the sample,

2/ The microenterprise estimate may be biased upwards more than the others by the inclusion of owners, apprentices, part-time and family workers.
Table A2.3: Entrepreneurs' Characteristics by Size and Age of Firm  
(years: means of responses; percentage of responses)

<table>
<thead>
<tr>
<th></th>
<th>All sample firms:</th>
<th>5-29 workers:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of workers</td>
<td>Age of firm</td>
</tr>
<tr>
<td></td>
<td>Total sample</td>
<td>1-9 Micro</td>
</tr>
<tr>
<td>Gender of owner (%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Female</td>
<td>20.0</td>
<td>22.4</td>
</tr>
<tr>
<td>Male</td>
<td>80.0</td>
<td>77.6</td>
</tr>
<tr>
<td>Age of owner (years)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>42.3</td>
<td>40.3</td>
</tr>
<tr>
<td>At start-up a/</td>
<td>33.9</td>
<td>34.2</td>
</tr>
<tr>
<td>Training (years)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>14.3</td>
<td>14.1</td>
</tr>
<tr>
<td>Apprenticeship</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Prior work experience (years)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee</td>
<td>7.6</td>
<td>8.2</td>
</tr>
<tr>
<td>Manager/owner</td>
<td>4.4</td>
<td>4.2</td>
</tr>
<tr>
<td>Educational level (%)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>None</td>
<td>4.8</td>
<td>2.7</td>
</tr>
<tr>
<td>Primary/middle</td>
<td>27.0</td>
<td>28.8</td>
</tr>
<tr>
<td>Secondary</td>
<td>15.9</td>
<td>11.0</td>
</tr>
<tr>
<td>Technical, polytechnic</td>
<td>30.9</td>
<td>38.4</td>
</tr>
<tr>
<td>University</td>
<td>21.4</td>
<td>17.8</td>
</tr>
</tbody>
</table>

a/ Derived by subtracting current average firm age from entrepreneur's age.

concentrated in textiles and food (88 percent). Although few women had firms with 30 or more workers, they were more or less proportionately distributed among those with 1-9 and 10-29 workers. The average age of the entrepreneur, like that of the firm, rises steadily with firm size (the differences are significant), averaging 42 years. However, the average age of the entrepreneur at the time of starting the current business declines slightly with size and sharply with age of the firm. Hence it appears that young people tend to start with relatively small businesses and (if they survive) "graduate" up the size range as they gain experience.
Entrepreneurs starting new firms today are more than three years older than the average age at start-up of those who began more than six years ago. These three years include an average of two in school and one of prior experience.

The average Ghanaian entrepreneur in the sample had 14 years of formal education, with no significant difference between the different size categories. The type of education, however, differs sharply between sizes: microentrepreneurs are much more likely to have had a technical education (38 percent, as against 23 percent and 7 percent in small and medium enterprises, respectively) and less likely to have gone to the university (18 percent as against 26 percent and 29 percent). New entrepreneurs have significantly more education and are more likely to have completed university (27 percent, as against 16 percent of the older entrepreneurs) or a technical/polytechnic school (38 percent, as against 24 percent) than older ones. In contrast, 45 percent of the entrepreneurs who had owned their business for at least six years have not gone past middle school, as against only 19 percent of the new ones.

Years of education was the variable most significantly correlated with success in enterprise growth as measured by growth of employment over the preceding five years (though not with rising profits over the previous year). Prior experience as an employee or manager has a mixed relationship with performance, depending on size classification and performance measure, and no clear conclusion can be drawn. Years of apprenticeship did not contribute positively to entrepreneurs' probability of success; indeed, among firms with fewer than 10 workers, those with falling employment had an average of 6.2 years of apprenticeship, as against 1.8 years for those with rising employment (who had significantly more education: 13.5 years as against 10.8 years). Years of apprenticeship and prior experience were not significantly related to size of firm or to success.

Constraints to Expansion

Entrepreneurs were asked to indicate the four most serious obstacles that hinder expansion of their business. Table A2.4 summarizes the major groups of constraints aggregated from 43 detailed responses under eight headings: finance, technology/equipment-space, demand, raw materials, labor and management, infrastructure, marketing, and business environment. Firms overwhelmingly (60 percent) viewed finance as their most serious problem. Smaller firms tended to emphasize finance more than larger ones. Controlling for size category (by looking only at firms with 5-29 workers), older firms felt more constrained by lack of finance than newer ones, which in turn were much more constrained by demand.

Other factors cited as the primary constraint on expansion were evenly divided among demand, raw materials, equipment, and other. The smallest firms were relatively more concerned about obsolete equipment, the larger ones with getting raw materials and marketing their products (however, differences in the pattern of responses across the major groups were not statistically significant).
Table A2.4: Major Constraints on Future Expansion by Firm Size
(percentage of responses in each category)

<table>
<thead>
<tr>
<th></th>
<th>Total sample</th>
<th>All sample firms: Number of workers</th>
<th>5-29 workers: Age of firm</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1-9 Micro</td>
<td>10-29 Small</td>
</tr>
<tr>
<td>First ranking</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial</td>
<td>59.5</td>
<td>61.8</td>
<td>57.5</td>
</tr>
<tr>
<td>Demand, marketing</td>
<td>10.7</td>
<td>9.2</td>
<td>12.5</td>
</tr>
<tr>
<td>Raw materials</td>
<td>9.9</td>
<td>9.2</td>
<td>7.5</td>
</tr>
<tr>
<td>Equipment</td>
<td>9.0</td>
<td>11.8</td>
<td>5.0</td>
</tr>
<tr>
<td>Other</td>
<td>10.9</td>
<td>7.9</td>
<td>17.5</td>
</tr>
<tr>
<td>Top 4 responses combined</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financial</td>
<td>47.8</td>
<td>48.3</td>
<td>48.5</td>
</tr>
<tr>
<td>Demand, marketing</td>
<td>10.1</td>
<td>10.6</td>
<td>8.9</td>
</tr>
<tr>
<td>Raw materials</td>
<td>8.2</td>
<td>8.3</td>
<td>6.9</td>
</tr>
<tr>
<td>Other</td>
<td>33.9</td>
<td>32.8</td>
<td>35.6</td>
</tr>
</tbody>
</table>

The detailed responses (not shown) reveal that small firms’ concerns about finance focused on lack of access to credit, rather than on profits being too low to generate internal funds or on high interest rates. Over 43 percent of firms listed credit for working capital or equipment as their primary constraint; only 10 percent were concerned about low profits and none listed interest rates first (even though they were relatively high at the time of the survey). Smaller firms tended to cite lack of access to credit more frequently than larger ones, but it was the dominant constraint in all size categories and for both new and old firms.

Lack of demand was cited much less frequently as a constraint by firms in this survey compared to a more randomly selected sample a year earlier (Steel and Webster 1992), reflecting the bias of the current sample toward firms considered to be successful or to have potential for growth. Only 5 percent mentioned consumers’ lack of money among the top four problems, compared to 35 percent in the previous survey. Although many small enterprises in Ghana may have trouble marketing their goods and services, lack of markets does not appear to be a good reason to deny credit to most of the established firms in the current sample. Not surprisingly, demand tends to be more of a problem for new firms that are still trying to break into the market than for more established ones (in part because older firms with severe demand problems may have exited).
Both the price and the availability of local raw materials ranked among the top ten specific problems facing firms (7 percent each, primarily in the textile and metal subsectors, with no clear pattern by size). Neither the availability nor the price of imported inputs was an important concern, suggesting that the policy of import liberalization with devaluation has benefited SMEs, which were effectively excluded from the previous import licensing system.

Among the combined top four responses, old equipment and lack of adequate workshop space were most frequently mentioned (by 18 percent and 17 percent of respondents, respectively) after access to finance. Thus, one source of strong demand for investment finance evidently is the desire to upgrade machinery and expand the size of the operation. Availability of spare parts did not appear to be an important problem, especially for the smallest firms (in contrast to the early 1980s when tight import controls constrained access to spare parts).

The only other problems listed by more than 5 percent of sample firms were the shortage of skilled labor and the high cost of transport. Very few of the firms felt that the business environment—including regulations and taxes—was an important constraint on their ability to do business (these issues, however, might rank higher for a new investor than for businesses that are already established).

Performance

Firms' performance was measured alternatively by whether they reported an increase in profits during the preceding year and by whether employment had increased in the past five years. (The section on "Ability to Get a Loan in Relation to Firm Performance," p. 95, relates firm performance to their success in obtaining a loan in the last five years).

About 60 percent of the firms in the sample reported increased profits over the previous year, and the same percentage reported employment growth since 1986 (or start-up, if less than 6 years old). These percentages show no consistent overall pattern by size group (Table A2.5). Among firms established since 1986, the share with rising employment declines with increasing firm size, whereas the reverse is the case with the older firms. Employment and profit growth are correlated among enterprises with 5-29 workers: a disproportionate number of those with rising employment also have rising profits, and a relatively high proportion of those with falling employment also have falling profits. In contrast, microenterprises (fewer than 10 workers) do not show a systematic relationship between employment growth and profit growth, perhaps because employment is driven more by excess supply of labor than by demand.

Among firms established by 1980, those with fewer than 10 employees showed relatively higher employment growth both from 1980 to 1986 (8.8 percent per annum) and from 1986 to 1991 (12.3 percent) than did those with 10-29 and more than 30 workers in 1980 (Table A2.5). These smallest firms appear to have benefitted most from the ERP. Employment growth declined among the firms with 10-29 employees in 1980 (from 4.0 percent per annum during 1980-1986 to 1.3 percent during 1986-1991) and recovered only slightly among those with 30 or more (from -0.4 percent to 0.5 percent). (These data do not include entry since 1980).
Table A2.5: Performance by Size Category
(% growth; % of respondents in category)

<table>
<thead>
<tr>
<th>Employment growth a/ (% per annum)</th>
<th>Total sample</th>
<th>1-9 Micro</th>
<th>10-29 Small</th>
<th>30+ Medium</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980-86</td>
<td>1.3</td>
<td>8.8</td>
<td>4.0</td>
<td>-0.4</td>
</tr>
<tr>
<td>1986-91</td>
<td>2.4</td>
<td>12.3</td>
<td>1.3</td>
<td>0.5</td>
</tr>
<tr>
<td>% of firms with rising employment b/</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All firms</td>
<td>59.5</td>
<td>57.9</td>
<td>64.1</td>
<td>56.3</td>
</tr>
<tr>
<td>New (6+ years)</td>
<td>63.8</td>
<td>74.2</td>
<td>59.3</td>
<td>45.5</td>
</tr>
<tr>
<td>Old (&lt;6 years)</td>
<td>54.8</td>
<td>46.7</td>
<td>75.0</td>
<td>80.0</td>
</tr>
<tr>
<td>Profits in last year (% of respondents)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rising</td>
<td>59.7</td>
<td>60.0</td>
<td>63.2</td>
<td>50.0</td>
</tr>
<tr>
<td>Falling/stagnant</td>
<td>40.3</td>
<td>40.0</td>
<td>36.8</td>
<td>50.0</td>
</tr>
</tbody>
</table>

a/ For firms existing in 1980 only, grouped on the basis of 1980 employment. Compound growth rates between end points are calculated for each firm and then weighted by average firm size.

b/ Since start-up for new firms, since 1986 for old firms. Classification is based on 1991 employment.

