

KWAME NKRUMAH UNIVERSITY OF SCIENCE AND TECHNOLOGY
INSTITUTE OF DISTANCE LEARNING

**FACTORS INFLUENCING LOAN DELINQUENCY IN SMALL AND MEDIUM
ENTERPRISES' IN GHANA COMMERCIAL BANK LTD.**

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DEDICATION

To my family Mr. Vincent Appiah and Mrs. Mavis Maame Kakraba Appiah, for which I am truly blessed. I also dedicate this work to David Nana Kwasi Afranie for his support and encouragement and for his love.

I love you all.

KNUST



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To God be the glory for seeing me through this programme.

I am greatly indebted to my supervisor, Mr. Jonathan Welbeck, who devoted valuable time to guide this work and placing at my disposal his splendid academic judgment, firmness, thoroughness and unusually fine research talents which were of enormous assistance in bringing this study into a final coherence and cohesion.

I am however responsible for any errors in this work

Benedicta Naana Appiah

(June, 2011)

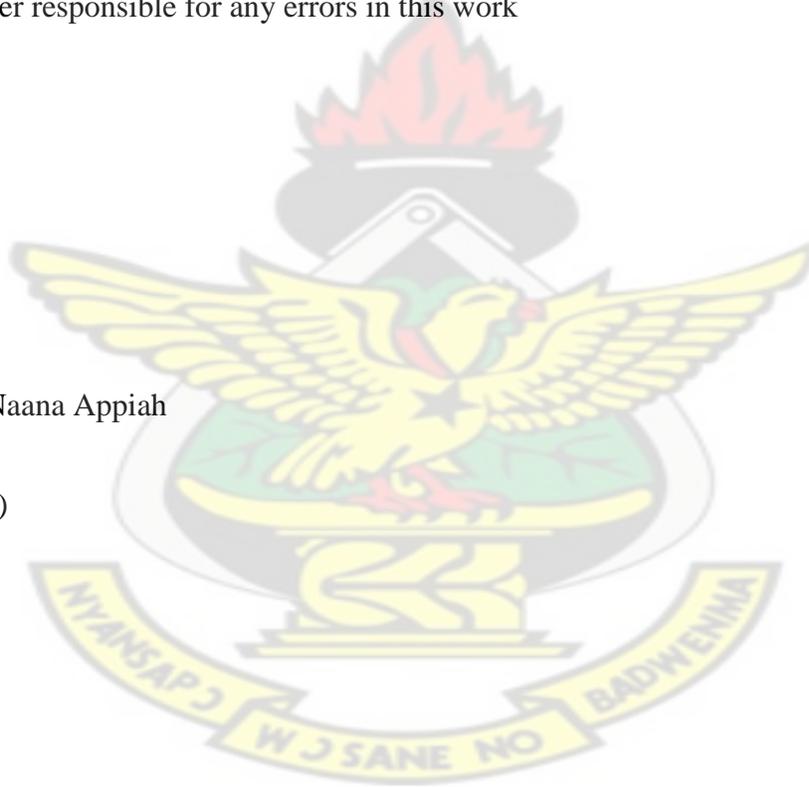


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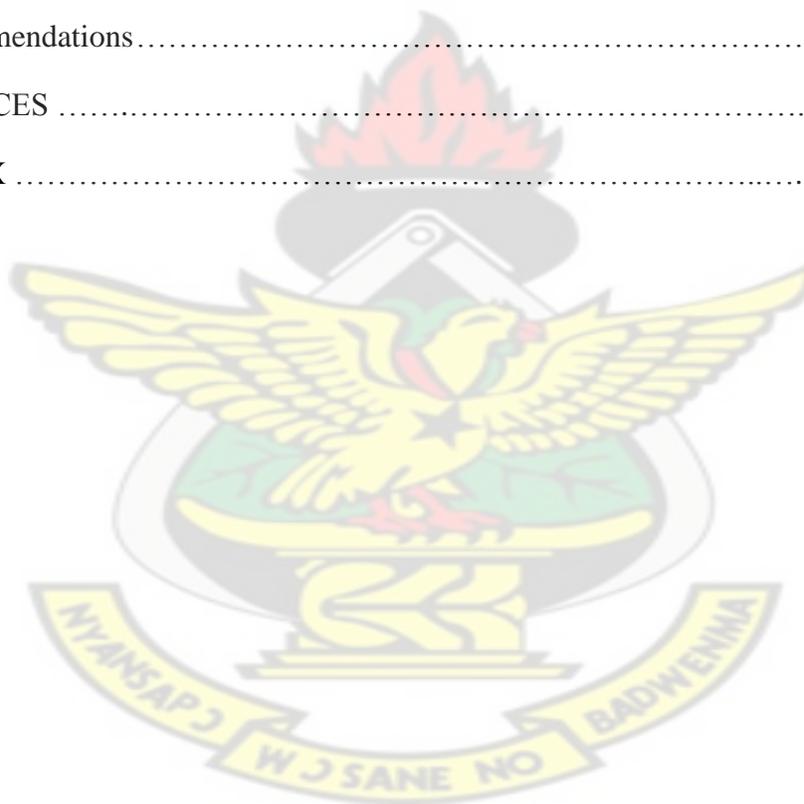
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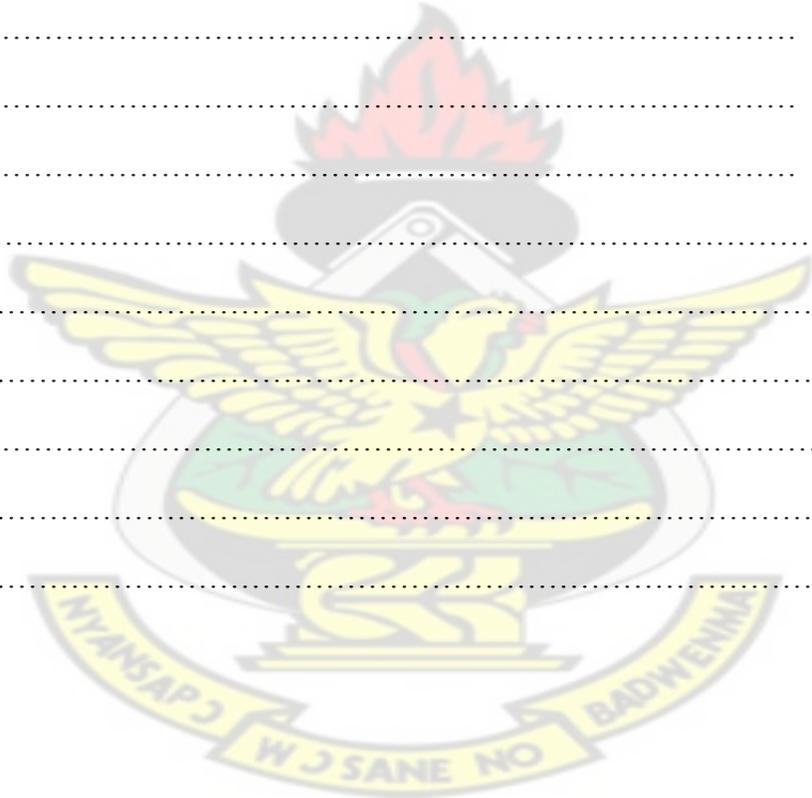
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ABSTRACT

The study investigated the determinants of loan defaults among SMEs in Abossey-Okai, Accra, using survey method. Structured questionnaires were administered to owners of SMEs in Abossey-Okai who accessed loans from the Ghana commercial bank from December 2005 to September 2009. The research is line with current efforts by bankers, regulators and international lending institutions to unravel the problem of persistent loan default among small business that has led to high non-performing loans in the banking sector. The findings from the study indicated that borrower screening mechanism employed by the GCB was defective and inefficient and credit need assessment conducted by the bank was flawed which increased the risk of default. Moreover, government policy intervention in the credit market tends to distort the efficiency and quality of term lending activities.

Results from the study also depicted that high officer-application ratio tends to reduce efficiency in credit assessment which increases risks of loan default. The findings of the study supported the assertion that SME loan default is the outcome of flawed financial role of banks and flawed public policy regimes.

The study therefore recommends a number of measures to deal with the problem. First, an efficient and transparent borrowers' screening mechanism should be employed as a proactive measure to deter the entry of less creditworthy borrowers to term loan regimes. Second, loan repayment performance of the old firms should be assessed before loans are sanctioned to new firms. Finally, Loan repayment schedules should be tagged not with the hypothetical but with the real cash flow situations of the firms and be extended more than the present number of loan repayment installment.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

SMEs all over the world play important roles in the process of industrialization and economic growth. Apart from increasing per capita income and output, SMEs create employment opportunities, enhance regional economic balance through industrial dispersal and generally promote effective resource utilization considered critical to engineering economic development and growth. There are indications in Ghana that the SMEs account for about 70 percent of industrial employment and well over 50 percent of the gross domestic product (Abor and Biekpe, 2007). Despite, the crucial role played by SMEs in economic development, these enterprises face serious difficulties when trying to obtain loans, especially from the formal financial institutions. The Association of Ghana Industries (AGI) business barometer report for the last quarter of 2010 revealed that access to credit has become the number one constraint facing SMEs in Ghana. The problem was attributed to the desire of the banks to minimize their non-performing loans which made them to greatly reduce credit to businesses (AGI's Business Barometer Report, December 2010)¹.

Tagoe et al. (2005) however asserted that the difficulty faced by SMEs in accessing credit is as a result of the inability of most SMEs to meet the conditions set by the financial

¹ The Association of Ghana industries (AGI) Business Barometer report is a periodic opinion survey about what chief executives make of the business environment.

institutions. Financial institutions often see SMEs as risk-prone sector because of poor guarantees and lack of information about their ability to repay loans.

Borrower's default risk is one of the fundamental concerns for financial institutions and as such accurately assessing all the relevant risks associated with loans will definitely increase their market efficiency (Lee and Liu, 2002). On the other hand, failure to do so could mean either losing the opportunity to make a profit or even generating losses in loans. Although banks today make use of a variety of techniques to aid in their loan decisions, still, most of these are 'rules-of-thumb' extracted from various borrower and property characteristics. In addition, banks often make use of information extracted from the borrower's personal financial condition and their credit rating. The means by which these various variables are incorporated into a decision rule on lending is often a procedure based upon the assessor's experience and feel for the market.

