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Financial Challenges Facing Urban SMEs under Financial Sector Liberalization in Ghana

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The paper examines the impact of financial sector liberalization (FSL) policies on the financial management of small and medium-sized enterprises (SME) in Ghana, using six case studies. Its findings, which confirm and extend the conclusions of previous studies, are integrated into a framework that explains the impact of FSL and the factors at work. The main financial challenge facing SMEs is access to affordable credit over a reasonable period. This is determined by the financing needs of SMEs and the action of investors. SME financing needs reflect their operational requirements, while the action of investors depends on their risk perception and the attractiveness of alternative investment (which affects their willingness to invest). Government borrowing, the general economic climate, availability of collateral, quality of SME record keeping, and SME investor relations skills affect the way in which this challenge is managed. The impact of the activities and potential of enterprise development agencies are also discussed.

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Introduction

This paper presents a framework to explain the impact of financial sector liberalization (FSL) on small and medium enterprises (SMEs) in Ghana. SMEs are vital for economic growth and development because they encourage entrepreneurship, generate employment, and reduce poverty (Kayanula and Quartey 2000; Mead and Liedholm 1998; Fischer 1995). Previous studies (Dawson 1993; Steel and Webster 1992, 1991) focused on the impact of structural adjustment rather than FSL per se; thus, their conclusions on FSL are tentative. We confirm, extend, and integrate their findings in new ways. In the rest of the paper we briefly review the SME literature, describe our research methodology, discuss our findings, and present the framework.

Brief Review of the Literature

After a decade of economic decline, Ghana implemented economic reform and structural adjustment policies in the 1980s, with FSL as an integral component. FSL removed government controls on interest and foreign exchange rates and on credit allocation. Proponents claim that FSL increases credit allocation efficiency and, when properly implemented, reduces poverty. This should lead to reallocation of domestic credit toward SMEs and replace expensive forms of credit with cheaper ones (Cook and Nixson 2000). Critics point to its constraints and negative consequences, which include the urban bias of banks (ISSER 1999; Chandavarkar 1992), high transaction costs (Steel 1994), and market failure due to informational imperfections (Stiglitz 2002, 1994; Mosley 1999). These lead to an overreliance by banks on collateral for lending (Mambula 2002; Collier 1994).

Credit is provided in the context of information asymmetry on both sides (Fischer 1995) and can be resolved by demonstrating creditworthiness and project viability. However, because of poor accounting practices and record keeping, many SMEs are unable to do so (Cook and Nixson 2000; Binks, Ennew, and Reed 1992). This increases the risks and transaction costs (for monitoring and screening) of SME lending. Banks require collateral to manage this risk.

High transaction costs, risks related to small loans, and lack of collateral restrict SME access to formal credit (Steel 1994). Their owners raise funds from friends and relatives (Osei et al. 1993), leading to inadequate working capital and investment funds, which threaten survival and impede growth. These issues exacerbate other managerial problems of SMEs. For example, they determine not just the level but also the nature of technology investment (Cobham 1999). Even with sound management and strong product demand, the lack of credit constrains their capacity to respond to the market and expand production (Cook and Nixson 2000).

Research Objective and Methodology

The study aimed to identify and explain the impact of FSL on the financing of SMEs. We asked the following questions: (1) What financial constraints and opportunities did FSL create for SMEs? (2) How did they manage these challenges? and (3) What factors explain the empirical observations?

Using a case-study approach (Yin 1994), we reviewed documents and interviewed people from three SMEs, a bank, a nonbank financial institution (NBFI), and the National Board for Small Scale Industries (NBSSI). The SMEs were electro-mechanical, printing, and manufacturing firms. Their principals discussed working capital and fixed-asset financing and explained their capital structure. We included the bank and

NBFI in order to compare their views with those of the SMEs. Also, the literature notes that FSL leads to a segmentation of credit markets such that banks focused on large firms while NBFIs catered to SMEs (Brownbridge and Gayi 2000). Their inclusion enabled us to examine how this segmentation operated, if at all. Finally, NBSSI was included to investigate the role of enterprise development agencies in facilitating SMEs' access to finance.