4. SOURCES OF FINANCE

Studies of small entrepreneurs in Ghana and elsewhere show that they typically obtain their start-up capital from their own savings and that of relatives, sometimes supplemented by short-term credit offered by supplier's and advances from buyers and occasionally by loans (Liedholm and Mead 1987). Neither formal financial institutions nor informal sources such as moneylenders usually play much role in start-ups, although some firms are able to tap into formal financial resources after they have established a successful track record.

Start-up Capital

Firms in our sample conformed to the general pattern. Own savings were the primary source for 67 percent of firms and was among the top three for 81 percent of the firms in the sample (Table A2.6). This source constituted, on average, about 67 percent of the initial capital.
Table A2.6: Sources of Initial Finance by Size and Age of Firm  
(percentage of respondents)

<table>
<thead>
<tr>
<th>PRINCIPAL SOURCE</th>
<th>Total sample</th>
<th>All sample firms: Number of workers</th>
<th>5-29 workers: Age of firm</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1-9 Micro</td>
<td>10-29 Small</td>
</tr>
<tr>
<td>Own savings</td>
<td>67.2</td>
<td>70.7</td>
<td>66.7</td>
</tr>
<tr>
<td>Pension</td>
<td>3.1</td>
<td>5.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Gifts, relations</td>
<td>7.8</td>
<td>10.7</td>
<td>5.1</td>
</tr>
<tr>
<td>Loans, relations</td>
<td>4.7</td>
<td>4.0</td>
<td>7.7</td>
</tr>
<tr>
<td>Co-investor</td>
<td>3.9</td>
<td>0.0</td>
<td>7.7</td>
</tr>
<tr>
<td>Bank loan</td>
<td>4.7</td>
<td>1.3</td>
<td>5.1</td>
</tr>
<tr>
<td>Insurance co.</td>
<td>0.8</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Supplier's credit</td>
<td>0.8</td>
<td>0.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Customers advances</td>
<td>0.8</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>PAMSCAD</td>
<td>1.6</td>
<td>2.7</td>
<td>0.0</td>
</tr>
<tr>
<td>Other GEDC</td>
<td>0.8</td>
<td>1.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Moneylender</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>3.8</td>
<td>4.0</td>
<td>5.1</td>
</tr>
<tr>
<td><strong>TOP THREE SOURCES (cumulative)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own savings</td>
<td>81.3</td>
<td>81.3</td>
<td>79.5</td>
</tr>
<tr>
<td>Pension</td>
<td>9.4</td>
<td>12.0</td>
<td>7.7</td>
</tr>
<tr>
<td>Gifts, relations</td>
<td>18.0</td>
<td>21.3</td>
<td>17.9</td>
</tr>
<tr>
<td>Loans, relations</td>
<td>13.3</td>
<td>12.0</td>
<td>12.8</td>
</tr>
<tr>
<td>Co-investor</td>
<td>7.8</td>
<td>2.7</td>
<td>15.4</td>
</tr>
<tr>
<td>Bank loan</td>
<td>10.2</td>
<td>8.0</td>
<td>7.7</td>
</tr>
<tr>
<td>Insurance co.</td>
<td>0.8</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Overdraft</td>
<td>0.8</td>
<td>1.3</td>
<td>-</td>
</tr>
<tr>
<td>Suppliers credit</td>
<td>10.2</td>
<td>5.3</td>
<td>15.4</td>
</tr>
<tr>
<td>Customer advances</td>
<td>2.3</td>
<td>2.7</td>
<td>-</td>
</tr>
<tr>
<td>PAMSCAD</td>
<td>5.5</td>
<td>8.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Other GEDC</td>
<td>1.6</td>
<td>2.7</td>
<td>-</td>
</tr>
<tr>
<td>Moneylender</td>
<td>0.8</td>
<td>1.3</td>
<td>-</td>
</tr>
<tr>
<td>Other</td>
<td>7.0</td>
<td>9.3</td>
<td>5.1</td>
</tr>
</tbody>
</table>

(Number of firms)                  | (128)        | (75)      | (39)        | (14)       | (37)    | (54)    |
Own savings were used heavily by firms of all sizes. Smaller firms were significantly more dependent on own savings as the principal source of finance: the share of initial capital from own savings declined steadily from 74 percent for micro enterprises to 52 percent for medium size firms, averaging 67 percent for the sample. For most small investors, relatives were the main alternative to own savings. Over 12 percent of sample firms were established primarily from relatives' and friends' gifts and loans (it is often hard to distinguish between them). However, firms based primarily on relatives' savings were unlikely to be very big; none of the medium-size firms received their principal funding from this source (although 21 percent received at least some assistance from a relative).

Firms with 30 or more workers were more likely to have had access to formal external finance. Banks and insurance companies were the primary source for over 28 percent of medium-size firms, whereas no more than 8 percent of the smaller firms had bank loans as part of their initial finance. Firms with at least 10 workers were also much more likely to have had funding from a co-investor. Thus, access to external finance at the time of start-up is associated with larger size at the time of the survey.

The greater access of larger firms to formal finance was only partially offset by government programs such as PAMSCAD and GEDC. Despite the bias of the sample toward clients of these programs, only 4 percent of microenterprises obtained the bulk of their initial finance from them. An additional 5 percent used pension payments (for example, from being "retrenched") to start their business.

The use of supplier's credit was a positive function of size. Only 5.3 percent of micro firms, compared with 15.4 percent and 21.4 percent of small and medium scale firms, made any use of this form of finance (but virtually none as the primary source). Conversely, small firms were more likely to have used informal sources of finance, although these were not very important in initial finance.

New firms differed little from old ones in their heavy reliance on own savings for initial finance. Older firms were somewhat more likely to have been established through gifts from relations. The main difference was in the availability of pension, PAMSCAD and GEDC funds (associated with the structural adjustment program), which provided the primary source of finance for 9 percent of the firms started since 1986 but less than 2 percent of those previously established. These programs have evidently played some compensatory role in facilitating the creation of additional microenterprises, although the vast majority of small investors manage to get started without them. (PAMSCAD has played a somewhat larger role in helping micro and small enterprises obtain additional equipment).

While there was no consistent relationship between access to loans from banks or PAMSCAD for start-up and subsequent growth of employment, firms that obtained supplier's credit were much more likely to have grown (Table A2.7). (This result did not carry over, however, into rising profits at the time of the survey). Growing firms were also more likely to have had financial support from relatives.
Table A2.7: Initial Sources of Finance, by Profit and Employment Class
(percentage of firms in each category listing response among top 3)

<table>
<thead>
<tr>
<th>Source</th>
<th>Total sample</th>
<th>Rising profit</th>
<th>Falling profit</th>
<th>Rising employment</th>
<th>Falling employment</th>
<th>Rising employment</th>
<th>Falling employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own savings</td>
<td>81.3</td>
<td>82.9</td>
<td>80.5</td>
<td>87.9</td>
<td>80.0</td>
<td>82.4</td>
<td>79.2</td>
</tr>
<tr>
<td>Gifts, relations</td>
<td>18.0</td>
<td>21.4</td>
<td>17.1</td>
<td>30.2</td>
<td>20.0</td>
<td>23.5</td>
<td>12.5</td>
</tr>
<tr>
<td>Pension</td>
<td>9.4</td>
<td>11.4</td>
<td>7.3</td>
<td>6.1</td>
<td>3.6</td>
<td>11.8</td>
<td>-</td>
</tr>
<tr>
<td>Loans, relations</td>
<td>13.3</td>
<td>11.4</td>
<td>9.8</td>
<td>18.2</td>
<td>3.6</td>
<td>5.9</td>
<td>8.3</td>
</tr>
<tr>
<td>Co-investor</td>
<td>7.8</td>
<td>5.7</td>
<td>9.8</td>
<td>-</td>
<td>-</td>
<td>17.6</td>
<td>16.7</td>
</tr>
<tr>
<td>Bank loan</td>
<td>10.2</td>
<td>8.6</td>
<td>12.2</td>
<td>3.0</td>
<td>3.6</td>
<td>11.8</td>
<td>8.3</td>
</tr>
<tr>
<td>Supplier's credit</td>
<td>10.2</td>
<td>5.7</td>
<td>17.1</td>
<td>21.2</td>
<td>-</td>
<td>23.5</td>
<td>12.5</td>
</tr>
<tr>
<td>PAMSCAD/GEDC</td>
<td>5.5</td>
<td>7.1</td>
<td>-</td>
<td>3.0</td>
<td>3.6</td>
<td>-</td>
<td>4.2</td>
</tr>
<tr>
<td>Other</td>
<td>7.0</td>
<td>11.4</td>
<td>-</td>
<td>6.1</td>
<td>20.0</td>
<td>11.8</td>
<td>-</td>
</tr>
</tbody>
</table>

Sources of Owners' Savings

Given the importance of owners' savings for the start-up of SMEs, they were asked for the source of this capital. The principal sources were profits obtained from other businesses (45.4 percent) and income from local employment (25.9 percent). Salary from abroad, pensions, and income obtained from travel abroad were additional, though much less important, sources.