There are several problems with the application of such analytically informal procedure as the sole criteria. First, there is the possibility of bias. Vandell (1984) argued that the assessor may be experienced in the market, but, in the absence of empirically validated procedures, his experience may be combined with extraneous factors which may produce bias. One of such instances may be the use of percentages of loan defaulting industries as the basis of undertaking lending decisions. Moreover, there could be collateral valuation differences among different assessors, especially for those who are less experienced. There could also be the possibility of inconsistency. Two assessors working with the same information may interpret it in different ways to result in different lending

decisions. Such inconsistencies result in inefficiencies in bank loans. Therefore, it is imperative to empirically determine an analytical technique that is devoid of bias when analyzing of loan default risk.

The purpose of this study is thus to examine the determinants of loan default among SMEs in Abossey-Okai within the Accra metropolis. The study fits into the quest to find a more objective and efficient way of accessing the default risk associated with SME lending in order to reduce the rate of non-performing loans in the banking sector.

1.2 Statement of Problem

There are many who believe that the single most important factor constraining the growth of the SME sector is the lack of finance. Because of the persistent financing gap, many interventions have been launched by governments and development partners to stimulate the flow of financing to SMEs over and above what is available from exiting private sector financial institutions. Government has in the past attempted to implement a number of such direct lending schemes to SMEs either out of government funds or with funds contracted from donor agencies. Financial institutions have traditionally looked at the SME sector with caution. Many banks are of the view that the loan default rate among SMEs is high.

While many SME had benefited from the various loan schemes obtained from Ghana Commercial Bank (GCB), some SME face difficulties in managing their debt. The high default rate associated with SME lending has resulted in substantial increase in non-performing loans of GCB, necessitating a reduction in credit extension to SMEs and

adoption of more stringent measures to control the situation. This confirms the argument by Baku and Smith (1998) that, the cost of loan delinquencies would be felt by both the lender and the borrower. The lender has costs in delinquency situations, including lost interest, opportunity cost of principal, legal fees and related costs. For the borrower, the decision to default is a trade-off between the penalties in lost reputation from default versus the low probability in accessing an additional credit facility. Thus, there is the need to investigate the determinants of loan default in order to unearth the factors that distinguish creditworthy borrowers from those with high probability of default.

1.3 Objectives of the Study

The main aim of the study is to analyze the determinants of loan delinquencies among SMEs who accessed loans from the Ghana Commercial Bank (GCB). In line with this, the following are the specific objectives of the study:

1. To examine bank specific factors causing loan default among SMEs.
2. To investigate the effect of bank lending policies on loan default among SMEs?
3. To explore the effect of fiscal and monetary policy variables on loan default among SMEs.

1.4 Research Questions

The research questions of the study are as follows:

1. What role do banks play in contributing to loan default among SMEs?

2. What is the relationship between lending policies and loan default among SMEs?
3. What fiscal and monetary policy variables account for loan delinquencies among SMEs?

1.5 Scope of the Study

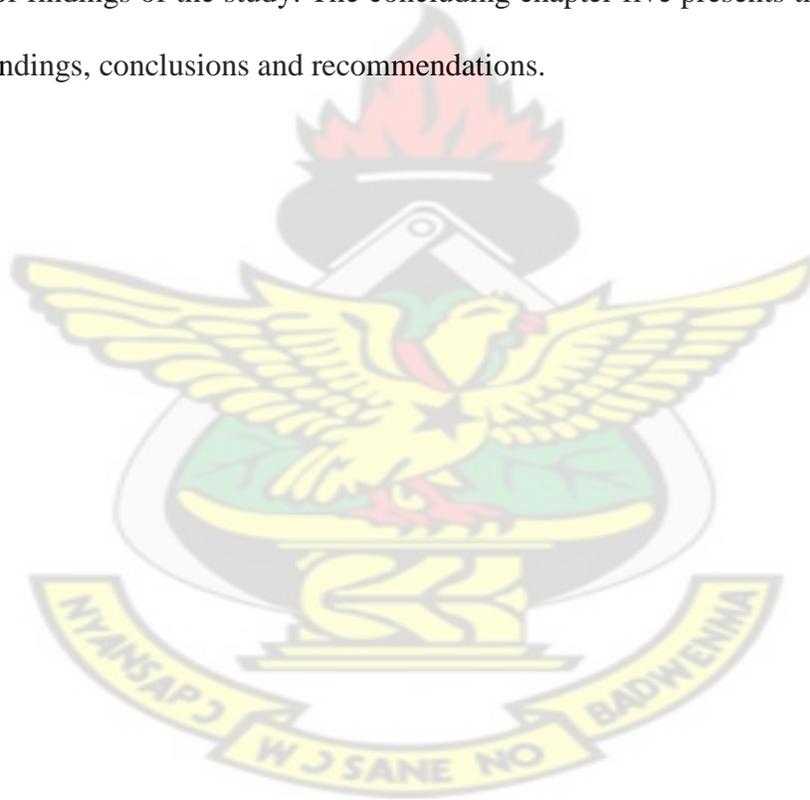
The study focused SMEs in Abossey-Okai who accessed loans from Ghana Commercial between December 2005 and September 2009. GCB was used primarily because of its level of involvement in the development of SMEs financing. The study was also limited to Abossey-Okai due to the increase in the number of SMEs in the area.

1.6 Significance of the Study

The motivation for this study is to have a better understanding of the level of loan delinquency among SMEs and evaluate the effect of existing lending policies on loan default. This is necessary in the spate of the surge in non-performing loans in the banking industry in recent times which is not a debacle only to financial institutions but regulators alike. The study's contribution to literature and practice cannot be underestimated. To date there has been little research on loan delinquency among SMEs in Ghana. Conducting such research would enable banks and other financial institutions to appreciate the factors causing loan default among SMEs, and develop antidotes to boost loan repayment rate. Although, the study relates to the Ghanaian situation, nonetheless, other developing countries with comparative economic growth will find the results of the study useful in their SMEs policy formulation.

1.7 Organisation of the Study

The study is organized into five chapters. Chapter one presents the background of the study, the problem statement, research objectives and questions. The chapter also covers the scope and significance of the study. Chapter two provides a survey of literature on SMEs and the determinants of loan default. The third chapter details the methodology adopted for the study: the population, sample, research design, and instrument for data collection and data collection procedures. Chapter four provides the main findings and discussion of findings of the study. The concluding chapter five presents the summary of the major findings, conclusions and recommendations.



CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

In order to conceive a clear understanding of the research problem a review of the relevant literature is necessary. The literature review is discussed under three main captions – the definition of SMEs, critical factors influencing banks lending to SMEs and determinants of loan defaults. Since literature on these variables is sparse in Ghana, the larger proportion of the literature focused on researches outside Ghana.

2.2 Definition of SMEs

According to Storey (1994), there is no universally accepted definition of a small and medium-sized business. To him, firms vary in their levels of capitalization, sales and employment. Hence, definitions which employ measures of size (number of employees, turnover, profitability, net worth, etc.) when applied to one sector could lead to all firms being classified as small, while the same size definition when applied to a different sector could lead to a different result. The Bolton Committee (1971) made the first attempt to overcome this definition problem by adopting an ‘economic’ and a ‘statistical’ definition of SMEs. Under the economic definition, variables such as market share of the firm, nature and type of management structure were used while the contribution of the firm to GDP, employment and export is used as a statistical benchmark in defining SMEs.

Alternative definitions of SMEs were also provided by organizations and individuals. The World Bank (1976) postulated that firms with fixed assets (excluding land) less than US\$ 250,000 in value are Small Scale Enterprises. Grindle et al. (1989:9-10) defined Small scale enterprises as firms with less than or equal to 25 permanent workers and with fixed assets (excluding land) worth up to US\$50,000. The United States Agency for International development (USAID) in the 1990s considered firms with less than 50 employees and at least half the output sold as small firms (also refer to Mead, 1994).

According to the definition by United Nations Industrial development organization (UNIDO), firms with more than 100 and more workers are classified as large firms, those with workers ranging from 20 to 99 are classified as medium sized firms; those with 5 to 19 workers are identified as small firms while a firm with less than 5 workers is regarded as a micro enterprises.

From the various definitions above, it can be said that there is no unique definition for a small and medium scale enterprise. The definition depends on the organization or the individual in question, and sometimes on the country. Thus, an operational definition is required.

In Ghana, small scale enterprises have been variously defined, but the most commonly used criterion is the number of employees of the enterprise. In applying this definition, confusion often arises in respect of the arbitrariness and cut off points used by the various official sources. The Ghana Statistical Service (GSS) considers firms with less than 10

employees as Small Scale Enterprises and their counterparts with more than 10 employees as Medium and Large-Sized Enterprises. Ironically, the GSS in its national accounts considered companies with up to 9 employees as Small and Medium Enterprises. The National Board of Small Scale Industries (NBSSI) in Ghana applied both the ‘fixed asset and number of employees’ criteria in defining SMEs. According to NBSSI, a Small Scale Enterprise is one with not more than 9 workers and has plant and machinery (excluding land, buildings and vehicles) not exceeding GH¢1000. The Ghana Enterprise Development Commission (GEDC) on the other hand uses the GH¢1000 upper limit definition for plant and machinery. A point of caution is that the process of valuing fixed assets in itself poses a problem. Secondly, the continuous depreciation in the exchange rate often makes such definitions out-dated.

Osei *et al.* (1993) in defining Small Scale Enterprises in Ghana used an employment cut off point of 30 employees to indicate Small Scale Enterprises. The latter, however, disaggregated the small scale enterprises into 3 categories: (i) micro -employing less than 6 people; (ii) very small, those employing 6-9 people; (iii) small -between 10 and 29 employees and medium employing 29 - 50 workers. From the definitions above, it can be said that there is no unique definition for a small and medium scale enterprise. This study adopted the Osei *et al.*'s definition for developing countries which states that an SME is a firm with 6-29 workers. The reason for choosing this particular definition was because the sector being investigated employs averagely within the range of 5-28 employees and the fact that Ghana is a developing country.

Ghana Commercial Bank working definition of Small and Medium Enterprises is an annual turnover of one million United States dollars equivalent in cedis, at that time the dollar to cedi equivalent was one cedi to one dollar that was in the year 2000 and whose borrowing were not exceeding fifty thousand Ghana cedis. This was as far back as the year 2000 the policy has not been reviewed since then but the bank goes beyond and has an average size loan of three hundred thousand Ghana cedis.

Those in project may take up five hundred thousand Ghana cedis for projects financing. Basically Ghana Commercial Banks, Small and Medium Scale Enterprise covers Sole Proprietors and limited liability companies which are run like enterprises without proper management team and well constituted board of directors. Operations are always limited to man and wife.