The case-study data were analyzed by using the grounded theory coding protocols of open, axial, and selective coding (Strauss and Corbin 1990). During open coding we identified categories (abstract classification of issues in the data) and developed them in terms of their properties and dimensions. With axial coding, we connected the categories using the paradigm model (Strauss and Corbin 1990). In this model causal conditions lead to a phenomenon (central idea in the data) operating within a context. Action and interaction strategies are used to manage the phenomenon to produce consequences. The strategies are facilitated or constrained by intervening conditions (the broader structural context of the phenomenon). For selective coding we refined the relationships between the categories and developed a "conceptual story" about them. The coding phases were not always sequential and involved iterations and simultaneous coding at different levels.

Case-Study Narratives

The SMEs

Table 1 summarizes the SME case studies. The electro-mechanical SME sold and serviced air-conditioning units. Opportunities for growth created the need for extra working capital. Its owner could not raise private equity, so he sought financing from local banks. The amounts offered were far below its requirement, the interest rates were too high, and the financing was short term instead of long term. The owner, therefore, opted for overseas financing. However, he could not provide the information required by the overseas financiers, so he engaged a consulting firm to provide and certify the information. The SME and the European Union Business Assistance Scheme (EU-BAS) jointly financed the consultancy because of its high cost.

The aluminium manufacturing SME needed funds for capital expenditure and working capital to exploit opportunities in the domestic and export markets. Its owner approached different banks, but none offered full financing. To overcome this problem, he opened accounts with several banks. Each bank provided some funds, although it did not know that other banks were simultaneously providing additional funds. Despite the firm's getting the full amount, the financing was still short term, and the interest rates were high.

The printing SME needed funds to replace aging equipment, so it approached its banker for financing. The bank offered minimal working capital support but not funds to retrofit the plant, because of the SME's inability to provide credible information about its operating activities. The principal attributed this to poor recordkeeping. The SME carried on by cannibalizing parts of the equipment. This led to loss of custom, cash flow restriction, and contraction of activity.

The Financial Institutions

The financial institutions comprised a local subsidiary of a multinational bank and a local NBFI. Bank credit officials confirmed that large firms dominated their loan portfolio for four reasons. First, relative to SMEs, their average screening and monitoring costs were smaller. Second, they could provide information about current operations and future plans to the bank. Third, they had better collateral. Fourth, the difficulty of

Table 1
Summary of SME Case Studies

SME	Principal's Background	Business Need	Financial Challenges	Search Strategy	Search Outcome
Electro-Mechanical Firm (Imports, Sells, and Services Air-Conditioning Units)	Engineering graduate Extensive experience Founder of the business	Expand to exploit good growth opportunities Increasing permanent working capital needs	Lack of long-term funds High interest rates for short-term funds	Seek low interest loans externally	Limited success but ongoing
				Hired external consultants to prepare project documents	Successful
				Used SME assistance scheme to finance consultancy	Successful
				Seeking equity investment	Ongoing
Printing Press (Family-Owned)	High school education Son of founder of business	Replacement of obsolete machines Working capital needs	Lack of long-term funds High interest rates for short-term funds	Reliance on retained earnings	Constrained growth
				Reliance on banker for short-term funds	Limited success
Aluminium Products Manufacturer (About 60 Percent of Products Exported)	Graduate Built seed capital when he worked in the United Kingdom Wants to be his own boss Founder of the business	Expand to exploit good growth opportunities Increasing permanent working capital needs	Lack of long-term funds Inadequate short-term funds High interest rates for short-term funds	Maintain accounts with different banks	Not applicable
				Source short-term funds from different banks	Successful

recovering nonperforming loans through the legal system made legal action worthwhile only in cases involving large loans. These factors reduced the banks' perception of the risk of large firms. Most SMEs did not meet these criteria. Finally, the banks had other investment opportunities such as high-yield, risk-free government treasury bills.

The NBFI set up a venture capital fund to provide SMEs with long-term funds, but the take-up rate was low because, in its opinion, SME principals did not want to share control of their businesses. Consequently, it provided high-interest short-term trade finance. The NBFI demanded involvement in strategy development, marketing, and financial management as part of its financing conditions. Financing was phased so that SMEs that cooperated were rewarded with more capital. Managerial involvement addressed the "lack of management expertise" and the agency problem of moral hazard. Participating in key management processes and decisions (in a nonexecutive capacity) reduced the cost of monitoring, and the phasing of financing provided incentive for goal-congruent behavior. To reduce the risk of default, payments from exports were made to both the SMEs and the firm. The SMEs received their share after their loans had been deducted.