More than half of the small- and medium-scale firms (56 percent and 54 percent, respectively) obtained their investment funds from profits from other businesses, while only 38 percent of the microenterprises obtained their funds from this source (Table A2.8). This suggests that "graduation" may occur when successful entrepreneurs invest profits from one business in a new, larger business, not just through gradual expansion of the original business. The fact that over half of the entrepreneurs in small- and medium-scale businesses had already accumulated profits from other businesses may also account for their greater access to formal finance; that is, they are more likely to have a business track record than new microentrepreneurs.

Correspondingly, microenterprises were much more likely (33 percent) than larger firms to be an outlet for savings from the local salaries of their owners—that is, to represent their initial foray into business for themselves. However, local employment has declined sharply as
Table A2.8: Principal Source of Owner’s Savings, by Size and Age of Firm
(percentage of respondents)

<table>
<thead>
<tr>
<th>Source</th>
<th>Total sample</th>
<th>All sample firms: Number of workers</th>
<th>5-29 workers: Age of firm</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1-9 Micro</td>
<td>10-29 Small</td>
</tr>
<tr>
<td>Profits from other business</td>
<td>45.4</td>
<td>37.7</td>
<td>55.9</td>
</tr>
<tr>
<td>Salary from local employment</td>
<td>25.9</td>
<td>32.8</td>
<td>14.7</td>
</tr>
<tr>
<td>Pension</td>
<td>6.5</td>
<td>6.6</td>
<td>5.9</td>
</tr>
<tr>
<td>Salary from abroad</td>
<td>6.5</td>
<td>8.2</td>
<td>2.9</td>
</tr>
<tr>
<td>Travel abroad</td>
<td>4.6</td>
<td>3.3</td>
<td>8.8</td>
</tr>
<tr>
<td>Inheritance</td>
<td>1.9</td>
<td>1.6</td>
<td>2.9</td>
</tr>
<tr>
<td>Other</td>
<td>8.3</td>
<td>8.2</td>
<td>8.8</td>
</tr>
<tr>
<td>Share of capital from own savings</td>
<td>66.7</td>
<td>74.0</td>
<td>60.4</td>
</tr>
</tbody>
</table>

the principal source of start-up capital, from 34 percent for older firms to 12 percent for newer ones, reflecting the decline in real wages. A much larger share (17 percent) of newer investors obtained their savings abroad than previously (6 percent). This suggests that making it easy for Ghanaians abroad to repatriate their earnings could help stimulate small business investment. Metal products were especially popular with new investors bringing money from salary and travel abroad (33 percent combined) and investing pension money (33 percent).

Methods of Accumulating Capital

Although small entrepreneurs are often thought to be reluctant to deal with banks, 74 percent of respondents said that they accumulated their investment funds in banks—the primary method for 67 percent. Although medium-size firms had a slightly higher propensity to rely on banks, the percentages for microenterprises were virtually the same as the overall average, indicating a surprisingly high receptivity to banks on the part of the smaller entrepreneurs (Table A2.9). New firms were somewhat more likely than old ones to have relied on banks to accumulate capital, especially as the primary source and especially in the metal products subsector.

An average of 13 percent of firms accumulated their savings at home, with no clear pattern by size of firm. Another 9 percent preferred to make periodic purchases of machinery
Table A2.9: Methods of Accumulating Savings
(percentage of respondents)

<table>
<thead>
<tr>
<th></th>
<th>All sample firms: Number of workers</th>
<th>5-29 workers: Age of firm</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total sample</td>
<td>1-9 Micro</td>
</tr>
<tr>
<td>At home</td>
<td>13.0</td>
<td>11.5</td>
</tr>
<tr>
<td>Bank</td>
<td>74.0</td>
<td>73.8</td>
</tr>
<tr>
<td>Periodic purchase</td>
<td>9.3</td>
<td>9.8</td>
</tr>
<tr>
<td>Susu</td>
<td>3.7</td>
<td>6.6</td>
</tr>
<tr>
<td>Other</td>
<td>13.9</td>
<td>13.1</td>
</tr>
<tr>
<td>(Number of firms)</td>
<td>(108)</td>
<td>(61)</td>
</tr>
</tbody>
</table>

Note: Column totals add to more than 100 percent because firms could list up to three methods.

(sometimes on supplier’s credits) rather than accumulate financial savings—a reasonable strategy in a highly inflationary period.

Old microenterprises were the only ones to accumulate funds through the susu system, and even among them only 7 percent did so. Saving through susu collectors is not a significant method of saving either for the initial investment or to purchase additional equipment.

More than half of the firm owners (57 percent) reported that they accumulate funds specifically for the eventual purchase of equipment. Despite their reported heavy use of banks to accumulate their initial investment, over 90 percent of those who saved to purchase additional equipment said that they did so at home—apparently because they considered the amounts to be too small and deposit rates too low to justify the high transaction cost in terms of time to do business with a bank.

Sources of Working Capital

SME firms in this sample were typical in complaining about inadequate working capital to utilize their capacity fully. Table A2.10 gives the actual sources of financing of working capital in the last 3-5 years by size of firm and compares them to prospective sources that owners might seek to meet a large order.

Internal finance is the most important source of working capital for almost all the firms, including retained profits (used by 70 percent of firms) and own savings (26 percent). External
Table A2.10: Major Sources of Actual and Additional Working Capital  
(percentage of respondents listing item among top three)

<table>
<thead>
<tr>
<th></th>
<th>Total sample</th>
<th>Number of workers</th>
<th>Employment last 5 years of sample</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1-9 Micro</td>
<td>10-29 Small</td>
</tr>
<tr>
<td><strong>Last 3-5 years</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own savings</td>
<td>26.0</td>
<td>27.9</td>
<td>25.6</td>
</tr>
<tr>
<td>Retained profits</td>
<td>69.9</td>
<td>66.2</td>
<td>76.9</td>
</tr>
<tr>
<td>Bank loans</td>
<td>9.8</td>
<td>2.9</td>
<td>15.4</td>
</tr>
<tr>
<td>Overdraft</td>
<td>16.3</td>
<td>14.7</td>
<td>15.4</td>
</tr>
<tr>
<td>Supplier's credit</td>
<td>14.6</td>
<td>14.7</td>
<td>15.4</td>
</tr>
<tr>
<td>Advances</td>
<td>28.5</td>
<td>27.9</td>
<td>33.3</td>
</tr>
<tr>
<td>PAMSCAD</td>
<td>10.6</td>
<td>13.2</td>
<td>7.7</td>
</tr>
<tr>
<td><strong>For large order</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own savings</td>
<td>21.1</td>
<td>25.4</td>
<td>22.4</td>
</tr>
<tr>
<td>Retained profits</td>
<td>42.2</td>
<td>42.3</td>
<td>40.0</td>
</tr>
<tr>
<td>Loans from relations</td>
<td>14.8</td>
<td>19.7</td>
<td>12.5</td>
</tr>
<tr>
<td>Bank loans</td>
<td>25.0</td>
<td>29.6</td>
<td>15.0</td>
</tr>
<tr>
<td>Overdraft</td>
<td>13.3</td>
<td>9.9</td>
<td>12.5</td>
</tr>
<tr>
<td>Supplier's credit</td>
<td>21.9</td>
<td>19.7</td>
<td>20.0</td>
</tr>
<tr>
<td>Advances</td>
<td>51.6</td>
<td>42.3</td>
<td>70.0</td>
</tr>
<tr>
<td>PAMSCAD</td>
<td>9.4</td>
<td>11.3</td>
<td>10.0</td>
</tr>
<tr>
<td><strong>Number of respondents</strong></td>
<td>(128)</td>
<td>(71)</td>
<td>(40)</td>
</tr>
</tbody>
</table>

\(a/\) Firms with 5-29 workers only, based on 1986 employment.

**Note:** Responses cited by fewer than 10 percent of all firms are not shown.

Finance consists mainly of advances from customers (29 percent), overdrafts (16 percent) and supplier's credit (15 percent). The principal differences from the pattern of initial finance are the large role of retained earnings (substituting for personal savings from other activities), the absence of funds from relatives, and the contribution of customers’ advances and bank overdrafts.
to working capital. Apart from retained profits, newer firms remained more dependent on their own savings for working capital, whereas older firms were better able to obtain overdrafts.

As in the case of initial finance, access to bank loans rises markedly with size, from 3 percent of microenterprises to 25 percent of medium-sized firms. There is somewhat less difference, however, in overdrafts; 15 percent of both micro and small firms have had overdrafts, as against 25 percent of medium firms. Banks may be more amenable to providing working capital—typically for a shorter term—than investment finance to smaller enterprises. Metal products firms were especially likely to have had access to bank finance for working capital (43 percent). Trade credit in the form of customers’ advances and, to a lesser extent, supplier’s credit, is also a source of working capital for 29 percent and 15 percent of firms, respectively. Advances are more important for firms with fewer than 30 workers than those with more.

Firms were asked to indicate the potential sources of working capital to finance additional raw materials needed to meet a large order. In this situation, most SMEs (52 percent) would rely heavily on advances from customers (27 percent as the principal source, 52 percent to at least some extent), followed by retained profits (19 percent principal source, 42 percent overall). With an order in hand, 38 percent of the firms expected to be able to obtain a bank loan or overdraft (19 percent as the primary source)—much higher than the 26 percent presently able to obtain such working capital. Microenterprises were perhaps excessively optimistic in this respect, with 40 percent expecting to be able to get a loan for additional working capital (as against 18 percent at present). Firms with fewer than 30 workers expected to turn to relatives and to use their own savings from other activities to finance a large order, whereas medium-sized firms did not expect to use any personal finance.

**Financing Additional Fixed Investment**

The pattern of financing additional fixed investment over the last 3-5 years is very similar to that for working capital, except for the absence of overdrafts. Internal finance dominates all size categories, especially retained profits (the principal source of additional investment for 45 percent of the firms). The use of own savings declines as firm size increases, while the use of bank loans rises sharply (from 2 percent of microenterprises to 33 percent of medium scale firms, in the aggregated responses). Firms with fewer than 30 workers have sought more diversified sources of investment, making use of PAMSCAD, advances, supplier’s credit, and other sources (none of which were used by medium-scale firms).

Food processing firms have had to rely relatively more on savings from other activities and less on retained earnings than other subsectors as the principal source of finance for additional investment. This suggests relatively low profitability in the food subsector, whereas a high proportion of metal products firms (74 percent) were able to use retained profits, indicating high profitability. PAMSCAD loans have been particularly important for textile firms and new wood products firms.
5. DEMAND FOR FINANCE

The low use of bank loans to finance the initial investment of small firms may reflect their reluctance to seek formal credit, their lack of creditworthiness, or the reluctance of banks to provide term loans to small clients. These explanations are mutually reinforcing and difficult to separate: poor performance by small borrowers may prejudice banks against small applicants; and a negative attitude by banks may discourage SMEs from even applying.