2.3 Factors Influencing Banks Lending to SMEs

2.3.1 Capital

According to Abor and Biekpe (2007), the bank capital channel views a change in interest rate as affecting lending through bank's capital, particularly when banks' lending is constrained by a capital adequacy requirement. Thus, an increase in interest rates will raise the cost of banks' external funding, but reduce banks' profits and capital. The tendency is for the banks to reduce their supply of loans, if the capital constraint becomes binding. However, banks could also become more willing to lend during certain periods because of an improvement in their underlying financial condition. This bank behavior is explained by the capital constraint models. Basically, banks are subjected to both market- and regulator – imposed capital requirements. For prudential purposes, banks regulators

generally require banks to maintain capital at not less than a stated fraction of the bank's total assets. For instance, banks are expected to meet the capital adequacy requirement of the Basel Accord of ten per cent. Also in Ghana, banks are expected to hold a certain percentage of liquid assets expressed as percentage of total deposits. Thus, the ability of banks to grant loans is constrained by the amount of financial resources at their command, based on the capital requirements.

2.3.2 Agency Theory

The agency theory is concerned with how agency affect the form of the contract and the way they are minimized, particularly, when contracting parties are asymmetrically informed. Fundamentally, the problem arises because lenders are imperfectly informed about the characteristics of potential borrowers, and it may be impossible, as a result, for lenders to distinguish 'good' borrowers from 'bad' ones (Fraser, 2004). As observed by Akerlof (1970), and cited by Kitchen (1972), a systematic bias may arise in SME financing, because of the theory of the market for 'lemons'. Akerlof (1970) argues that small businesses, especially in developing countries, are regarded as 'high-risk', and the level of risk associated with the riskiest small business tends to be applied to all small businesses. Therefore, the problem of information asymmetries highlights the importance of relationships between lenders and borrowers. As Fraser (2004) observes, longer and broader relationships increase the amount and flow of information to lenders, enabling good borrowers to obtain better access to finance over time. Therefore, information asymmetries lead to sub-optimal flows of finance available to smaller firms compared to larger firms (Cook, 2001). The implication of the lack of adequate funding is that SMEs

are caught up in a vicious cycle of low investment, low incomes, low profits and savings for investment.

According to Abor and Biekpe (2007), while the banks are undeniably more qualified to provide lending to SMEs, it is a widely held view that banks, particularly commercial banks, have the greatest difficulties in providing start-up capitals to SMEs in spite of the significant number of SMEs coming up. In addition, SMEs dominate economic activities and make a very significant contribution to GDP. The SME sector employs about 15.5% of the labour force (Parker et al. 1994) and its contribution to GDP was estimated at 6% in 1998 (Kayanula and Quartey, 2000).

Aryeetey (2003) outline some of the reasons why banks are reluctant to lend to SMEs:

- Limited branch network
- Limited range of financial instruments and lending conditions
- Banks' risk-averse behavior; preference for investing in Treasury bills
- Non-performing assets, which make the banks too cautious to undertake further lending
- Lack of established information network such as a credit reference bureau for tracking defaulters
- Weak inter-bank collaboration
- Banks' inadequate capacity to appraise the creditworthiness of SMEs

According to Griffiths (2002), banks require cash flow forecast and budget before considering any financing proposal. If customers are unable to produce these themselves, banks usually look out to accountants to assist them. Once those documents are produced, the bank then question assumptions behind them. Sales in such projections are often excessively optimistic. It is by no means unusual to find that the projections are produced from the bottom up; thus, potential sales are based on what is required to obtain the finance and not necessarily the potential sales target. The lack of historical sales data then makes it difficult to verify whether the sales targets are realistic and therefore bankers face the difficulty to distinguish between impressive-looking documents produced and designed to maximize the chances of obtaining a loan and the underlying soundness of the lending proposition.

Black and Strahan (2002) also argue that, it is ironic that cash flow forecasts are always positive and therefore it would be prudent for bankers to be skeptical of these forecasts unless they are supported by recent actual performance. They identified that the major problem faced in appraising unsophisticated small businesses is the ability to assemble independent evidence to support the key assumptions that underlie their proposal.

Love and Mylenko (2003) outline the following evidence that is generally required by banks in their lending decisions.

(a)The ability and integrity of the proprietors of the business:

- How long have they had a relationship with us?
- Do they have a track record with any other bank or with us? Why are they coming to us?

- Has the account been satisfactorily conducted?
- What is their reputation in town?
- What experience do they have in running a business?
- What is their personal commitment to the business? How much is their stake?

(b)The availability of physical and production resources:

- Are the premises of the right size and in a good location?
- Is the machinery in good condition? How old is it? Maintenance record?

According to Husain (2005), many small scale firms are owned or operated by the family. As a result, business and personal finance are not kept separately. Therefore, when there is a family problem such as school fees his/her child or that of a relative's child, money from the business is used. While one pressing problem is solved, a potential future cash flow problem for the business ensues. Husain (2005) therefore calls for the need for trust between a banker and his customer. In other words, there is a bridge of trust is the bank find out that the customer have not been honest, by failing to disclose banking arrangements at another institution, the relationship tend to break down and once broken, it is difficult to mend. Husain (2005) explains that, one approach to mitigate the high degree of insecurity that surrounds small business lending is to insist on 'good' security in all cases. It undoubtedly has a major role to play in making small business propositions acceptable. However, its availability should not deny bankers the need to have an inform judgment about the underlying viability of any project.

Mensah (2004) suggest that in such situations, the banks would prefer to lend by way of loan rather than overdraft to the customers. By this mechanism the bank can establish an

automatic monitoring mechanism for ensuring repayment as well as trying to ensure that the funds are used for the purpose for which they are granted. Mensah (2004) revealed that there have been many instances where customers have used trading overdraft facilities for fixed asset purchases which has robbed them of much-needed working capital and led to its ultimate demise. He suggests that businesses should be able to provide the bank with monthly information to enable progress to be monitored and that, accuracy is important and one should not try to cover up bad news.

Tagoe, Nyarko and Anuwa-Armah (2005) asserts that, banks see SME lending as a high-risk activity, given the larger proportion of business failures in this sector. As a result, they will inevitably charge a higher risk premium. They suggested that, the price to some extent could be mitigated depending on:

- The level of capital that the owner has in the business
- The degree of profitability
- The extent to which profits remain in the business
- The value/desirability of security offered

2.4 Determinants of Default Rates

2.4.1 Loan Default Defined

Loan default can be defined as the inability of a borrower to fulfil his or her loan obligation as at when due (Balogun and Alimi, 1990). High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing. Von-Pischke (1980) states that some of

the impacts associated with default include: the inability to recycle funds to other borrowers; unwillingness of other financial intermediaries to serve the needs of small borrowers; and the creation of distrust. As noted by Baku and Smith (1998), the costs of loan delinquencies would be felt by both the lenders and the borrowers. The lender has costs in delinquency situations, including lost interest, opportunity cost of principal, legal fees and related costs. For the borrower, the decision to default is a trade-off between the penalties in lost reputation from default versus the opportunity cost of forgoing investments due to working out the current loan.

2.4.2 Factors Affecting Repayment of Loans

This section of the literature is related to the default rates and the problems of asymmetric information. A review of the literature on informal lending activities indicates that informal lending and borrowing arrangements have effectively persisted for a long time in low-income countries. The loans typically are small and unsecured, with high real interest rates. However, as pointed out by Wai (1957) the interest rates are not out of line given the high level of risk. The middle man is an important ingredient in these credit transactions. In many instances this individual is the village shopkeeper (i.e. is generally in an excellent position to know the resources and character of those in the area). Ward (1960) suggests that the middle man is limited in the number of loans he can carry because of the size of his own resources and his need to have close and accurate personal knowledge of each debtor. Moreover, in those rural societies where it is customary for borrowers to pledge land and/or its product to creditors, each creditor is further limited by the small number of farms he can effectively supervise. Corroborative evidence

concerning the market area for lending activities in informal settings comes from Nisbet's (1967) study in Chile. He found that rural moneylenders operated within a two-mile radius of their home villages. Nisbet agrees that moneylenders and shopkeepers have and need close personal knowledge of their borrowers' circumstances. The studies by Ward and Nisbet suggest that credit information, that is, the knowledge of who are and who are not good credit risks, is valuable information and may limit the geographical size of rural informal credit markets. Ward further suggests that some of the methods of entering into a credit relationship in peasant producing populations and in the West are more similar than might be expected. As she states; 'if a private individual in England wants to borrow money or open a credit account, he too has to establish his credentials, and in the last resort this means that he too depends on personal knowledge on the part of his creditor.'

As noted above, a few studies have examined the determinants of default rates in low-income countries in the case of formal lending situations. The vast majority of work in this area has taken place in India or other eastern countries. Reddy (1976) tried to identify characteristics of defaulters and non-defaulters based upon data from rural credit cooperatives from 12 villages in two separate regions in India. The author found some similarities and many differences between these characteristics in the final discriminant functions. In both regions, primary occupation made a difference in the default rate. For example, borrowers depending primarily on agricultural occupations for their incomes were more likely to repay debts promptly than those who had to supplement their income with highly uncertain non-farm employment. The purpose of the loan also was a good predictor of defaults. For example, farmyard manure applications were positively associated with timely repayment.

Pandy and Muralidharan (1979), using data from the Uttar Pradesh State in India, attempted to develop criteria for classifying borrowers as to their willingness to repay their loans on the basis of differences in their socio-economic characteristics. The discriminant function analysis indicated that the percentage of total income derived from sources other than crop production, the amount of loan, the purpose of loan, per capita consumption expenditure, and the ratio of cash expenditure to total expenditure were the major characteristics that classified borrowers into defaulter and non-defaulters. Finally, Meier (1987) developed a model for predicting loan defaults. Fifteen defaulters and fifteen non-defaulters in Karnataka, India, were randomly selected from four cooperatives in the district of Mandya. During April, 1985, the author conducted 113 interviews. Thus, independent variables were a measure of political influence, the education level of the household head, acres of irrigated land owned, the ratio of short-term loans to expenses, debt to asset ratio, and a measure of the household's average propensity to consume. As the author states, the study was not successful in its primary goal of describing how defaulters differ from non-defaulters. Of the six variables, only household average propensity to consume even remotely contributed to the model's discriminatory power. Clearly, if lending agencies in developing countries want to improve their default record, they need more information than is currently available on the determinants of loan default.