The SME Assistance Organization

The NBSSI was intended to be a single, dynamic, and integrated organization adequately capitalized to respond to the needs of the small-scale enterprises sector. It has a head office in Accra and offices (comprising credit units and business advisory centers [BACs]) throughout Ghana. An executive director and management committee run the NBSSI and report to a board. The BACs and credit units provide SMEs with nonfinancial advisory services and financing (Table 2), respectively.

In 2000 the NBSSI advanced an average of US$290 to 546 microenterprises (without access to formal credit). It invited financial institutions to partner with it to arrange special financing for SMEs. Of the 45 institutions targeted, only one responded. Its representatives attended some meetings but were not interested in financing SMEs. Similar observations have been made about Nigerian banks (Adegbite 1997). NBSSI's performance was constrained by delayed release of government grants and coun-

Table 2
Credit Schemes Operated by NBSSI[a]

Credit Scheme	Number of Beneficiaries	Amount (in US$)	Average (in US$)
PAMSCAD[b] Credit Line	68	4,393	65
Revolving Loan Fund	24	7,815	326
Decentralized Business Assistance Fund	429	14,838	35
SME Promotion Fund	25	132,143	5,286
Total	546	159,189	292

[a]NBSSI = National Board for Small Scale Industries.
[b]PAMSCAD = Programme of Action to Mitigate the Social Costs of Adjustment.

terpart funds for credit lines, by inadequate funds for credit delivery, and by low staffing levels.

Case-Study Analysis

Open Coding—Discovering and Developing Categories, Properties, and Dimensions

All the interviewees identified lack of credit as the main impact of FSL on SMEs, so it became the main phenomenon of the study. SMEs could not afford the high interest rates (cost); banks preferred short-term to long-term financing (duration); and often, banks offered part rather than full financing (adequacy). Access to credit meant getting adequate, affordable financing over a suitable timescale. Thus, the properties of this phenomenon were access (open to close), duration (long- to short-term), cost (affordable to unaffordable), and adequacy (adequate to inadequate).

All three SMEs managed this *financial challenge* by searching for funds. The electro-mechanical SME explored private equity finance and local banks before opting for a dollar-denominated loan overseas. The aluminum manufacturer sourced funds from several banks at the same time. However, the principal of the printing press limited himself to his main banker. We called the search for funds *investor relations activity*. The data revealed that successful SMEs searched extensively, frequently, and put their case for financing better. Thus, frequency (often to never), coverage (extensive to limited), and quality (excellent to poor) were properties of this category.

The data confirmed that a critical skill for getting funds was the ability to convince financiers that a project was viable and a firm is creditworthy. We referred to this as *investor relations skills*, with its main property being quality (excellent to poor). Whereas the aluminum manufacturer had moderate skills, the printing press and electro-mechanical SMEs lacked these skills. The electro-mechanical firm improved its skills by buying it from a reputable financial consulting firm.

The printing press manager attributed its lack of success in investor relations activity to poor recordkeeping. Indeed, the aluminum and electro-mechanical SMEs, who were more successful, kept better records than did the printing press. Good recordkeeping meant recording, analyzing, and reporting information relating to SMEs as and when needed. We referred to this category as *information management* and characterized it in terms of frequency (often to never) and quality (excellent to poor).

The financial institutions explained their bias toward financing large firms in terms of their relatively low risks compared with SMEs. In addition, the feasibility of using the courts to recover large debts (but not small debts) meant that the risk related to large firm lending was manageable. Therefore, *risk perception* became a category, and its properties were risk level (high to low) and control (manageable to unmanageable).

Providing *collateral* reduced risk perception. For example, the NBFI used the export earnings of SMEs placed in escrow accounts as collateral for financing export activities. For collateral to be acceptable, its value must adequately cover the investors' exposure and the provider must have perfect title. As a category, therefore, collateral was characterized in terms of its perfection and value.