While the most dynamic SMEs in Ghana have financed their creation, operation and growth to date principally from internal sources, they have actively sought additional external finance. To test the strength of their demand, firms were asked how useful a credit at 30 percent interest (the upper end of bank lending rates at the time) would be to them for new investment and for working capital. Overall, 41 percent of the firms would find this credit "very useful" and 21 percent "moderately useful" for new investment. Differences between size classes were not significant. For working capital, an even higher proportion—50 percent overall, 60 percent in the small category—of the firms would find this type of loan "very useful." Demand is somewhat weaker among the medium firms, about half of which would not find credit at 30 percent interest useful. More older than newer firms would find the credit useful for working capital.

Analysis of firms' perceptions of their constraints reinforces the interpretation that their demand for finance is related to growth and normal business operation, rather than simply to liquidity problems. About 47 percent of both the groups of firms with 5-29 workers and with fewer than 10 workers cited lack of access to finance for working capital or expansion as their primary operational constraint, but no more than 10 percent complained that profits were unduly low. A large share of firms with declining employment also mentioned obsolete equipment or inadequate space as constraints, indicating that they might be seeking finance to update their equipment and workshops.

Credit for new investment was more strongly desired by new firms in the food and metal subsectors (67-71 percent "very useful") than in textiles and wood products (60-67 percent "not useful"). Demand for credit for working capital followed a similar pattern across subsectors to that for investment, although with less variation. About 57-60 percent of firms in the metal and food subsectors would view credit at 30 percent for working capital as "very useful," while 27-33 percent of textile and wood firms would not find it useful.

To test whether SMEs' expressed desire for external financing had been translated into effective demand, the study team asked if they had actively sought credit. This section analyses past attempts by sample firms to obtain formal and informal finance in relation to firm performance; differences in characteristics of finance obtained; and the characteristics of the financial arrangements desired by firms. As before, the results are analyzed by size group and age to test for differences in the nature of demand. It was expected that success in obtaining a loan would be positively associated with growth (as a criterion of repayment ability), size
(whether because of discriminatory practices or because of lower risks and transaction costs), and age (because older firms can provide more reliable information and fixed assets as collateral).

**Past Attempts to Obtain Formal Finance**

Two-thirds of sample firms had applied for a bank loan at least once, rising from 60 percent of microenterprises to 87 percent of medium-scale firms (Table A2.11; 4 percent of applications were for a previous business or personal use). On average, firms had applied more than twice, with a 1.7 to 1 ratio of rejections to success. These results indicate a strong demand for bank credit and a greater willingness than might be thought of SMEs to deal with loan application procedures.

### Table A2.11: Bank Loan Application and Success Rates

<table>
<thead>
<tr>
<th>Percentage share of respondents that:</th>
<th>Total sample</th>
<th>All sample firms: Number of workers</th>
<th>5-29 workers: Age of firm</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1-9 Micro</td>
<td>10-29 Small</td>
</tr>
<tr>
<td>Applied for loan</td>
<td>67.0</td>
<td>59.7</td>
<td>71.8</td>
</tr>
<tr>
<td>Enquired but discouraged</td>
<td>16.5</td>
<td>18.1</td>
<td>17.9</td>
</tr>
<tr>
<td>Never applied</td>
<td>16.5</td>
<td>22.2</td>
<td>10.3</td>
</tr>
<tr>
<td>No. of applications for</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank loans g/</td>
<td>2.60</td>
<td>1.72</td>
<td>2.82</td>
</tr>
<tr>
<td>Number successful</td>
<td>0.96</td>
<td>0.58</td>
<td>1.27</td>
</tr>
<tr>
<td>Number of failures before one</td>
<td>1.67</td>
<td>2.79</td>
<td>1.00</td>
</tr>
<tr>
<td>successful</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Success ratios:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percent of applications</td>
<td>44.4</td>
<td>33.7</td>
<td>45.0</td>
</tr>
<tr>
<td>Percent of firms applying who got</td>
<td>44.4</td>
<td>50.0</td>
<td>30.0</td>
</tr>
<tr>
<td>Profits rising (percent of firms)</td>
<td>59.7</td>
<td>60.0</td>
<td>63.2</td>
</tr>
</tbody>
</table>

\* Among those applying. Details do not add to totals because of differences in number of respondents (only firms who had received a loan specified the number of prior failures).
The share who had ever applied for a loan rises steadily with size from 60 percent of those with fewer than 10 workers to 87 percent of those with 30 or more. Thus, demand for bank loans is positively related to firm size.

Part of the size differential in application rates is accounted for by banks' negative attitude toward smaller clients. About 18 percent of the micro and small firms who enquired about the possibilities of obtaining loans were discouraged from doing so, but only 6 percent of the medium-sized firms. In this context, it is to be expected that a higher percentage of microenterprises (22 percent) than medium-sized firms (6 percent) had never sought a loan. Still, it is surprising that only 17 percent of the sample had never sought a loan.

Microenterprises averaged the fewest reported number of applications (1.72), small firms the most (2.82), with medium firms in between (2.07). The number of successful applications is positively related to size (statistically significant), as is the success rate. The number of unsuccessful attempts that have to be made before obtaining a loan declines sharply with increasing size. Microenterprises that obtained a loan were especially persistent after an initial rejection, averaging 2.79 unsuccessful applications, while medium-sized firms succeeded almost on the first attempt.

Intended Use of Loan

Over half of recent applications for bank loans by firms in all size categories were intended for working capital, either exclusively (especially the larger firms) or in combination with investment (especially microenterprises; Table A2.12). Over a third of sample firms had applied for loans to expand their capacity. Only microenterprises had applied for start-up capital, most likely associated with PAMSCAD.

<table>
<thead>
<tr>
<th>Intended use of funds</th>
<th>Total sample</th>
<th>(1-9) Micro</th>
<th>(10-29) Small</th>
<th>(30+) Medium</th>
<th>Rising</th>
<th>Falling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working capital:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alone</td>
<td>44.2</td>
<td>38.1</td>
<td>48.3</td>
<td>53.3</td>
<td>43.8</td>
<td>53.3</td>
</tr>
<tr>
<td>With investment</td>
<td>9.3</td>
<td>14.3</td>
<td>3.4</td>
<td>6.7</td>
<td>6.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Investment:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>To start business</td>
<td>8.1</td>
<td>16.7</td>
<td>0.0</td>
<td>0.0</td>
<td>6.3</td>
<td>6.7</td>
</tr>
<tr>
<td>To expand business</td>
<td>36.0</td>
<td>31.0</td>
<td>41.4</td>
<td>40.0</td>
<td>43.8</td>
<td>40.0</td>
</tr>
<tr>
<td>Other</td>
<td>2.3</td>
<td>0.0</td>
<td>6.9</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

\(a/\) Firms with 5-29 workers only, based on 1986 employment.
Although applicants with 30 or more workers were most likely to have received a loan (63 percent), as might be expected, a surprisingly high 50 percent of microenterprises also had received at least one loan. This high success rate is due in part to the PAMSCAD program, whose loans are administered by a commercial bank; half of the microenterprises with loans were PAMSCAD clients. Without the PAMSCAD loans, the success rate of both micro and small enterprises would have been less than half that of the larger firms, despite their slightly better average performance in terms of profit and employment growth. Thus, there is some indication that access to bank loans is more closely related to size than to criteria such as growth (or owner's education)—but that access can be broadened through special programs.

**Ability to Get a Loan in Relation to Firm Performance**

Although older firms were more likely to have applied for a bank loan, a smaller proportion (39 percent) of those who applied received loans than did new-firm applicants (47 percent); the latter were also more likely to have rising profits (Table A2.11). However, new firms had to be extremely persistent, making an average of three applications before being granted a loan.

The overall success rate (44 percent) is unexpectedly high in view of the common complaints about the SMEs' difficulty in obtaining loans. Furthermore, 64 percent of those responding reported receiving at least one loan, and 44 percent received no rejections. If the high rate of success reflects the bias of the sample toward firms considered to have good potential for expansion, then the results suggest that these firms, at least, do have a reasonable chance of obtaining credit (if not directly from a bank, then through a program such as PAMSCAD). For small firms, the principal reason for rejection was lack of collateral (about half of firms under 30 workers that did not receive loans). No firms in the sample were told that their planned project was unsatisfactory or that they lacked adequate experience.

To further analyze the relationship between profit and employment performance and firm characteristics while controlling for size, firms were classified as "micro" (1-9 workers) or "small" (5-29 workers) on the basis of their employment in 1986 or at subsequent start-up. Table A2.13 indicates little consistent correlation between performance and whether a firm obtained a loan. Although a significantly higher proportion of microenterprises with rising profits received a loan (34 percent) than those with falling or stagnant profits (14 percent), there is no significant difference for small enterprises with profits rising as opposed to falling (36 percent versus 35 percent). Furthermore, microenterprises with falling employment were more likely to have received a loan (32 percent) than those with rising employment (25 percent)—perhaps because of the influence of PAMSCAD lending. (Differences in loan success rates for firms with rising and falling employment are not significant for either micro or small enterprises).

On the other hand, a significantly higher proportion of the loan applications coming from growing firms were accepted, and they received significantly larger amounts than firms with declining employment. Furthermore, 46 percent of the declining-employment firms said
Table A2.13: Share of Firms Receiving Bank Loan since 1986
(percent of respondents in each category)

<table>
<thead>
<tr>
<th>Size</th>
<th>Employment</th>
<th>Profits in last year</th>
<th>Age categories</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rising</td>
<td>Falling</td>
<td>Rising</td>
</tr>
<tr>
<td>Micro (1 - 9)</td>
<td>25.0</td>
<td>32.1</td>
<td>34.0*</td>
</tr>
<tr>
<td>Small (5 - 29)</td>
<td>42.1</td>
<td>32.0</td>
<td>36.4</td>
</tr>
</tbody>
</table>

* Significantly different at the 0.05 level.

a/ Out of 14 micro enterprises (based on 1986 employment data) reporting a loan since 1986, 5 had PAMSCAD, 2 had both PAMSCAD and bank loan or overdraft, and 5 had a bank loan or overdraft.

their loans were rejected for lack of collateral but only 18 percent of rising-employment firms said so—suggesting that banks may have used collateral as an excuse to turn down firms with weak performance.