Problems of asymmetric information play an important role in financing SMEs. These problems - adverse selection and ex ante moral hazard - should be more severe in the new member states of the EU. According to the so-called 'observed-risk hypothesis', banks

can observe the firm's risk ex ante and can adjust the terms of the credit contract accordingly so as to adjust pricing to the riskiness of the loan (Blazy and Weill, 2006).

Many factors have been identified as major determinants of loan defaults. The problems of asymmetric information arise for all loans, although these problems aggravate as the relative debt level increases. However, different legal forms may also provide different incentives, which may result in different default probabilities. Other variables are also likely to determine the default rates. The first relationship is most closely related to our initial motivation with regard to financial vulnerability in the new member states. If firms are highly indebted, when successful they have to pay a higher proportion of their payoff to the bank. As a result, ceteris paribus, the difference between the payoffs for success and failure decreases, and so does the incentive to exert effort and/or invest the loan for the purpose agreed upon in the credit contract. This behavior decreases the probability of success.

The degree of the moral hazard problems depends a lot on the characteristics of the firm. If the debtor is fully liable, he internalizes the effect of his investment decision on payoffs. In contrast, when the degree of debtor's liability is restricted, for example, if he does not have sufficient assets that can be used as collateral² and can be liquidated in the case of failure, the debtor repays only in the case of a successful outcome. Of course, he has to repay more in the case of success because with failure, the bank gets no repayment. As a consequence, the incentives of the debtor are distorted if he is not (fully) liable (see Bester, 1994 and Hainz, 2003).

A similar argument applies to strategic default. Suppose that the creditor cannot observe the actual outcome of a project. This allows the debtor to claim that his project has failed (although it was successful) and to keep the return. If the debtor is liable and loses assets in the case of failure, the likelihood of strategic default is much lower (Bester, 1994). The debtor's liability is largely determined by the legal form. On the one hand, natural persons are fully liable for their losses. On the other hand, owners can limit their liability more easily by incorporating the firm as a legal body.

Loan default is closely related to corporate bankruptcy. The causes of bankruptcy are problems in the fields of profitability, liquidity and solvency (Altman and Suggit, 2000). These financial ratios can be used to predict the probability of corporate bankruptcy. The only paper studying default rates of bank loans is Altman and Suggitt (2000). They base their analysis on syndicated loans which exceed US\$ 100 million, are rated and are issued between 1991 and 1996. After a five year period, the cumulative default rates are remarkable similar to those of corporate bonds. However, the time patterns of default differ considerably. Compared to bonds the default rates of loans are significantly higher in the first two years. Some more evidence is available on the default recovery rates of loans that range between mean values of 65 and 87 per cent in developed countries, depending on the data set (Carty *et al.*, 1998; Asarnow and Edwards, 1995).

Martin (1997) analysed the determinants of the repayment performance of Grameen Bank borrowers and discovered that education level and the area of land possessed (proxy of wealth) by the borrowers have a positive impact on repayment performance. In a related study, Godquin (2004) contended that borrowers who have enough money to reimburse

might also default strategically. He also reported that both age and size of loan have an inverse relationship to repayment performance. These results confirm the finding of an earlier study conducted by Freimer and Gordon (1965).

Young, Glennon and Nigro (2006) proposed that collateral (assets to secure the debt), capacity (sufficient cash flow to service the obligations), character (integrity), condition of the economy as well as capital (net worth) need to be included in the credit scoring model. In a related study, Weinberg (2006)'s findings have provided support to that of Young *et al's* suggestion. He contended that two main determinants of household repayment obligations are the amount of debt and the interest charged.

On the contrary, Paul (1973) suggested the need for non-traditional measures of psychological attributes such as stability, sense of commitment and future orientation. This attributes might be reflected in religious body or club membership and newspaper readership. This was documented after the author failed to develop a scoring system with predictive power after studying 800 respondents in the Washington D. C. area.

Another study by Young, Glennon and Nigro (2006) documented that both 'soft' and 'hard' information have an impact on the repayment patterns of the borrowers. Hard information such as borrowers' capacity, indebtedness and monthly installments need to be taken into consideration. On the other hand, soft information like borrower-lender distance is important. A larger borrower-leader distance is associated with higher default risk because distance interferes with information collection.

Meanwhile, the condition of the economy is equally important; the recent U.S. economic slowdown has resulted in total delinquencies and monthly defaults climbing

approximately 65 percent (Young, Glennon and Nigro, 2006). Besides being affected by the economic crisis, Athmer and Vletter (2006) added that 70 percent of the defaulters in their samples are facing crisis related to health or experiencing death in the family. Finally, loans that are too big also lead to repayment problems, dissatisfaction and high drop outs (Ganbold, 2008).

The study of Balogun and Alimi (1988) shows the main causes of loan default, which include shortages in loan, delay in the delivery time of loan, poor supervision, non-profitability of farm enterprises as well as undue government intervention with the operations and procedures of the programmes being sponsored by the government.

Okorie (1986) shows that the nature, time of disbursement, supervision and profitability of enterprises which benefited from small holder loan scheme in Ondo State, contributed to the repayment ability and consequently high default rates. Other critical factors associated with loan delinquencies are: type of the loan; term of the loan; interest rate on the loan; poor credit history; borrowers' income and transaction cost of the loans. However, the lending perception by banks of SMEs as being involved in high loan defaults could not be confirmed by the study. The SMEs owners were asked to indicate the status of their loans in order to determine the level of default in loans repayment. Based on the responses and in line with acceptable banking practices, the loans were classified into Performing loans and nonperforming loans.

A loan is deemed to be performing if the repayments of both principal and interest are up to date in accordance with the agreed repayment terms. On the other hand, a loan is deemed as non-performing when any of the following conditions exists: (i) interest on

principal is due and unpaid for 90 days or more; (ii) interest payment equal to 90 days interest or more have been capitalized, rescheduled or rolled over into a new loan.

Some studies of mortgage default based on race have attracted a great deal of attention. Canner *et al.* (1991) evaluated a model of mortgage loan allocation based on default risk, and further test in that context for any remaining effects associated with household race or neighborhood racial composition. Kelly (1995) also looked at white, black and Hispanic race to examine their mortgage prepayment rates and the result proved that there exists a significant difference among these races. Lastly, Munnell *et al.* (1996) found that minorities are more than twice as likely to be denied a mortgage as whites. Therefore, the decision making process of mortgage loans is different among applicants of different races since race does matter in terms of the determinants of mortgage default. However, race issue does not matter in the mortgage loan process of Taiwan's financial institutions, which is obviously distinct from the U.S. case. On the contrary, the classification of homes always plays an important role in the initial loan application process. The main reason is that financial institutions considered the used ones to be of inferior quality, limited lifespan and costly maintenance, and hence put more restrictions on their mortgages. In the previous literature, no studies have assessed the determinants of default risk based on the classification of homes for home mortgage loan applicants.

Balogun and Alimi (1988) found that the default rates in loans to small farmers in Lagos region in 1985 and 1986 were in the range of 55 and 90 per cent respectively. However, the study by Balogun and Alimi (1988) relate only to small farmers, unlike this study that was based on enterprises from many sectors of the economy. Anderson (1982) spoke of

default rates as varying from 10 per cent to 60 per cent or more in most developing countries. The observed low delinquency rates by the SMEs operators could be to preserve their reputations as good borrowers and to avoid the threat of direct sanctions. As warned by Albee (1996), this development presumes that there is no potential ‘debt trap’ for the borrowers by using new loans to pay off old loans, creating the illusion of high repayment rates. Other possible reasons for the low delinquency rates among the SMEs include:

- improved borrowers’ knowledge, commitment to business; counseling and monitoring activities of banks. As observed by Baku and Smith (1998), lenders’ actions in preventing delinquency include the underwriting process prior to making a loan, counseling and follow-up after a loan is made, collection.
- practices should a borrower fail to make payments, and forbearance or movement to default and foreclosure.

CHAPTER THREE

METHODOLOGY

3.1 Introduction

This chapter presents the blueprint of how the researcher intended to conduct the study to ensure that the most valid findings are reached. The most appropriate operations or procedure were performed in order to provide answers to the research questions. This includes type of research design employed, the measuring instrument, the sampling procedure, data management and data analysis.

3.2 Population and Sample

Population has been defined as the total collection of elements about which we wish to make some inferences (Cooper and Schindler, 2001). The population for this study was all SME customers who have assessed credit from Ghana Commercial Bank Ltd. Since the population is large and it will be prohibitively expensive to cover every element, the study adopted sampling technique to select the respondents of the survey. Sampling, according to (Cooper and Schindler, 2001) involves selecting some of the elements in a population and draw conclusions about the entire population. The compelling reasons behind the decision to sample includes the lower cost, greater accuracy of results and greater ease of data collection associated with sampling. Based on this, fifty (50) SMEs from Abossey Okai who are GCB customers were drawn for the study given the time constraints and limited resources available for carrying out the study. The researcher

chose the fifty firms based on the database containing the list of SMEs who have applied for loans. The choice of SMEs from the Abossey Okai for the study is based on the fact that more businesses are concentrated in the area and also due to the interest of the researcher to study the rate of loan delinquency among spare part dealers.

3.3 Sampling Technique

The study combines both the probability and non-probability sampling methods. Probability sampling according to (Jankowicz, 2000) involves identifying and questioning people because they are members of some population to ensure that your assertions are valid for your respondents and directly generalizable without further inference, to that population. Stratified random sampling, which is one of the probability sampling methods, is used in this study. The technique is a modification of random sampling in which the population is divided into two or more relevant and significant strata based on one or a number of attributes (Saunders et al, 2007). The non – probability sampling method adopted is the convenience method. The choice of convenience sampling method is motivated by the fact that it is relatively easier in obtaining accurate information on SMEs in the Abossey Okai area in Accra, since the researcher resides in the area.

3.4 Research Technique

Research techniques are particular, step-by-step procedures which you can follow in order to gather data, and analyze them for the information they contain (Jankowicz, 2000), the structured technique is used. This is the use of structured questionnaire and

face-to-interview. The questionnaire is the main research instrument used in collecting the data for the study, taking into consideration the specific objectives of the study and the sample size. Majority of the items on the questionnaire are closed ended-questions. This is because they are easier for respondents to answer and also facilitates interpretation of data by standardizing alternative responses. Few open - ended questions were also asked in order to provide the opportunity to respondents express their own opinions or suggestions about the causes of loan default, open-ended questions is also included in the questionnaire.