Finally, the financial institutions revealed that buying high-yield, risk-free treasury bills was an important part of their investment strategy. They demanded risk premium above the risk-free rate to cover the extra risk of lending to SMEs. This was not necessarily the case with large firms for whom the financial institutions provided a range of lucrative fee-based services. The treasury bills and the fee-based services that the financial institutions provided to large firms constituted alternative investments to SME lending. The properties of this category were availability and attractiveness.

Axial Coding—Connecting Categories in the Paradigm Model

This phase involved connecting the categories in the paradigm model. Financial challenges (the phenomenon) were managed through investor relations activity (action and interaction strategy). However, none of the other categories were either causal conditions or consequences. Further investigation revealed that successful management of the challenges resulted in growth and better performance and that the inability to manage them well led to worsening performance and corporate health. Thus, a new category, *SME State*, became the consequence with performance and SME health as its properties.

Risk perception, alternative investments, and the other categories identified above were antecedent to the phenomenon but were not immediate causes. Further interviews and analyses revealed that two main events defined the nature of the challenges. The first, financing need of SMEs, arose out of their operational needs and opportunities in the market. For example, the printing press had financial challenges because it needed funds to replace aging equipment. Similarly, the challenges of the aluminum and electro-mechanical SMEs arose from the need for finance to exploit market opportunities. *Financing need* was thus identified as a new category and causal condition. Its properties were level (high to low), duration (long-term to short-term), and urgency (urgent to not urgent). The second event was the decision by investors to finance SMEs. The financial challenges arose because investors did not meet the financing needs of SMEs fully. We called this category *investor action*—its properties being decision type (favorable to unfavorable) and extent of provision (full to limited). The rest of the categories formed part of the broader structural context of the phenomenon and its management and were therefore classified as intervening conditions. At this stage, the intervening conditions were not connected to each other. A fuller picture emerged during selective coding.

Selective Coding—Conceptualizing a Story of SME Financial Challenges under FSL

After several iterations of connecting the data and finding a central plot for the SME–FSL story, three more categories were added to the intervening conditions. First, it was recognized that risk perceptions and alternative investments affected investor action through their impact on the investor's willingness to provide funds. A willing investor responded favorably to a request for funds. Thus, *investor attitude* was made a category, with willingness as its property. Second, high-interest, risk-free government treasury bills became alternative investments for the financial institutions. *Government borrowing* was therefore made a category and was described in terms of quantity (large to small) and returns (high to low). Finally, the financial institutions noted that a growing *economy* with good prospects provided further investment opportunities. This became a new category, with prospects (good to bad) and growth (high to low) as its properties. With the addition of these categories, a story of SME financial challenges under FSL was conceptualized. Table 3 summarizes the categories, properties, and dimensions developed at this stage. Figure 1 presents the SME financial challenges framework in diagram form.

The Financial Challenges Framework

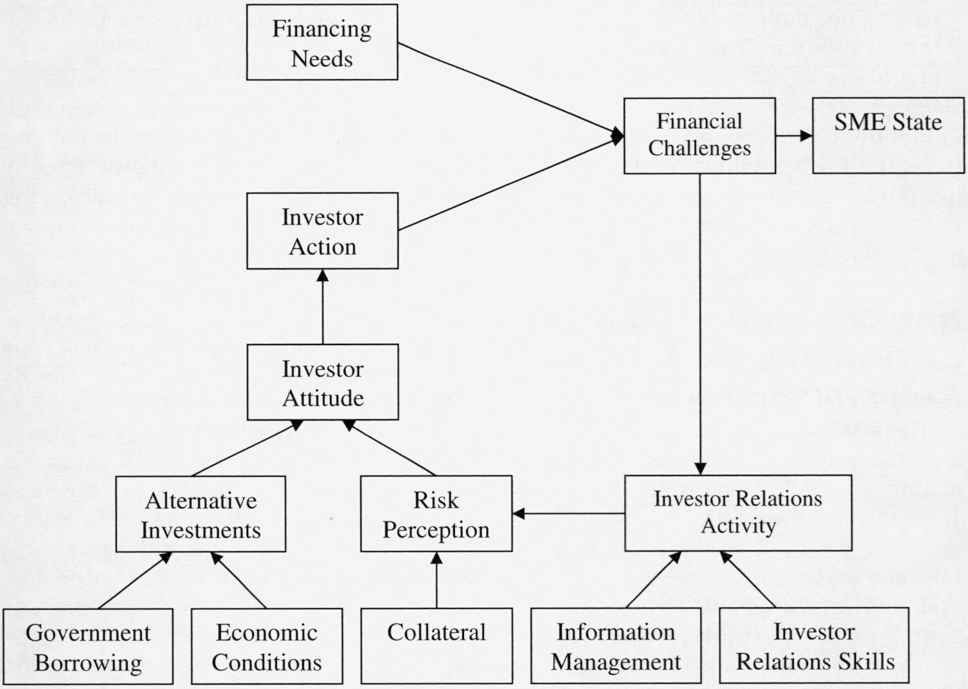
Financing needs and investor action combined to create financial challenges