Loan success appears more closely related to the age of the enterprise. No new (since 1986) enterprises with 5-29 workers had received a loan by 1991, whereas 48 percent of pre-existing firms had (the difference is significant). Likewise, a higher proportion of established firms with fewer than 10 workers (31 percent) than new ones (25 percent) had received loans; although this difference is not significant, the latter figure is biased upwards by the high participation of sample firms in PAMSCAD.

There is no discernible relation between loan success rates and profit growth at the subsector level. Indeed, new food processing firms (with the highest rate of profitability) had the lowest success rate, while the old ones (with the worst profit record) had the highest.

When firms’ bank loan applications were rejected, 58 percent made further attempts to borrow from other sources. For firms with fewer than 30 workers, relatives were the most important alternative source of finance (64.3 percent of microenterprises and 30.8 percent of small firms). They also were more likely to turn to a savings and loan association or an equity partner than medium-sized firms, who (somewhat surprisingly) were much more likely to turn to a money lender than were smaller firms (50 percent had considered a money lender; only 14 percent of firms with fewer than 30 workers did so).

Characteristics of Actual and Desired Bank Loans

Firms with rising employment were more interested in credit for new investment than those in decline, as might be expected. Among firms with 5-29 workers as of 1986, 58 percent of those with rising employment viewed an investment loan at 30 percent interest as "very
useful", as against only 24 percent of those with declining employment. Declining small enterprises were much more interested in finance for working capital—probably to ease liquidity problems of poor cash flow—although among firms with fewer than 10 workers, the growing firms had a relatively stronger demand for working capital finance (over half would find it "very useful" to have such a loan at 30 percent interest).

**Amount**

Smaller firms might be expected to apply for a smaller share of their financial requirements than larger firms, given smaller firms’ greater dependence on their own savings. Indeed, the loan amount applied for by the micro firms constituted only 49 percent of the desired amount of investment, as against 64 percent for small and 90 percent for the medium firms (main report Table 4.1). In the end, loans actually received accounted for similar proportion of actual investment (ranging from 43 percent for microenterprises to 100 percent for medium). However, smaller firms had to make a considerable downward adjustment in the size of their intended investment. Microenterprises received only 3 percent of the amount applied for and small firms 38 percent, while medium-sized firms received 54.5 percent. (It may be, of course, that the loan applications were considerably inflated compared to realistic requirements or ability to pay).

**Loan Terms**

Banks do not charge higher interest rates to smaller firms; the average interest rate (2 percent a month) rose slightly with firm size, but the differences were not significant. Firms generally thought that loan rates should be about 5 percent below the prevailing rates, although most were in fact willing to pay higher rates if necessary to obtain access to credit.

The average maturity rose with firm size from 13 months for microenterprises to 48 months for medium-sized firms (Table A2.14). These differences reflect bank policies, as they are far below the maturities that firms desire (about half, on the average). Newer firms were more willing to accept shorter maturities than older ones (although the difference is not significant). Only 26 percent and 15 percent of the micro and small firms, respectively, indicated that they were able to bargain with the banks in determining loan maturity.

Most firms with fewer than 30 workers prefer to repay loans monthly, whereas larger firms are more likely to seek quarterly payments. Overall, 57 percent would like monthly interest payments and 32 percent would like quarterly payments.

**Collateral**

Since banks evidently are reluctant to vary interest rates to cover differential risks, they must seek other methods to offset risk. The most common approach is to require collateral, both as an incentive to repay and to offset losses in case of default. Collateral was required of nearly
three-quarters of the sample firms that received loans, rising from 59 percent of microenterprises to 100 percent of medium-scale firms (Table A2.15). The lower rate for microenterprises reflects the reality that owners of smaller firms are less likely to have property suitable for collateral.

Only a quarter of respondents said that they had no property they could use as collateral, with the share falling sharply as firm size increases from 37 percent of microenterprises to 6 percent of medium-sized firms. In all size categories, a house was the form of property most commonly available (banks, however, were more likely to prefer farmland). Older firms tended to have an advantage over newer ones; a larger percentage had some form of property. Of course, problems with proving clear title to the property may diminish the usefulness of some of it as legal security. On the other hand, few banks really wanted to go through the costly, time-consuming process of actually seizing property through the legal system; rather, they expected that the threat of losing property would be sufficient to force most defaulters to find some means to pay.

SME owners without landed property were most likely to suggest equipment as an alternative form of security (63 percent), followed by guarantors with bank accounts (13 percent) and personal guarantors (13 percent). Microenterprises showed a roughly similar pattern, while some small firms suggested using savings accounts as collateral. Medium-scale firms without landed property offered little recourse for collateral other than their equipment.

### Table A2.14: Characteristics of Actual and Desired Finance by Size and Age

<table>
<thead>
<tr>
<th>Loan term</th>
<th>All sample firms:</th>
<th>5-29 workers:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total sample</td>
<td>Number of workers</td>
</tr>
<tr>
<td></td>
<td>Micro</td>
<td>Small</td>
</tr>
<tr>
<td>Interest (percent per year)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual</td>
<td>24.6</td>
<td>24.2</td>
</tr>
<tr>
<td>Desired</td>
<td>19.5</td>
<td>19.7</td>
</tr>
<tr>
<td>Maturity (months)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Actual</td>
<td>22.2</td>
<td>12.8</td>
</tr>
<tr>
<td>Desired</td>
<td>45.2</td>
<td>40.7</td>
</tr>
</tbody>
</table>


Table A2.15: Types of Collateral Requested, Provided and Available

<table>
<thead>
<tr>
<th>Type of collateral</th>
<th>Total sample</th>
<th>All sample firms:</th>
<th>5-29 workers:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Number of workers</td>
<td>Age of firm</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Micro 1-9</td>
<td>Small 10-29</td>
</tr>
<tr>
<td>Requested by banks:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Landed property</td>
<td>69.8</td>
<td>59.3</td>
<td>73.9</td>
</tr>
<tr>
<td>Bank savings</td>
<td>3.2</td>
<td>7.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Other physical assets</td>
<td>9.5</td>
<td>3.7</td>
<td>13.0</td>
</tr>
<tr>
<td>Guarantor</td>
<td>12.7</td>
<td>25.9</td>
<td>4.3</td>
</tr>
<tr>
<td>Other</td>
<td>4.8</td>
<td>3.7</td>
<td>8.7</td>
</tr>
<tr>
<td>Type of borrowers provided:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Farmland</td>
<td>60.4</td>
<td>31.8</td>
<td>73.7</td>
</tr>
<tr>
<td>Other landed property</td>
<td>11.3</td>
<td>13.6</td>
<td>10.5</td>
</tr>
<tr>
<td>Bank savings</td>
<td>7.5</td>
<td>13.6</td>
<td>5.3</td>
</tr>
<tr>
<td>Guarantor</td>
<td>13.2</td>
<td>27.3</td>
<td>5.3</td>
</tr>
<tr>
<td>Other</td>
<td>7.5</td>
<td>13.6</td>
<td>5.3</td>
</tr>
<tr>
<td>Property available as collateral:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>None</td>
<td>26.2</td>
<td>37.0</td>
<td>15.0</td>
</tr>
<tr>
<td>House</td>
<td>43.1</td>
<td>34.2</td>
<td>55.0</td>
</tr>
<tr>
<td>Farmland</td>
<td>13.1</td>
<td>12.3</td>
<td>10.0</td>
</tr>
<tr>
<td>Other property</td>
<td>17.7</td>
<td>16.4</td>
<td>20.0</td>
</tr>
</tbody>
</table>

**Repayment**

A large share of the firms (59 percent) were unable to repay the loans granted by the banks on time. Small firms had the highest arrears rate (68 percent) compared with 52 percent of micro firms and 56 percent of medium firms. A common reason given for inability to pay on time was an unanticipated marketing problem or change in demand. For instance, a batik producer had trouble repaying a bank loan when that type of material suddenly went out of fashion. In some cases, the grace period and repayment schedule were too short relative to the time required to order and import a machine and put it into operation. In one case, the poor quality of the product caused orders to be rejected and the borrower was unable to repay.
Characteristics of Informal Finance

Only 8.1 percent of the sample had actually applied for credit from a moneylender and 2.5 percent from a susu operator (Table A2.16). Larger, older firms were more likely to use moneylenders and smaller ones susu operators. Whereas less than 8 percent of firms under 30 workers had dealt with moneylenders, 12.5 percent of medium-sized firms had (but none with susu operators). This may be because only moneylenders (who typically have their own businesses) can quickly provide the substantial sums of money for a short period that medium-sized firms may need urgently, for example to clear goods from the port. In such cases, the moneylender provides a service of immediate finance that banks are not able to meet (for which the client is willing to pay a high rate).