3.5 Research Design

The study was basically a survey research hence the use of primary data collection instruments such as questionnaire and follow-up interviews for response clarifications.

3.6 Data from Primary Sources

As adequate data could not be gathered from the institutional or secondary sources, study relied mainly on data from primary sources. Data collection from primary sources involved a field survey since it has the capacity for generating data from a large number of people. The survey was limited to the owners of 50 SMEs which were selected for secondary data. This research strategy was deliberately chosen to see how results from primary data compared with the results obtained from secondary data. The survey instruments applied to collect data from the primary source were a structured questionnaire, firm and visits and interviews.

In order to generate data from the primary sources, a written and self-administered questionnaire which was relatively cheap, time-efficient and free from interviewer bias was developed. Considering the time and costs involved in other instruments, this instrument was chosen despite objections from several authors on the ground that it yields incomplete responses, contains confused questions and lacks spontaneity. However, given the circumstances that constrained the use of other efficient instruments, it was believed that the advantages of a self-administered questionnaire far outweighed the disadvantages associated with it. With this understanding, self-administered questionnaires, shown in Appendix A, were personally administered to the 50 firms during the first week of March 2011.

With this end in view, the questionnaire was structured into several parts. Part A provided the introductory aspect of the firm and Parts B and C contained questions relating to problems experienced by the SMEs at the stage of project identification and credit disbursement. Part D focused on issues relating to project implementation and Part E deals with questions relating to project supervision and monitoring. The questions relating to working capital and project management are provided in Parts F, G and H, respectively. The last part focused on public policies.

The multiple method strategy was adopted for this study to reduce the possibility of personal bias by not depending on only one method of approach or response coming from only one firm. A multiple method strategy is one in which more than one method of approach is used in data collection and analysis while conducting research. The current address and telephone numbers of SME owners/managers – who took a loan from GCB

for the period under consideration – were used to reach out to the respondents. Executives of these firms were all contacted and interviewed personally using structured questionnaires.

3.6.1 Interview

As a part of the qualitative research method, the researcher also interviewed some loan officers and operational managers from selected branches of GCB in Accra. The aim of such interviews was to find out the views of bankers on the causes loan default in Ghana. It should be noted that, prior to conducting interviews, attempts were made to gather information through a structured questionnaire. Purposive sampling method was used to select the officials for the interview.

3.7 Data Analysis

The data was coded into Statistical Package for Social Sciences (SPSS). Analysis of data is essentially descriptive. As such statistical techniques such as frequencies and percentages were used to analyze the data. Besides, results were presented using tables, pie chart and bar charts.

CHAPTER FOUR

PRESENTATION AND DISCUSSION OF RESULTS

4.1 Introduction

This section is devoted to the presentation and analysis of data collected for the study. The analysis is based on the lending policies of banks towards SMEs and factors explaining loan default among SMEs.

4.2 Financial Role in Loan Default among SMEs

Respondents were asked a number of questions relating to four financial role variables. Data relating to lending policies, credit disbursement, debt-equity ratio, term and variable loan ratio, and loan repayment period are provided in this section.

4.2.1 GCB Lending Policies towards SMEs

The lending policies of the bank to small and large enterprises in Ghana are almost similar, except for few documentation such as company registration/incorporation and project/business plans. While the big enterprises are required to submit names of directors and good track records, the small firms, especially sole proprietorship are required to submit evidence of company registration/incorporation and project/business plans. The same types of forms are used by both the small and large firms, with the firms filling the areas relevant to them. To the extent of the explanation above, one may be tempted to say that the lending practices towards SMEs are not that different from large enterprises.

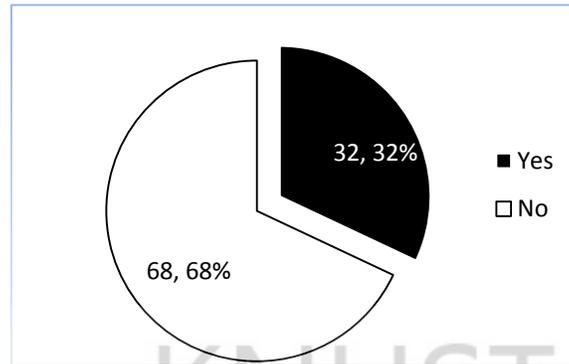
In granting loans, however, the bank employs different criteria to assess the creditworthiness of SMEs. The range of factors include financial strength, profitability, net worth, track record, management quality, relations and payment records with other banks, business prospects, business risks and collateral securities. In most cases, the bank requests for guarantee for SME loans. The bank requests for collateral as an additional requirement, apart from requiring personal guarantees for SME loans, because the financial and operational transparencies of SMEs are relatively low and their accounting standards are poor. The enterprises are also perceived as risky due to the fact that, in most cases, the death of the owner leads to the death of the business, diversion of funds, high cost of monitoring loans and the fact that most of the loans may not be collateralised.

Generally, it is always difficult for the SMEs to meet the standardized requirements of the bank. However, when the bank is favorably disposed to lend to the small firms, the operational records of the small firms with the bank are used to determine the suitability or otherwise, of such enterprises in obtaining loan. Sometimes, the issues of the length of time of operating the accounts and the customers' relationship with the bank are considered in lending. With these policies in place, what factors cause SMEs to default on their loans?

4.2.2 Credit Disbursement

The respondents were asked about timely disbursement of credit by GCB. Nearly two-thirds (68 percent or 34 firms) of the 50 SMEs confirmed that they experienced delays in disbursement of credit by GCB (Figure 4.1). Only 16 firms representing 32 percent received credit in due time.

Figure 4.1 Disbursement of credit by GCB in due time



As the number of credit installments varies from firm to firm, delay in credit disbursement also varies from firm to firm. Those who received credit disbursement in more than one installment experienced more delays than those who received credit by single installment. SMEs (32 percent) experiencing no delays in credit disbursement may have received their loans in a single installment.

When asked to list the reasons for delayed credit disbursement, 40 firms provided multiple answers. Of these 50, 11 SMEs (22 percent) cited delay in pre-disbursement inspection as the reason for not receiving credit in time. Eight percent of them indicated that credit disbursement was delayed due to GCB’s demand for documents supporting owner’s equity investment (Table 4.1).

Table 4.1 Table 1 Reasons for delayed disbursement of credit from GCB

Response Category	No. of Mention	Percent
Delayed inspection by the bank	11	22
Demand for documents regarding pre-investment	4	8
Delayed loan processing	25	50
Inadequate pre-disbursement of the loan	8	16

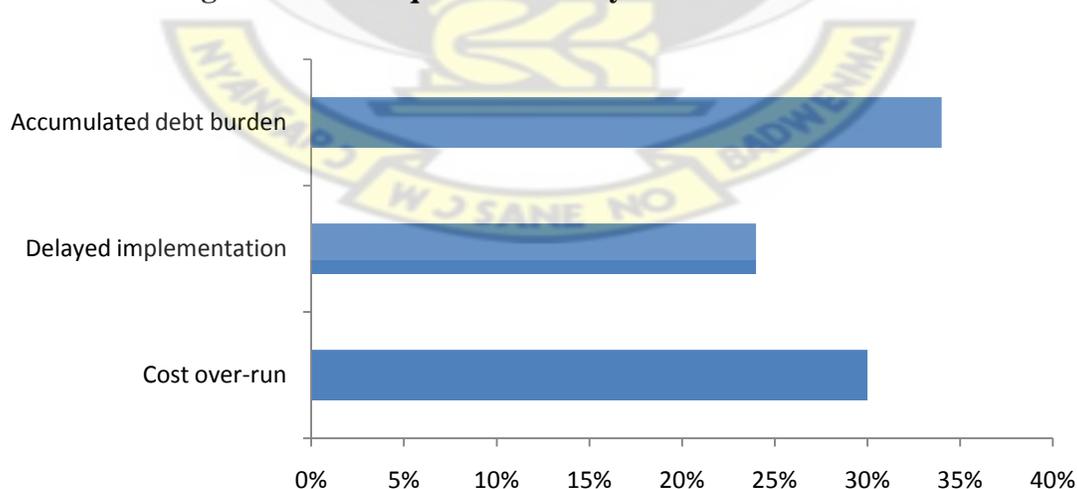
N = 50

Source: Field Data, 2011

Even after lodgment of documents relating to equity investment, credit disbursement was delayed for 25 firms (50 percent) of responding firms due to delayed loan processing by GCB. But 8 firms (16 percent) could not invest enough equity capital which delayed credit disbursement to them. Though the majority (84 percent) firms did not admit that inadequacy of equity capital was responsible for delayed disbursement of credit, the existence of some stuck-up SMEs in GCB's loan portfolio support the answer of the 6 responding firms that inadequate equity capital was a factor for delayed disbursement of loans (Table 4.1).

The firms receiving delayed credit disbursement (50 SMEs) were asked to state the effects that delayed credit disbursement had on their cost of operation. They provided multiple answers to this question (Figure 4.2). Because of delayed disbursement of credit, 30 percent of the SMEs experienced cost overrun and 12 firms (24 percent) could not be implemented as per scheduled time. As Figure 4.2 shows, 17 firms (34 percent) suffered accumulation of debt burden.

Figure 4.2 Consequences of delayed credit disbursement



GCB disburses loans in four, sometimes more, installments subject to the prior fulfillment of specified conditions. These conditions take different forms depending on whether borrowers are seeking large loans. Usually, GCB prepares a loan disbursement schedule incorporating the following conditions.

- Depositing with GCB fully paid share certificates of the concern as collateral security; and
- Completing all formalities and auxiliary works for putting the concern into trial production.

Loan disbursement takes place as soon as the conditions are fulfilled to the satisfaction of GCB. However, fulfilment of such conditions takes a considerable period of time due to the borrowers' failure to mobilise equity capital on one hand and to GCB's delay in carrying out pre-disbursement inspections to verify compliance of these conditions on the other hand. Most of the borrowers do not have readily investible liquid assets. They mobilise their equity money either by selling fixed assets or by borrowing from the formal and informal credit markets and, in both cases, this takes considerable time.

Delay in the disbursement of loans of either type is a regular phenomenon in GCB. It is evident from Table 2 that most of the sponsors of 50 firms investigated waited up to 5 months after the first disbursement to get final disbursement of loans. Sponsors of more than a third of these enterprises had to wait between 6 and 10 months to obtain the final disbursement after they received the first disbursement of loans.