Table 3
Grounded Theory Categories, Properties, and Dimensions in Paradigm Model

Type	Category	Property	Dimension
Causal Conditions	Financing Need	Level	High–Low
		Duration	Long-term–Short-term
		Urgency	Urgent–Not Urgent
	Investor Action	Decision	Favorable–Unfavorable
		Provision	Full–Limited
Phenomenon	Financial Challenges	Access	Open–Close
		Duration	Long term–Short-term
		Cost	Affordable–Unaffordable
		Adequacy	Adequate–Inadequate
Action and Interaction	Investor Relations Activity	Coverage	Extensive–Limited
		Frequency	Often–Never
		Quality	Excellent–Poor
Consequence	SME State	Health	Healthy–Unhealthy
		Performance	Excellent–Poor
Intervening Conditions	Information Management	Frequency	Often–Never
		Quality	Excellent–Poor
	Investor Relations Skills	Quality	Excellent–Poor
	Investor Attitude	Willingness	Willing–Unwilling
	Risk Perception	Level	High–Low
		Control	Manageable–Unmanageable
	Collateral	Value	Adequate–Inadequate
		Perfection	Perfect–Imperfect
	Alternative Investments	Availability	High–Low
		Attractiveness	Attractive–Unattractive
	Government Borrowing	Quantity	Large–Small
		Returns	High–Low
	Macro Economic Conditions	Prospects	Good–Bad
		Growth	High–Low

for SMEs. The challenges entailed access to adequate financing over suitable periods of time at affordable costs. Those that met the challenges successfully performed well and became stronger. SMEs influenced this process by engaging in investor relations activities. Frequent and extensive activity of excellent quality reduced investors' perceptions of SME risk. Risk perception was also reduced with the provision of adequate and perfect collateral. Together with the availability of attractive alternative investments, risk perception determined investors' willingness to finance SMEs. This attitude led to the decision to

Figure 1
Financial Challenges Framework



provide funds and the actual provision of funds (that is, investor action).

The extent and quality of SME investor relations activity depended on their information management practices and investor relations skills. Excellent and frequent information management practices ensured that relevant information about the activities and state of SMEs were recorded, analyzed, and reported when needed. This information was used to make a case for financing SMEs (investor relations skills).

General economic conditions and government borrowing determined the availability and attractiveness of alternative investments. New investment opportunities characterize growing economies with excellent prospects. This increases competition for funds and reduces the chances of SMEs receiving adequate financing. Further, the availability of (virtually risk-free) government debt instruments (borrowing) with attractive rates of return increased the investment opportunity set of investors and reduced the willingness of investors to finance SMEs.

A Word on SME Assistance Organizations

The size of the financing that NBSSI provided minimized its influence on SMEs with much larger financing requirements, such as the aluminum SME. This did not apply to all the assistance schemes. For example, the electromechanical firm used EU-BAS to pay for high quality consulting services. The difference between the NBSSI and the EU-BAS was not limited to the availability of funding, although that was very important. Phillips (2002) has noted that public schemes that provide both advice and operational funding are likely to fail. Instead, they are better served by assisting SMEs to buy consulting services to enable them to access credit from the formal financial sector.