Table A2.16: Characteristics of Informal Finance

<table>
<thead>
<tr>
<th></th>
<th>Total sample</th>
<th>Size categories</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1-9</td>
<td>10-29</td>
<td>30+</td>
<td>New</td>
<td>Old</td>
<td></td>
</tr>
<tr>
<td>Susu</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percent applied</td>
<td>2.5</td>
<td>2.9</td>
<td>2.7</td>
<td>5.6</td>
<td>1.9</td>
<td></td>
</tr>
<tr>
<td>Number of applications</td>
<td>3.0</td>
<td>5.0</td>
<td>1.0</td>
<td>0.5</td>
<td>5.5a</td>
<td></td>
</tr>
<tr>
<td>Number successful</td>
<td>3.0</td>
<td>4.0</td>
<td>1.0</td>
<td>0.5</td>
<td>8.0</td>
<td></td>
</tr>
<tr>
<td>Money lender</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percent applied</td>
<td>8.1</td>
<td>7.2</td>
<td>7.9</td>
<td>12.5</td>
<td>5.4</td>
<td>11.5</td>
</tr>
<tr>
<td>Number of applications</td>
<td>2.0</td>
<td>2.3</td>
<td>2.0</td>
<td>1.0</td>
<td>1.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Number successful</td>
<td>1.7</td>
<td>1.7</td>
<td>2.0</td>
<td>1.0</td>
<td>2.3</td>
<td></td>
</tr>
<tr>
<td>Amount applied for (£'000)</td>
<td>273.0</td>
<td>372.0</td>
<td>125.0</td>
<td>-</td>
<td>-</td>
<td>329.0</td>
</tr>
<tr>
<td>As percent of intended investment</td>
<td>95.0</td>
<td>90.0</td>
<td>100.0</td>
<td>-</td>
<td>-</td>
<td>95.0</td>
</tr>
<tr>
<td>Amount received (£'000)</td>
<td>105.0</td>
<td>58.0</td>
<td>200.0</td>
<td>-</td>
<td>-</td>
<td>132.0</td>
</tr>
<tr>
<td>As percent of application</td>
<td>38.5</td>
<td>15.5</td>
<td>160.0</td>
<td>-</td>
<td>-</td>
<td>40.1</td>
</tr>
<tr>
<td>As percent of actual investment</td>
<td>90.0</td>
<td>80.0</td>
<td>100.0</td>
<td>-</td>
<td>-</td>
<td>90.0</td>
</tr>
<tr>
<td>Maturity (months)</td>
<td>1.7</td>
<td>2.5</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Interest (percent per month)</td>
<td>28.5</td>
<td>40.4</td>
<td>20.0</td>
<td>10.0</td>
<td>10.0</td>
<td>15.3</td>
</tr>
</tbody>
</table>

a/ Includes respondents who did not provide the number of successes.

Note: Number of responses to different questions varies.

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On average, those firms that sought informal finance had made two applications to moneylenders and three to *susu* operators, the averages decreasing with firm size. Older firms averaged a much higher number of applications and successes than new ones for both moneylenders and susu operators (the latter exclusively in metal products). Loan applications to informal sources were almost always successful, except occasionally for the smallest size group.

All of the medium- and small-sized firms and 56 percent of the microenterprises that had sought credit from moneylenders had also attempted to obtain a bank loan. This result suggests that small enterprises operate in both formal and informal markets—although they are more likely to seek bank loans because the interest rate is lower and they perceive a greater chance of success (contrary to what the results show).

### Amount

Informal lenders discriminate by size and age of firm. They cut back drastically (84 percent) on the initial amounts requested by microenterprises, whereas the average loan to firms with over ten workers equals or exceeds the average amount requested (including unsuccessful applications). (The fact that the loans microenterprises received financed 80 percent of their investment suggests that they either exaggerated their requests or were forced to severely reduce their planned investment for lack of funds). New firms received an average of only *€*50,000, much less than the *€*132,500 received by the average firm established before 1986.

### Loan Terms

Interest rates in the informal sector are relatively high. They average 28.5 percent a month compared to 2.1 percent for loans from the formal financial sector. Unlike the formal sector, rates differ markedly among size groups. Microentrepreneurs pay about 40 percent a month, while small and medium scale firms pay on the average 20 percent and 10 percent, respectively (Table A2.16). This result suggests that informal lenders use the interest rate to compensate for the higher risk of lending to smaller firms. (Higher rates to smaller firms could also represent monopoly power vis-à-vis borrowers who are excluded from formal finance because of market imperfections).

Since it is costly to acquire knowledge of the attributes of a borrower and most informal lenders deal in small amounts, they prefer to confine their lending to those they know well. All of the sample firms that borrowed from moneylenders had some prior business relationships with them (other than borrowing). This outside relationship evidently enabled the moneylenders to lend without demanding fixed assets as security. Most of the firms (71.4 percent) indicated that they did not have to provide security, the proportion declining as the size of the firms increases. When collateral was required, the smaller firms were permitted to provide a "guarantor" as security, while the medium-sized firms provided landed property.
Informal sector loans are most commonly provided initially for one month—the average reported by small- and medium-sized firms. Average maturity was longer for microenterprises (2.5 months)—probably reflecting the difficulties they reported in repaying and the month-to-month rollover of the initial loan. The determination of the loan did not involve bargaining.

**Repayment**

All of the medium-sized firms were able to repay the principal and interest on loans by moneylenders on time, while one-third of microenterprises were unable to make payments on time (compared to 52 percent of those who obtained bank loans). SMEs cited greater competition than expected from imports as the principal reason for delays in repayment. Since those entrepreneurs who go to the banks instead of to moneylenders state that the difference in cost is an important reason, the high cost of informal loans could contribute to the high default rate by decreasing the profitability of investment and the ability and willingness to repay. Nevertheless, default rates for informal loans were much lower than for bank loans.

**Demand for Equity Finance**

Most sample firms (56 percent) preferred debt to equity finance. Over a third of firms were receptive to equity investment, but an equal share viewed equity partners as undesirable. Firms with 30 or more workers tended to view equity more positively than smaller firms. Newer firms also were more receptive to equity than older ones, as were metal products firms compared to other subsectors.

If firms wanted to expand but could not obtain a large enough loan, 40 percent of micro and small enterprises would still find an equity partner not desirable. This reluctance is rooted in the fear that a financially potent partner might take an undue share relative to the "sweat equity" of the owner and in a general view that partners cannot be trusted. Nevertheless, attitudes differ considerably among firms. Within the food subsector, for example, 33 percent of firms find an equity partner "not desirable" but 50 percent would find one "very desirable." Only 18 percent of medium-scale firms would refuse an equity partner to help finance an expansion.

SMEs were much more receptive to equity finance in the form of an arms-length institution than a private individual. Most firms (65 percent, similar for all size groups) would view positively participation by a venture capital fund, especially new firms.

Finally, selling shares to public is the least desirable method of finance. The percentage of firms that dislike this method of finance increases with size from 42 percent of micro firms to 53 percent of medium firms, yet the medium size group also has the highest percentage of firms (41 percent) that find this method of finance "very desirable." More older than newer firms find this method "not desirable."
Table A2.17: Principal Constraint by Loan Application Status
(percentage of respondents in each category)

<table>
<thead>
<tr>
<th>Problems</th>
<th>All</th>
<th>Received loan</th>
<th>Denied</th>
<th>Did not apply</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit for:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Working capital</td>
<td>23.8</td>
<td>24.5</td>
<td>25.7</td>
<td>21.4</td>
</tr>
<tr>
<td>Equipment</td>
<td>20.6</td>
<td>26.5</td>
<td>20.0</td>
<td>14.3</td>
</tr>
<tr>
<td>Profits low</td>
<td>9.5</td>
<td>4.1</td>
<td>5.7</td>
<td>19.1</td>
</tr>
<tr>
<td>Demand, competition</td>
<td>8.8</td>
<td>10.2</td>
<td>0.0</td>
<td>14.3</td>
</tr>
<tr>
<td>Equipment</td>
<td>7.2</td>
<td>8.2</td>
<td>5.7</td>
<td>7.2</td>
</tr>
<tr>
<td>Space</td>
<td>7.1</td>
<td>6.1</td>
<td>8.6</td>
<td>7.1</td>
</tr>
<tr>
<td>Raw materials:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Availability</td>
<td>5.6</td>
<td>6.1</td>
<td>5.7</td>
<td>4.8</td>
</tr>
<tr>
<td>Price</td>
<td>4.0</td>
<td>6.1</td>
<td>5.8</td>
<td>4.8</td>
</tr>
<tr>
<td>Banks too difficult</td>
<td>4.0</td>
<td>2.0</td>
<td>11.4</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Note: Principal constraints cited by fewer than 4 percent of firms are not shown.

6. DIFFERENCES AMONG FIRMS BY LOAN APPLICATION STATUS

This section investigates some of the determinants of whether firms received or were denied a bank loan, or indeed even bothered to apply. There is some evidence that firms were self-selective in applying. For instance, firms that did not apply were much more likely (33 percent) to cite low profits and demand or heavy competition as their principal operational constraint than those who applied (Table A2.17). These are conditions that would make it difficult for them to make productive use of credit, or to repay it. About half of the firms that applied for loans cited lack of credit for working capital or equipment as their primary constraint, as against 35 percent of those who did not apply. In contrast to the firms that applied for loans, those that did not apply showed no growth since 1986 in number of workers and had added little to the real value of their capital assets since start-up (Table A2.18).

As might be expected, success in getting a loan is strongly associated with size—especially as measured in terms of assets (Table A2.18). The average labor force of firms that received loans was much larger than the other categories at all points in time from start-up to the time of the survey. In addition, enterprises that obtained loans tended to be relatively old
Table A2.18: Entrepreneur and Firm Characteristics by Loan Application Status
(means of responses)

<table>
<thead>
<tr>
<th></th>
<th>All</th>
<th>Received loan</th>
<th>Denied</th>
<th>Did not apply</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Entrepreneur characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age of owner</td>
<td>42.6</td>
<td>44.0</td>
<td>41.7</td>
<td>41.7</td>
</tr>
<tr>
<td>Years of training:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>14.2</td>
<td>14.9</td>
<td>14.5</td>
<td>13.2</td>
</tr>
<tr>
<td>Apprenticeship</td>
<td>1.9</td>
<td>1.5</td>
<td>2.1</td>
<td>2.3</td>
</tr>
<tr>
<td>Prior years work as:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee</td>
<td>7.7</td>
<td>7.0</td>
<td>9.6</td>
<td>7.0</td>
</tr>
<tr>
<td>Manager/owner</td>
<td>4.5</td>
<td>3.9</td>
<td>5.8</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>B. Enterprise characteristics</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm age</td>
<td>8.6</td>
<td>11.5</td>
<td>7.1</td>
<td>6.3</td>
</tr>
<tr>
<td>Number of workers:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Start-up</td>
<td>5.8</td>
<td>8.1</td>
<td>3.7</td>
<td>4.8</td>
</tr>
<tr>
<td>1986 labor</td>
<td>16.1</td>
<td>20.0</td>
<td>14.0</td>
<td>11.1</td>
</tr>
<tr>
<td>1991</td>
<td>15.3</td>
<td>21.4</td>
<td>11.5</td>
<td>11.2</td>
</tr>
<tr>
<td>Monthly sales g/</td>
<td>2776.0</td>
<td>5079.0</td>
<td>1969.0</td>
<td>889.0</td>
</tr>
<tr>
<td>Asset replacement cost: g/</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Start-up</td>
<td>11686.0</td>
<td>23421.0</td>
<td>2786.0</td>
<td>6398.0</td>
</tr>
<tr>
<td>1991</td>
<td>27549.0</td>
<td>59281.0</td>
<td>8698.0</td>
<td>6895.0</td>
</tr>
<tr>
<td>(Number of firms)</td>
<td>(127)</td>
<td>(50)</td>
<td>(35)</td>
<td>(42)</td>
</tr>
</tbody>
</table>

*Measured in thousands of cedis in 1991 prices.*

(11.5 years as against 7.1 for those denied) and their owners somewhat older and better educated. Prior work experience and training as an apprentice do not raise the probability of success; indeed, entrepreneurs who were denied loans had more years of each than those who succeeded. Firms that received loans had more years of each than those who succeeded. Firms that received loans were more likely to have landed property available as collateral (51.0
than those that were denied (38.2 percent) or did not apply (43.9 percent). Firms that had been denied loans were much more likely (45.7 percent) to view an equity partner as "very desirable" than were those that had obtained loans (22.4 percent). Similarly, the proportions interested in venture capital by an institution were 81.8 percent and 60.0 percent, respectively, and those willing to sell shares to the public were 44.1 percent and 32.7 percent, respectively. These responses indicate a high degree of receptivity to innovative means of finance, especially by firms that, for one reason or another, lack access to bank credit.