Table 2 Months Spent Between First and Last Disbursement of Loans

Months Spent	No. of Firms	Percent
0 – 5	21	42
6 – 10	17	34
11 – 15	11	22
16 or more	1	2
N = 50		

Source: GCB, Loan Department. Data were computed by the author

Twenty-four percent of these firms waited more than 10 months after they took first disbursement. This may be due to the problems associated with the delayed equity investment or with delayed loan processing by GCB. At least 16 percent of the borrowers surveyed admitted that they had problems with pre-disbursement equity investment (Table 4.1).

Delay in loan disbursements may not be entirely due to the failure of the borrowers to satisfy pre-disbursement conditions. Sixty-eight percent of responding firms blamed delayed loan processing for delays in disbursement (Figure 1). About 22 percent or 11 firms of these respondents alleged that credit disbursement was delayed due to delayed inspection by GCB (Table 4.1). When interviewed, the officials of GCB admitted that shortage of personnel was responsible for delayed pre-disbursement inspection. But Price Waterhouse (2004) found that bank staff in Ghana were too bossy, hostile or arrogant and saw the borrowers at their mercy. Price Waterhouse specifically mentioned that bank staff makes little effort to help clients complete the necessary documentation against disbursement of loans and that some of them demanded bribes, commissions and other forms of kickbacks.

All these indicate that the delay in loan disbursement may be partly attributed to the borrower's failure to make pre-disbursement equity investment in the project and partly due to delays in loan processing and corruption of loan-officers and managers. Such delays in loan disbursement resulted in cost overrun, high cost of borrowing and increased transaction costs. The borrowers surveyed by the author also expressed identical views. Of the 50 borrowers asked to report on the consequences of the delayed credit disbursement, 22 borrowers (55 percent) said that they experienced cost overrun and 20 borrowers (50 percent) acknowledged delayed implementation of the firm (Figure 4.2).

It is to be mentioned here that delayed credit disbursement increases debt burden. When borrowers get part disbursement of credit and wait too long for disbursement of another part of credit, they are to count interest on the past loans disbursed. This means that the more delays that occur in getting any subsequent disbursement of credit after the first disbursement, the higher is the interest repayment liability that borrowers are to bear. Table 4.2 shows that 36 firms spent more than 10 months between first and last disbursement of credit and these firms *will* to bear more interest burden than 50 firms which waited less than 6 months.

4.2.3 Officer-Application Ratio

The credit needs of SMEs are assessed by loan officers and financial analysts. While the assessment of borrowers' credit worthiness is done by the loan officers, assessment of the economic, technical and financial viability of the enterprise is carried out by the financial analysts, respectively. The quality of the assessment of credit worthiness of the borrowers

and the project feasibility reports on the enterprise is likely to deteriorate if the growth of the number of loan applications is not matched by the increased number of loan officers and financial analyst. This creates scope for the would-be defaulters to obtain SME credit.

Table 4.3 Officer-Application Ratio in GCB

Period	No. of Loan Application Received	No. of Loan Application Processed	No. of Loan Application Pending
Sep 2005 – Aug. 2006	255	121	134
Sept. 2006 – Aug. 2007	519	306	187
Sept. 2007 – Aug. 2008	622	359	254
Sept. 2008 – Aug. 2009	521	213	218

Sources: GCB, Loan Department. Data were compiled by the author

Table 2 shows that loan applications received by GCB jumped to 519 between September 2006 and August 2007 from 255 between September 2005 and August 2006. Such a phenomenal growth in loan applications was unmatched by the number of loan officers which remained almost static. For example, the number of loan officers engaged in assessing credit worthiness hovered between 1-3 and that of financial analysts between 5-7. With such under-resourced manpower, GCB had to deal with a large number of applications. Under the surge of loan applications from the borrowers until August 2007, the officer-application ratios, particularly financial analyst and loan-case ratio have decreased manifold. Though the average number of loan applications continuously declined 2007 due to the drying up of loan able funds, the number of loan officers engaged in loan processing was also reduced and they were relocated to recovery departments of GCB to help recover loans. As the number of loan officers was reduced

from September 2007 onwards, the officer application ratio remained always low, irrespective of the fact that the number of loan applications declined.

The presence of a low officer- application ratio may also be indicated by the existence of loan cases awaiting processing or pending cases and delays in loan processing. It is evident from Table 2 that the average annual number of pending loan cases soared from August 2006. Delay in loan-case processing is also another indication that loan officers suffered from a log-jam of applications, though the inability and/or unwillingness of borrowers to provide necessary information and documents in time may have contributed to such delay.

Under these circumstances of loan-rush, it was highly unlikely that GCB was able to maintain a high standard and efficiency of credit control, regardless of the honesty and job commitment of its employees. Since loan officers, professionals and credit approval authorities, were required to make haste to unload their loan case-processing work, they had to compromise with their standards relating to the enterprise as well as borrowers' selection conditions and accept an inefficient credit control mechanism to cope with the growing number of loan applications. The huge pile-up of loan applications together with the pressure from the government to provide funds without too careful a scrutiny of the borrowers or of the projects have contributed towards the financing of projects with doubtful commercial viability. All these are indicative of the fact that the loan officers, over-stressed by the surge in loan applications, were more likely to compromise with quality and efficiency of the loan screening mechanism which allowed the unworthy borrowers to receive loans they did not deserve thus increasing the risks of default.

Borrowers' Creditworthiness: Unworthy borrowers may have access to the credit regime if the screening mechanism is defective. Whether the screening mechanism employed by GCB was defective can be tested with the help of some proxy variables: the presence of stuck-up cases; the time taken to get disbursement of funds, and repeat lending to defaulters.

Stuck-Up Loan Cases: SME projects become stuck-up when its sponsors cannot either implement it or put it into commercial operations due to their insolvent or weak financial position. The existence of stuck-up loan cases in GCB's loan portfolio means that uncreditworthy borrowers were able to get access to term loan facilities. Borrowers face the test of financial soundness when they are required to mobilise their equity before any installment of the loan is disbursed to them. GCB disburses term loans to borrowers in four installments and disbursement of each loan installment is preceded by substantial equity investment by the borrower. A financially unsound borrower obtains only part disbursement of the loans by meeting pre-disbursement (equity investment) conditions. Consequently, the enterprise remains partly implemented or in a condition which does not allow its commercial operation. GCB describes such firms as stuck-up cases. That is, stuck-up cases are the indicators of the existence of a defective screening mechanism. The higher the number of stuck-up cases, the stronger is the indication that the screening mechanism is defective. There are a large number of stuck-up cases in GCB's loan portfolio. The stuck-up loan cases remained partly implemented due to the fact that the owners of these cases were not able to mobilize their equity money due to their financial insolvency.

These stuck-up cases accumulated loan repayment burdens and, since they could not go into their intended operation, GCB could not recover its credit by executing the normal loan repayment schedule. As such, it had to file cases against about two-thirds of the total stuck-up cases to recover its loans. The presence of such a large number of stuck-up cases indicates that the borrower screening mechanism employed by GCB was highly inefficient and flawed.

4.2.4 Time Taken for Loan Disbursement

The disbursement of credit by GCB is preceded by fulfillment of certain conditions by the borrowers. For example, to get disbursement of the first installment of loans, borrowers are required to construct a substantial portion of the project by mobilising their own equity. When GCB is satisfied with the level of equity investment, it disburses a part of the loans. While credit worthy borrowers take a reasonable time to meet these conditions prior to the disbursement of credit, unworthy borrowers find it difficult to fulfill pre-disbursement conditions and take excessive time. When borrowers take excessive time to qualify, for instance, for the first disbursement, the defect of the screening mechanism is exposed. That is, the more time borrowers take to get the first disbursement, the clearer is the exposure of the flaws in the borrower screening mechanism. The data in Table 4 show that 38 percent of the 50 firms investigated took less than six months to complete their equity investment before the first disbursement of credit was obtained from GCB. Nearly one-quarter of them took between 6 and 10 months to mobilise their equity. There were 8 firms (about 16 percent) which took 11 and 15 months to arrange equity investment in their projects before they were qualified to get the first disbursement of credit from GCB. These borrowers seem to be financially weak

and less capable than the borrowers of 7 firms who took between 16 and 20 months to get the first disbursement. The presence of these long-time takers among the borrowers reinforces earlier findings that the borrower screening mechanism in GCB is problematic.

Table 4.4 Months Taken to Invest Equity before Disbursement of First Installment of Loans

Months Taken	No. of Mention	Percent
0 – 5	19	38
6 – 10	11	22
11-15	8	16
16 – 20	7	14
Above 20	5	10
N = 50		

Source: GCB Data were compiled and computed by the author

4.2.5 Lending to Repeat Defaulters

The flawed screening mechanism may allow defaulting borrowers of one lending institution to receive a loan from another lending institution. In other words, the existence of the repeat defaulters in the loan portfolio indicates defects in the borrower screening mechanism. These repeat defaulters are able to take advantage of the flawed or inefficient borrower screening mechanism to obtain huge loans. Although the character and integrity of borrowers are important for corporate lending, these borrowers - whose character and integrity regarding loan repayment were previously exposed by the government and the press - were able to evade the borrower screening mechanism in GCB. The existence of inefficient borrower screening mechanism in Ghana facilitates the flow of term credit to high risk borrowers who default in repaying loans.

4.2.6 Credit Need Assessment

The assessment of credit need is carried out in the form of economic, technical and financial feasibility studies of the project after the loan case has passed through the borrowers' credit worthiness test. GCB conducts, as a part of credit need assessment, economic and market feasibility studies. The project appraisal reports prepared by the project-economists, show demand, and supply gap for the particular products the project proposes to produce and if a supply gap is established, the project is declared feasible from the market point of view. Economic analysis focuses on costs and benefits and quantifies the effect of the project on the general economy.

The technical appraisal report concentrates on production capacity, manufacturing processes, building and civil works, selection of local and imported machinery, technical service and all other technical aspects. After the project is found feasible from economic and technical view points, it is sent to the financial analyst who quantifies the costs and return of the project on the basis of market, economic and technical appraisal reports. So the market and economic appraisal reports of the project are crucial because other appraisal reports follow them. Though the project-economists of GCB follow a World Bank Manual for preparing the market and economic appraisal reports of the proposed projects, the competence and skills of the recent graduates, who comprise the majority of appraisal-officers, are highly questionable. As GCB has a very high officer turn-over ratio, experienced financial analysts tend to leave GCB after a few years' service because of unattractive remuneration. As such, the task of preparing economic and market appraisals reports is mostly left to the fresh staff. This results in inadequate economic and markets appraisals of the projects. However, the availability of highly skilled and

competent economists does not provide a guarantee that the viable project *will* be chosen by GCB, since findings of a genuine study are, sometimes, tempered by outside interference. Three such loan officers who were interviewed revealed that they were informally asked by the top management on several occasions to manipulate data to make some projects seem viable. An identical type of interference was also reported by the financial-analyst.