Implications of Findings for Practice and Recommendations

The study has important implications for stakeholders in the SME sector. First, it showed that good information management and the ability to use information to present a well-crafted business case for financing reduces risk perception and increases the chance of SMEs getting adequate funds. Therefore, SME principals should seek to improve their information management practices and investor relations skills to improve their access to credit. SME umbrella associations and SME assistance organizations can help source funds to buy expertise in these areas. The EU-BAS assistance to procure consultancy services is a step in the right direction, as is the Africa Project Development Facility (APDF) of the World Bank. SMEs should be trained and assisted to set up basic planning and record keeping systems, and to write financing proposals. With the shortage of funds, this appears to be a more effective use of resources than directly funding the SMEs.

Second, the level of government borrowing reflects its fiscal discipline. Fiscal indiscipline leads to higher deficits that are financed with larger borrowing on the financial markets. To secure such borrowing, the debt instruments offer attractive rates of return. This raises the cost of borrowing for SMEs and restricts their access to formal credit. Thus, governments intending to promote and develop the SME sector as a driver of economic growth must exercise fiscal discipline.

Third, consideration must be given to setting up credit guarantee schemes. By sharing the risk of SME lending with the banks, such schemes directly reduce risk perception. Because the guarantors would scrutinize SME request for guarantees, banks' costs of screening SME financing application would also be reduced. Currently, the U.S. Agency for International Development is considering such a scheme. The EU-BAS and APDF could emulate them.

Finally, in order to diversify their loan portfolios, financial institutions must set up and strengthen their small-business advisory and lending units. Standardizing and automating loan application procedures can significantly reduce the cost of lending. These units can provide account management facilities for SMEs using information technology and guide SMEs on their information requirements. Although some banks have begun doing this, more effort is needed. With pressure on governments to reduce budgetary deficits, both the quantum and returns from treasury bills will be reduced, closing off an important avenue of alternative investment. SME lending would therefore be necessary if banks are to make good use of their investable funds. These recommendations are summarized in Table 4.

Limitations of the Study and Implications for Future Research

Although the framework is grounded in the data, it does not necessarily hold true for all SMEs operating under FSL. This is because the sample is small and not representative of urban SMEs.

Table 4
Macroeconomic and Microeconomic Improvement Recommendations

Recommendation	Benefit	Responsibility
Improved Information Management	Reduction in risk perception leading to improved access to financing	1. SME principals 2. Enterprise assistance organizations
Improved Investor Relations Skills	Reduction in risk perception leading to improved access to financing	1. SME principals 2. Enterprise assistance organizations
Reduced Government Borrowing	Reduce competition for investment funds	1. Government
Establishment of Credit Guarantee Schemes	Act as collateral for SMEs to reduce risk perception and cost of screening SME loan applications	1. Government 2. Enterprise assistance organizations
Diversification of Bank Loan Portfolio	Open up access to sme and "insures" banks against fall in rates and quantity of government debt instruments	1. Banks 2. Other investors

However, its findings can be used as hypotheses for future studies using large and more representative samples of urban SMEs. Some of the hypotheses are suggested as follows:

1. Good information management practices lower risk perception.
2. Good investor relations skills lower risk perception.
3. Perfect and adequate collateral lowers risk perception.
4. Lower risk perception leads to favorable investor financing decision.
5. Smaller government borrowing leads to favorable investor financing decision.
6. Favorable investor financing decision leads to access to adequate and affordable financing for SMEs.
7. Access to adequate and affordable financing makes SMEs stronger.
8. Good information management practices result in access to adequate and affordable financing for SMEs.
9. Good investor relations skills result in access to adequate and affordable financing for SMEs.
10. Perfect and adequate collateral result in access to adequate and affordable financing for SMEs.
11. Smaller government borrowing results in access to adequate and affordable financing for SMEs.

Conclusion

Our study confirmed and extended the findings of previous studies into a framework that explains the impact of FSL on SMEs. The findings imply that SME investor relations skills, record keeping, and provision of collateral improve SME access to formal credit. SMEs without these qualities can be assisted by enterprise assistance schemes to acquire them. In addition, lax fiscal management, which leads to large and persistent government borrowing from the financial sector, deprives SMEs of credit. The findings are applicable to the Ghanaian situation, although they are not unique. Other African countries implementing FSL (after Ghana) can learn from the experiences of Ghanaian SMEs and put in place impact-mitigation schemes. Because this is a small-sample study, its findings can be used as hypotheses to be tested in a large-sample study.

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