Firms that obtained loans were willing to pay significantly higher interest rates (an average of 21.3 percent) than those that were denied (19.3 percent) or did not apply (18.1 percent). Nevertheless, they also wanted considerably more time to repay: over 52 months, as against about 40 months for the other groups.

7. Participation in an Entrepreneurship Development Program

One reason sometimes given for the relative lack of SMEs in African countries, and for banks' lack of interest in financing them, is the scarcity of experienced entrepreneurs. In an effort to raise the level of entrepreneurship in Ghana, NBSSI launched a series of Entrepreneurship Development Programmes (EDPs) in 1987. These were initially aimed at preparing would-be entrepreneurs to utilize loans for new businesses, including civil servants who had been "retrenched." However, the hoped-for financing for EDP graduates did not materialize.

In an effort to assess the problems and impact of the EDPs, the survey was extended to include twenty-two EDP participants who had not been able to launch an enterprise, for comparison with the fifty-one firms in the initial sample whose owners were EDP graduate. The comparison is somewhat complicated by the fact that most of the participants who had not started a firm took the course in 1988 when financing for EDP graduates was expected.

The EDP graduates with firms were more likely to have taken the training in 1990 and to have had lower expectation that finance would automatically be available. Many of them already had firms (twenty-one of fifty-one started before 1988) and were looking to upgrade their skills. Their different expectations make them not entirely comparable to the EDP participants without firms—although their response patterns generally were not significantly different. Furthermore, their EDP experience was too recent to evaluate the impact on their firms' performance. Hence, the comparisons in this section should be taken as preliminary indicators, subject to further investigation. The most interesting comparison is between the EDP graduates without firms and those with microenterprises—the most likely size for a would-be entrepreneur with no external finance. The characteristics of EDP graduates with firms closely resemble those of microenterprises as a whole (shown in the last column of tables in this section for comparison), although their firms are slightly younger.
Sources of Funds and Motivation for Participation

The three main categories of EDP participants in terms of the source of their own funds were owners of existing businesses (43 percent of the sample), employees of other business (36 percent), and retirees. It has already been established that initial finance of small enterprises comes overwhelmingly from the owner's own resources. The interesting differences concern the sources of those savings.

Among the EDP graduates with relatively larger firms of five or more workers, an exceptionally high (79 percent) had obtained their savings from the profits of other businesses (Table A2.19). This share is much higher not only than that of microenterprises as a whole (38 percent) but also than that of firms with 10-29 and 30 or more workers (56 percent and 54 percent).

<table>
<thead>
<tr>
<th>Table A2.19: EDP Participants' Motivation and Sources of Savings (percentage of responses in each category)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total EDP sample</strong></td>
</tr>
<tr>
<td>----------------------</td>
</tr>
<tr>
<td><strong>Source of owner's savings</strong></td>
</tr>
<tr>
<td>Other business</td>
</tr>
<tr>
<td>Local employment</td>
</tr>
<tr>
<td>Pension</td>
</tr>
<tr>
<td>Inheritance</td>
</tr>
<tr>
<td>Salary/travel abroad</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td><strong>Motivation for taking EDP</strong></td>
</tr>
<tr>
<td>Be a better manager</td>
</tr>
<tr>
<td>Access to finance</td>
</tr>
<tr>
<td>Make business plan</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td><strong>(Number of firms)</strong></td>
</tr>
</tbody>
</table>

*Note:* Total EDP sample included seven applicants who did not take the program (not shown in table).
percent, respectively; not shown in the tables). These appear to be entrepreneurs who are in the process of moving up the size scale and are concerned about their ability to manage the process; 78 percent said they took the EDP primarily to improve their management ability.

While profits from their existing business provide some resources for this "graduation" process, supplementary financial resources are also needed. Among EDP graduates with firms of five or more workers, 11 percent cited access to finance as their principal motivation for taking the EDP. Thus, they are likely to exhibit strong demand for finance, and also to be in a better position to obtain it than EDP graduates with no business or a very small one.

Retirees have funds for investment from their pensions when they are retired or laid off. Without supplementary finance, however, pensions are unlikely to be sufficient to start more than a very small business; nearly 12 percent of EDP graduates with firms employing fewer than five workers had launched their business from pension funds, but none of those with five or more workers were started from this source. In contrast, savings from abroad are nearly as likely to be a source of investment in a relatively larger firm as a smaller one, both among EDP graduates with firms and in the larger survey of firms.

Savings from employment is a relatively meagre source of investment funds, given the low salary levels in Ghana. Overall, 33 percent of microentrepreneurs obtained their savings primarily from this source, much higher than among firms with 10-29 and 30 more employees (15 percent and 23 percent, respectively). Among EDP graduate with firms, 42 percent of those with firms under five workers had accumulated their savings primarily from employment, as against only 7 percent of those with five or more workers.

Among the EDP graduates who had not yet launched businesses, 42 percent had savings mainly from employment and 8 percent from pensions, suggesting that they are more likely to be able to start a very small business with fewer than five workers than a larger one. Even for the 42 percent with savings from another business, it would be difficult to launch a larger business without external financing. Surprisingly, none of this group cited access to finance as their initial motivation for taking the EDP, although in their interviews and group discussions they strongly emphasized their disappointment that the EDP did not automatically provide funds to finance their project proposals.

The focus on finance by EDP graduates without firms is also evident in their responses to questions on the most important constraints on their ability to invest: 55 percent cited the lack of credit for equipment as the principal constraint. This proportion is considerably higher than that for EDP graduates with firms (19 percent of those with firms under five workers, 32 percent of those with five or more workers). They also were more likely to complain that bank procedures are too difficult (10 percent cited this as the principal constraint, 20 percent as one of the top four). Indeed, EDP graduates generally (whether with firms or without) were more likely than microenterprises as a whole to complain about the difficulty in dealing with banks.
Entrepreneurs' Characteristics and Expectations

EDP graduates without firms have significantly more years as an employee (13.6) than the average microentrepreneur (8.2) and than EDP graduates with firms (Table A2.20). This result probably reflects a higher proportion of retired civil servants among the EDP graduates/applicants without firms. However, prior employment experience has been shown in this study to be unrelated to measures of firm performance. Although EDP graduates tend to be slightly older and more educated than the average microentrepreneur, differences in education and age are not statistically significant.

The most revealing characteristic of the EDP graduates without firms is the high cost of their proposed projects (€16.9 million, or $42,000) compared to the average replacement cost of the business assets of other EDP graduates (€1.4 million) and microenterprises as a whole (€1.9 million). This figure is similar to the initial value of assets in the sample of firms with 10-29 workers at the time of the survey (Table A2.20), but considerably below the average loan (€4.6 million) for firms that had succeeded in getting a bank loan. Even for the 41 percent with savings from another business (suggesting both a reasonable level of own resources and a track record on which a loan might be based), the current average loan level appears insufficient to realize the envisaged scale of projects.

<table>
<thead>
<tr>
<th>Table A2.20: Entrepreneur and Firm Characteristics by EDP Status (means of responses)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total EDP sample</td>
</tr>
<tr>
<td>No. of workers</td>
</tr>
<tr>
<td>Owner's age (years)</td>
</tr>
<tr>
<td>Years education</td>
</tr>
<tr>
<td>Years apprenticeship</td>
</tr>
<tr>
<td>Prior years work as:</td>
</tr>
<tr>
<td>Employee</td>
</tr>
<tr>
<td>Manager</td>
</tr>
<tr>
<td>Firm age (years)</td>
</tr>
<tr>
<td>Total labor</td>
</tr>
<tr>
<td>Assets if new (€ mil.)</td>
</tr>
<tr>
<td>(Number of firms)</td>
</tr>
</tbody>
</table>

h/ Grouped by total number of workers in the firm.
g/ EDP with firms only.
g/ Size of proposed investment.
Whether or not obtaining finance was their original motivation, it appears that expectations created by the programme that finance would eventually become available may have delayed the efforts of some 1988 EDP participants to start a much smaller business on their own. Under prevailing conditions, however, their expectations are highly unrealistic in terms of the size of business they could hope to establish, especially for those who could provide savings only from employment or pensions. Hence, it does not appear helpful for the EDP to encourage new entrepreneurs to develop initial business plans in the small-to-medium size range, where capital requirements exceed most small investors' resources and the likely size of a bank loan (if one is obtained).

Instead, it might be more suitable for the EDP to include case studies of Ghanaian entrepreneurs who started microenterprises from their own resources, grew by reinvesting profits, and reached the stage where they could obtain external financing for working capital or further expansion (see section on "Patterns of Entrepreneurial Experience").

**Demand for Finance**

Strong differences emerge in credit demand and the experience of EDP graduates without firms and those with firms (the latter being similar to microenterprises as a whole). EDP graduates with microenterprises were much more likely to have applied directly for bank credit: over 60 percent, as against 24 percent of those without firms (Table A2.21). This gap, however, is explained by 38 percent of those without firms who had applied for through PAMSCAD or GEDC. Their unwillingness to approach banks directly was confirmed by the relatively high proportion (29 percent) that had never enquired about bank loans—more likely due to the recognition of their low probability of success than to lack of interest in borrowing.