In the course of an interview, the manager in charge of the loan department revealed that about 80 percent of the decision taken relating to loan sanction was the product of outside intervention in the loan intermediation process. The intervention by the top executives in the loan approval process has compounded the loan default problem.

The feasibility study of SME projects is also constrained by the lack of reliable and adequate data in Ghana. As such, the level of accuracy in the projections and various estimations such as projected demand for the product, cash-flow, debt-service coverage ratio, and costs and benefits calculation (e.g., net present value and internal rate of return) have wide variations from the actual results. In an examination of some project reports, it was found that appraisal-officers across the board followed some stereo type style of analysis by disregarding variability in the nature and type of products of diverse SMEs. The loan manager revealed that project appraisal reports have not found any significant improvement even though Price Waterhouse (2004) registered the following points some years ago.

Individual appraisals often seem superficial also, with inadequate analysis of the inherent interrelationships of the different aspects - technical, economic, financial,

commercial, management - that will determine project viability and repayment capacity. Sometimes, indeed, successive appraisals in a given subsector could be carbon copies, with different sponsors' names and plant locations inserted in the proper blanks'.

4.2.7 Debt-Equity Ratio

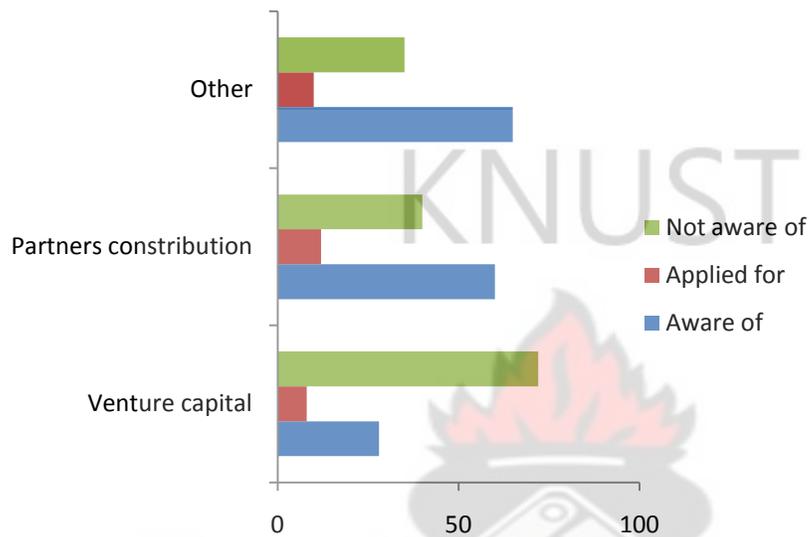
SME investment in developing countries basically comes from two sources: bank loan and borrowers' equity (Tagoe, Nyarko and Anuwa-Amarh, 2005). The banks demand that the borrowers must be willing to invest their money in their enterprises along with the funds they would like to receive from the bank. Borrowers in developing countries such as Ghana are resource-poor and are not in a position to provide adequate capital and they depend mostly on bank credit to finance their enterprises. It should be mentioned here that Ghanaian entrepreneurs mobilise funds from three major sources: accumulated personal fund or assets, financial institutions, and venture capital provider. There were borrowers who mobilized funds from personal savings, trading business and/or from sales proceeds.

Many venture capital deals focus on 'larger, later stage deals' due to: the transaction costs associated with the provision of small amounts of capital, a shortage of available exit options and the historically lower returns gained from early stage investment. This means that equity finance is only ever going to be a viable option for a fraction of SMEs. For instance, the venture capital deals set up by the government involving early stage companies (i.e. SMEs) in 2005 across the whole economy totaled 22, according to figures collated by Ghana Venture Capital Funds (GVCF)². As expected, awareness of the

² www.venturecapitalghana.com

provision of venture capital funds among the businesses surveyed is substantially lower than the awareness of partnership formation (see Figure 4.3).

Figure 4.3 SMEs’ Awareness of, and application of finance



Source: Field Data, 2011

4.2.8 Term and Variable Loan Ratio

Variable or working capital received wider attention from the responding firms. More than four-fifths (84 percent) of the 50 responding firms said that they got insufficient working capital from the banking sector as a whole. This implies that inadequate working capital was a problem for most SMEs. Table 6 shows that GCB provided inadequate working capital to all the responding firms. The majority (96 percent) of these respondents did not receive working capital in time.

Table 4.5: Firms responding to the questions relating to working capital

	Yes		No	
	No. of Mention	Percent	No. of Mention	Percent
Insufficient working capital from all banks	38	76	12	24
Inadequate working capital from GCB	50	100	-	-
In time availability of working capital	2	4	48	96
Inadequate working capital caused loan default	32	64	18	36

N = 50 (in each case)

Source: Field Data, 2011

It appears from the above that 64 percent (32 firms) answered affirmatively that inadequate working capital was responsible for loan default. Close to a fourth of them answered negatively which meant that loan default was not solely attributed to the dearth of working capital.

Credit policy of GCB has been heavily weighted towards term loans for procuring fixed assets such as machinery and equipment rather than working capital loans for building inventories. This is evidenced by GCB's sanctioning of GH¢728,000.2 as working capital against disbursement of term loans amounting GH¢1.2 million between September 2007 and August 2008 (GCB, Loan Department 2009). This shows that variable loans comprised 1.65 percent of total term loans sanctioned during that period. The supply of such a low proportion of working capital provided by GCB contrasts with the practice of its counterparts in the financial sector where term loans and working capital loans are given almost equal importance. In every loan agreement sponsors of the project are required to provide an undertaking that they will arrange working capital from the banking sector which is dominated by the conventional commercial or trading banks.

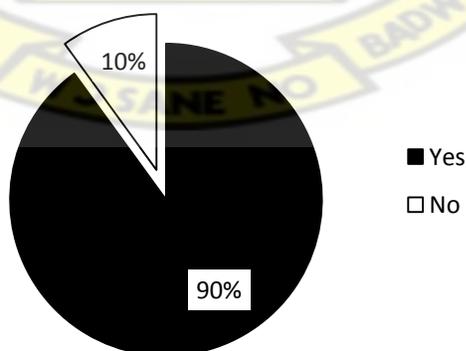
The volume of working capital loans supplied by GCB has never matched the surge in its term lending which indicates that working capital fell well below the level of capital required to utilize the plant and machinery it financed under term loans. As observed, almost all the SMEs said that they received inadequate working capital from GCB. Most SMEs said that they did not receive working capital in due time (Table 6). This not only shows that the term and variable loan ratio in GCB was very high but also indicates existence of potential risks of low level cash generation caused by unavailability of sufficient amount of working capital loans either from GCB or from the commercial banks. The extent of the problem of working capital shortage is far deeper than it appears.

4.2.9 Loan Repayment Period

Respondents were asked to select their options regarding the loan repayment period.

Responses were received from 50 firms and 90 percent (45 firms) of them favored the extension of the loan repayment period (Figure 4). One-tenth (5 firms) of the responding firms opposed such extension of loan repayment period.

Figure 4.4: Firms supporting longer loan repayment period than those fixed by GCB



Source: Field Data, 2011

GCB provides loan terms for a maximum period of 5 years. It fixes loan repayment period and installments according to the types of projects. For example, the loan repayment period for the transport sector (i.e. bus and truck) and service sector (i.e., restaurant hall) varies between 5 and 3 years while it is 4 years for manufacturing sector. Again, firms falling into building and construction industries have a 5-year repayment period. Except in the transport sector, repayment of loan starts 18 to 42 months after from the opening of letter of credit for imported machinery or twenty four months after the project goes into operations whichever is earlier. However, repayment for the transport sector starts 6 months after the commissioning of the project. Loan installments are at 6 monthly intervals.

GCB provides a moratorium on repayment of interest that is accrued during the period when the project remains under implementation or construction. This period of construction of project varies between 20 to 40 months due to cost overrun and other factors which are beyond the control of the borrowers. However, GCB's decision regarding length of the construction period of the project is final and conclusive and is binding on the borrowers. It is the policy of GCB to realize this accrued interest in four equal half-yearly installments and borrowers are required to repay interest installments even though construction work remains incomplete. This puts the borrowers in a financially distressful condition since they are not in position to repay loans. How such interest repayment policy created extra burden on the borrowers can be grasped from the case study presented here.

This case study shows GCB's calculation of the repayment schedule on account of the above project for a term loan amounting to GH¢42,201.60 which was to be repaid 5 years excluding 1 year required for implementation.

Table 4.6: Repayment Schedule for Borrowers

Item	First Year	Second Year	Third Year	Fourth Year
Principal loan	26,524.70	26,524.70	19,893.50	13,262.30
Installment	-	6,631.20	6,631.20	6,631.20
Balance	26,524.70	19,893.50	13,262.30	6,631.10
Interest	9,018.40	6,763.80	4,509.20	2,254.60
Repayable loan	9,018.40	13,395.00	11,140.40	8,885.80

Source: GCB, Project Appraisal Report of the Firm, 2008.

It is clear from Table 7 that the borrower was required to repay interest amounting to GH¢15,782.20 within two years of when the project was under implementation and before the project generated any cash flow or income. Moreover, a loan repayment burden of GH¢11,140.40 which included both principal and interest for the third year, when the project just starts commercial operation, adds another financial burden on the borrowers. It is highly unlikely that borrowers will be able to repay GH¢11,140.40 within three years of the project being implemented, and as such, there is a strong possibility that borrowers would default. The consequence of default will result in the capitalization of GH¢11,140.40 and imposition of interest at the rate of 34 percent plus penalty interest at the rate of 2 percent, in addition to GH¢11,140.40 interest rate which was charged previously. This means that loan repayment installments do not commensurate with the cash-flow situation of the project and this may trigger loan default.

Also it appears from Table 4.7 that yearly debt burden (which includes both principal and interest installments) goes down to GH¢8,885.80 from the fourth year as the principal loan drops to GH¢13,262.30 in fourth year from GH¢19,893.50 in the third year. This shows that the loan repayment installment is relatively higher in the initial period than the installment in the subsequent period. This does not match with the cash flow position of the firm which is relatively low at the initial period and higher at the later period. It means that the cash flow position of the firm fits well with repayment installments, which is lower in the initial stage and higher in the later stage. This suggests that loan repayment schedules, which fail to recognise the strength of firm's financial ability to repay loans, increase the chances of loan default.