Those EDP graduates without firms who did apply to banks averaged about the same number of application as those with firms (1.3 to 1.5), but with a much lower rate of success (11 percent, only a third of the rate for those with firms). This low success rate suggests that EDP training alone cannot offset the high risk in lending to new entrepreneurs without a track record. It also corresponds to the interviewers' assessment of creditworthy, as against 31 percent of those with firms under five workers and 58 percent of those with five or more. Nevertheless, the latter figure is much higher than the 34 percent of microenterprises as a whole that were so ranked, suggesting that EDP training may help improve the creditworthiness of entrepreneurs who already have firms.

Despite their weak credit position, EDP graduates without firms were seeking a lower interest rate (18 percent per annum) and a much longer maturity period (forty-two months) than those with firms, indicating a low ability to repay and/or unrealistic expectations. Nevertheless, a relatively high proportion (62 percent) said they would take a loan at 30 percent interest for new investment, as against 53 percent of EDP graduates with firms that had fewer than five workers and 32 percent of those with five or more workers (the latter were more interested—53 percent—in such a loan for working capital).
Table A2.21: Demand for Finance by EDP Status  
(percentage of responses in each category)

<table>
<thead>
<tr>
<th>Constraints</th>
<th>Total EDP sample</th>
<th>EDP w/o firms</th>
<th>EDP with firms No. of workers</th>
<th>All firms with 1-9 workers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>1-4</td>
<td>5+</td>
</tr>
<tr>
<td>Share applying for bank loan (percent)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>For this business</td>
<td>43.4</td>
<td>23.8</td>
<td>62.1</td>
<td>47.4</td>
</tr>
<tr>
<td>For other business</td>
<td>3.9</td>
<td>0.0</td>
<td>0.0</td>
<td>15.8</td>
</tr>
<tr>
<td>For personal use</td>
<td>6.6</td>
<td>0.0</td>
<td>6.9</td>
<td>0.0</td>
</tr>
<tr>
<td>Enquired, discouraged</td>
<td>10.5</td>
<td>9.5</td>
<td>6.9</td>
<td>21.1</td>
</tr>
<tr>
<td>Never enquired</td>
<td>25.0</td>
<td>28.6</td>
<td>24.1</td>
<td>15.8</td>
</tr>
<tr>
<td>Applications for bank loans (means)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of applications</td>
<td>1.5</td>
<td>1.5</td>
<td>1.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Number successful</td>
<td>0.5</td>
<td>0.2</td>
<td>0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Number failed</td>
<td>2.2</td>
<td>0.2</td>
<td>5.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Percent successful</td>
<td>34.2</td>
<td>11.0</td>
<td>33.3</td>
<td>35.2</td>
</tr>
<tr>
<td>Amount received (£'000)</td>
<td>2539.0</td>
<td>9344.0</td>
<td>338.0</td>
<td>671.0</td>
</tr>
<tr>
<td>Attempts to obtain informal finance (means)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Applications to moneylender</td>
<td>0.8</td>
<td>0.0</td>
<td>2.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Number successful</td>
<td>0.8</td>
<td>0.0</td>
<td>2.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Amount received (£'000)</td>
<td>58.0</td>
<td>0.0</td>
<td>50.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Applications to susu</td>
<td>1.0</td>
<td>0.3</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Number successful</td>
<td>0.8</td>
<td>0.0</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Characteristics of desired finance (means)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maturity (months)</td>
<td>14.9</td>
<td>42.0</td>
<td>10.5</td>
<td>13.4</td>
</tr>
<tr>
<td>Interest (percent/month)</td>
<td>1.63</td>
<td>1.53</td>
<td>1.58</td>
<td>1.75</td>
</tr>
<tr>
<td>Percent rated &quot;highly creditworthy&quot;</td>
<td>31.6</td>
<td>19.0</td>
<td>31.3</td>
<td>57.9</td>
</tr>
</tbody>
</table>

* Ranking by interview team.
It must be noted that the relatively low success rate of EDP graduates without firms cannot be explained simply by a relative lack of collateral: 71.4 percent claim to have landed property that could serve as collateral, as against only 46.7 percent and 52.6 percent, respectively, of EDP graduates with firms under five workers and those with five or more. Many of those without landed property stated that they could obtain guarantors with substantial bank accounts to back a loan (42.9 percent of those without firms and 57.9 percent of those with firms under five workers; those with firms of five or more workers overwhelmingly suggested equipment as alternate collateral). This suggests that even with collateral, EDP training, and a business plan, would-be entrepreneurs cannot readily obtain bank finance.

As for SME owners in the firm sample, less than 4 percent of EDP graduates sought informal finance, and those who did received relatively small amounts.

Usefulness of EDP Training

EDP graduates viewed their training as most useful in motivating them to start their own business and helping them to draw up a business plan (Table A2.22). They found it least useful in obtaining finance. In general, there is little difference between those with and without firms. The principal exception is with respect to the marketing aspect of EDP training; 60 percent or more of those in business found this "very useful", but few of those without businesses agreed (perhaps because they as yet had nothing to market). In all other aspects, at least 50 percent of each group found the training "very useful" (except that owners of firms with five or more employees were less enthusiastic about the training in keeping accounts and selecting a business).

<table>
<thead>
<tr>
<th>EDP objective</th>
<th>Total EDP sample</th>
<th>EDP w/o firms</th>
<th>EDP w/ firms No. of workers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>1-4</td>
</tr>
<tr>
<td>Preparing business plan</td>
<td>76.9</td>
<td>75.0</td>
<td>83.9</td>
</tr>
<tr>
<td>Motivating to start own business</td>
<td>75.9</td>
<td>78.6</td>
<td>76.0</td>
</tr>
<tr>
<td>How to register business</td>
<td>60.7</td>
<td>56.3</td>
<td>63.0</td>
</tr>
<tr>
<td>Learning to keep accounts</td>
<td>55.2</td>
<td>52.9</td>
<td>62.5</td>
</tr>
<tr>
<td>Selecting business</td>
<td>53.6</td>
<td>56.8</td>
<td>54.2</td>
</tr>
<tr>
<td>Marketing</td>
<td>52.3</td>
<td>23.5</td>
<td>60.0</td>
</tr>
<tr>
<td>Obtaining finance</td>
<td>37.9</td>
<td>16.7</td>
<td>53.3</td>
</tr>
</tbody>
</table>
Patterns of Entrepreneurial Experience

The statistics presented in this study cannot do justice to the wide range of experiences of Ghana's entrepreneurs. In the course of the research, we collected some thirty anecdotal stories of how firms got started, selected from among the firms studied. A common thread is that most started small, reinvested profits and other resources, and grew gradually, adapting or shifting product lines as need be. Financing the entire initial investment entirely from loan funds is virtually unheard of; even the PAMSCAD loans generally supplemented the investor's own resources (for example, redeployment funds). The EDP would do well to have some of these entrepreneurs tell their stories to future trainees, so that the latter would not get false expectations about getting a loan to launch a medium-sized business.

A common pattern is for employees to strike off on their own, usually using the knowledge they have gained. For example, former employees of construction firms can be found making concrete blocks and roofing tiles; former teachers of arts and crafts are now producing ceramic products. Only occasionally do entrepreneurs gain their experience from their parents' business, as in the case of two entrepreneurs (one male, one female) who grew up in their parents' akpeteshie (local gin) brewing business and eventually started their own alcohol blending plants. While employed, future entrepreneurs often purchase the equipment they will need bit by bit, so that they will be able to start production immediately when they are ready to leave. In some cases, supplier's credit helps them to accumulate the necessary equipment—as in the case of one of the alcohol blenders, who bought a piece of equipment each year and repaid the credit out of his earnings, and a relatively large wood products firm that obtained the initial machinery from Britain on supplier's credit.

Businesses can be started even without substantial savings from employment or supplier's credit. A printer got started with no equipment by taking orders from people and seeking out printers with idle machinery. A woman who now exports garments initially did not even have enough money to buy a sewing machine; she started buying bits of material and sewing supplies from her monthly wages, then struck off on her own by renting a sewing machine. After she gradually built up her business, she was able to expand by virtue of a development assistance loan to import used industrial sewing machines.

Another common pattern is for profits from one business to be reinvested in another. Several entrepreneurs in the sample began as traders and then moved into manufacturing—for example, a cloth seller who set up her own batik operation, and a pharmaceutical seller who branched into production (though in many cases the manufacturing activity is unrelated to the type of goods traded). By the same token, profits from SMEs may be invested into other activities; both alcohol blenders are establishing hotels (in part as a way of marketing their products).

Two other recurrent themes are assistance from parents and earnings from abroad. Some of the respondents were in business because their parents insisted on apprenticing them, not because they sought out a business opportunity. A well-trained employee of a firm that
manufactures leather bags left to work overseas until he could save enough to start his own leather goods business.

The successful SMEs typically have built up their capacity gradually by reinvesting profits, sometimes aided by bank overdrafts (occasionally loans), supplier's credit, or foreign assistance. Gradual growth appears to enable the entrepreneur to adapt to the market and master management tasks. For example, a successful engineering firm that now employs about twenty people started as a backyard operation producing school equipment, shifted to simple workbenches and equipment for wood processing, then tried making a corn mill, used both technical innovation and strong after-sales service to build a good reputation, obtained a loan to import used equipment, developed a wide range of products, and is now looking to expand to a permanent structure and specialize in a limited number of items. In such a growth process, EDPs can play a useful role in upgrading entrepreneurs' skills and helping them prepare to "graduate" to larger, more complex operations.

While most entrepreneurs express a desire for bank loans, virtually all who have had any experience with banks complain about the difficulties and delays involved. The cumbersome documentation and the repeated requests to go for more information and come back are a major obstacle because small entrepreneurs can ill afford the time involved. Even when loans are approved, the long delays mean that opportunities have been missed. In at least two cases, the entrepreneur did not take an approved loan because he could not, or would not pay the "commission" demanded by the bank manager (as much as a quarter of the loan amount). Nevertheless, loans would clearly have a high return in many cases, whether for working capital to utilize excess capacity to meet existing orders, or for replacement of outmoded machinery to raise quality and productivity.

Many of the larger, established businesses reported making substantial use of overdrafts. Because overdrafts are frequently extended over a long period of time, bank credit to SMEs may be somewhat greater than it appears from the difficulty they experience in getting formal term loans.
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