With short period of repayment the firm may not be able to earn sufficient income to service the loan which suggests that loan default is associated with shorter loan repayment period. The loan repayment burden can be eased by working out a loan repayment schedule commensurate with the prospective cash flow position of the firm. As cash generation varies from firm to firm, a uniform loan repayment schedule should not be applied to all types of firms. It is generally believed that as the loan repayment period increases, loan repayment installment decreases which reduces the risks of loan default. Take the case above for instance, if the loan repayment period is increased for more years than nine years, the repayment installment will be relatively smaller. Since small loan repayment installment may match low cash flow position of the firm, there is strong possibility that the default risk will be relatively much lower with long repayment period than short repayment period.

4.3 Developmental Role in Loan Default among SMEs

In order to understand the extent of the involvement of GCB in the entrepreneurial development activities, questions relating to choice of firm, project implementation, project supervision and monitoring were examined.

4.3.1 Choice of Firm

The respondents were asked to identify the factors which motivated them to apply for loans to GCB. Multiple answers received from the 50 borrowers which are reproduced in Table 4.8. The table shows that a little over a quarter (28 percent) of the respondents have industry experience. However, close a quarter (22 percent) of them applied for loans after they heard that term loans were available from GCB. Though 20 borrowers (40 percent) identified marketing opportunity for their products as one the reasons for taking loans from GCB, 5 borrowers admitted that they were motivated by their friend to apply for loans.

Table 4.7 Reasons for choosing firms financed by GCB

Reasons	No. of Mention	Percent
Industry experience	14	28
Product's market prospect	20	40
GCB's loan offer	11	22
Motivation by friends	5	10
N = 50		

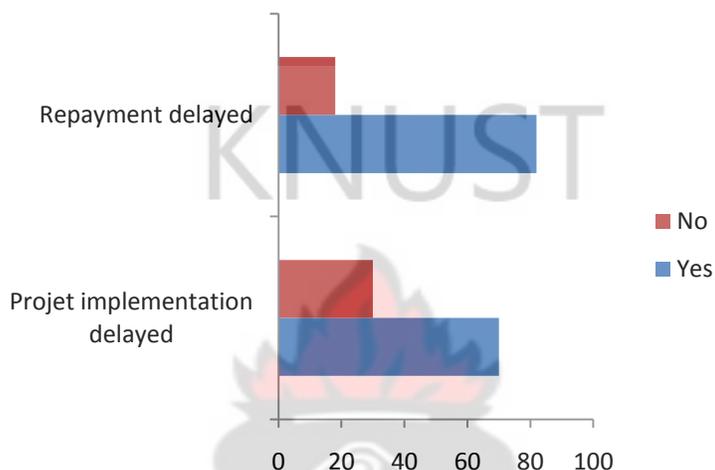
Source: Field Data, 2011

4.3.2 Project Implementation

The entrepreneurs of 34 firms were asked to state their experiences regarding delayed implementation. Responses received from the 52 firms are presented in Figure 4.5. The

table reveals that project implementation was delayed for 70 percent of responding firms and this delay contributed to delayed loan repayment for 82 percent of the responding firms.

Figure 4.5 Delayed implementation of project and delayed loan repayment



Source: Field Data, 2011

The firms (35 firms) experiencing delayed implementation were subsequently asked to identify the reasons for such delay in the implementation of the firms. All of them resorted to multiple answers which are presented in Table 4.9. The results show that 33.3 percent of the responding firms experienced delay in foreign currency. Other factors responsible for delayed implementation were delayed arrival of machinery (14.3 percent), delayed construction (9.5 percent), delayed machinery selection (19 percent) and delayed machinery installation (23.8 percent).

Table 4.8 Reasons for delayed implementation of the firm

Item	No. of mention	Percent
Delay in foreign currency allocation	7	33.3
Delay in building construction	2	9.5
Delay in machinery selection	4	19.0
Delay in machinery arrival	3	14.3
Delay in machinery installation	5	23.8
N = 21		

Source: Field Data, 2011

All the firms indicated the involvement of GCB in project implementation in terms of providing professional advice. Of them, over half of them confirmed that they received different form of assistance from GCB, which did not cover either building construction or machinery installation. However, close to 29 percent and 14 percent of the responding firms received assistance in respect of machinery installation or building construction respectively (Table 4.10).

Table 4.9 GCB's assistance regarding machinery installation and construction work

Item	No. of mention	Percent
Building construction	1	14.3
Machinery installation	2	28.6
Neither of these	4	57.1
N = 7		

Source: Field Data, 2011

4.3.3 Supervision and Follow-up

The involvement of GCB in the supervision and follow-up of the implementation work can be understood from the frequency of visits or inspections it undertook to the firms. Table 11 shows that 82 percent of the responding firms were visited by GCB officials to carry out pre-disbursement inspection. It is to be mentioned here that pre-disbursement inspection involves detailed assessment or thorough examination of the project. Investigations into the files of the loan-cases revealed that in most of the cases, professionals unsuited for the work were sent to the firm to prepare inspection reports. Several instances were found where mechanical engineers were deputed to carry out inspection related to building construction and civil engineers were sent to report about machinery installation. Consequently, project inspection ended up as form filling exercises in 20 firms (Table 11). However, 8 firms (16 percent) received some form of professional advice from GCB in respect of implementation, although 34 firms (68 percent) were visited by GCB officials in connection with loan recovery.

Table 4.10 Project Supervision, Follow-up and Monitoring

Item	No. of mention	Percent
Pre-disbursement inspection	41	82
Follow-up inspection	30	60
Fill-out forms	20	40
Loan recovery	34	68
Advice regarding implementation	8	16
N = 50 (in each case)		

Source: Field Data, 2011

Follow-up visit after pre-investment visits were undertaken to 30 (60 percent) firms.

The extremely low level of attendance to the operational problems was the result of few requests from firms for such assistance from GCB. Table 4.12 shows that 23 firms (46 percent) sought advice regarding the project they were working on and 15 firms (30 percent) requested GCB to provide advice regarding machinery installation.

Table 4.11 Reasons for requesting GCB to carry out inspection

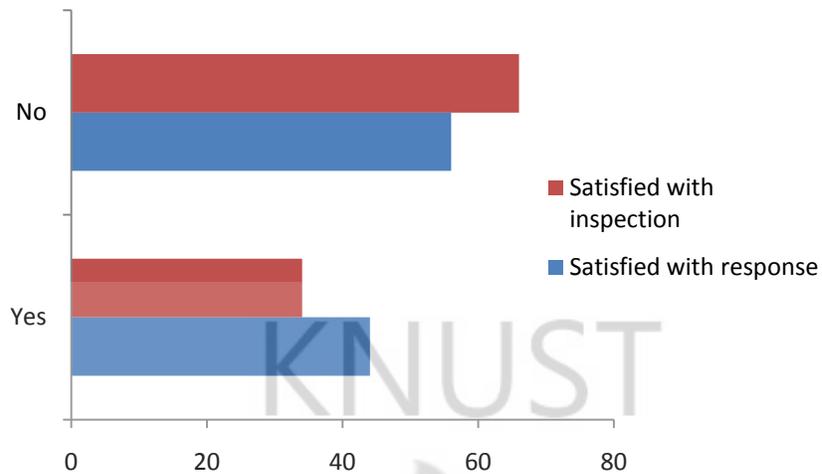
Item	No. of mention	Percent
Equity investment verification	48	96
Advice regarding project	23	46
Advice regarding machinery installation	15	30
N = 50 (in each case)		

Source: Field Data, 2011

It appears that the advice for project implementation were outcomes of the initiatives of the GCB rather than of requests from the entrepreneurs for such service. Almost all (86 percent) of the requests were related to equity investment verification.

When asked about the satisfaction drawn from the response of GCB to the requests to carry out inspection, over a half (28 firms) of the responding firms answered negatively. Two-thirds (28 firms) of the responding firms were dissatisfied with the inspection carried out by GCB officials (Figure 4.6).

Figure 4.6 Satisfaction drawn from GCB’s response to inspection request



Source: Field Data, 2011

It appears from Table 4.12 that less than half (41 percent or 51 firms) of the firms were visited between four and six times and more than one third of them were visited less than four times. While 8 firms (16 percent) got between six and eight visits, 4 firms were visited between eight and ten times. There were 2 firms (4 percent) which were visited more than ten times. This reinforces the responses of the entrepreneurs that most visits were related to pre-disbursement inspection and the loan recovery drive.

Table 4.12 Project Supervision, Follow-up and Monitoring

Item	No. of mention	Percent
Less than 4 times	15	30
4 – 6 times	20	40
6 – 8 times	8	16
8 – 10 times	4	8
Above 10 times	2	4
N = 50		

Source: Field Data, 2011

4.4 Public Policy in Loan Default among SMEs

In order to test the effect of public policy regimes on the loan repayment performance, respondent were asked questions relating to interest rates and depreciation of the cedi, and high taxes on the imported raw materials. The responses were multiple (Table 4.14)

Table 4.13 Policy factors affecting loan repayment performance

Item	No. of mention	Percent
High interest rate	50	100
Depreciation of the cedi	36	72
High taxes on imports	28	56
N = 50 (in each case)		

Source: Field Data, 2011

It appears that high interest rates were considered by all the responding firms (Table 4.14) as one of the significant policy factors that adversely affected their loan repayment performance. The depreciation of cedi was a problem to 72 percent (36 firms) of the firms which responded. High taxes on imported raw materials were pointed out by more than half (28 firms) of the responding firms. The data in Table 4.14 suggest that public policies had adverse effects on the operations and loan repayment performances of the responding firms.

4.4.1 Exchange Rate Policy

The management of foreign exchange rate remains an important monetary policy instrument in Ghana. The BOG borrows foreign currency loans from the MFIs such as the World Bank and re-lends those to the banks, which disburses them to large firms, SMEs and other individuals for importing goods or services. Although the bulk of these

foreign currency loans is denominated in the US dollar, some loans are also provided in terms of other foreign currencies such as Euro and Pound Sterling depending on the origin of imported capital goods. As the borrowers are required to repay foreign currency loans in terms of equivalent cedis, their debt level increases or decreases with every appreciation or depreciation of the cedi respectively. This means that the fluctuation of foreign exchange rate influences the borrowers' financial capacity to repay loans. Borrowers' debt burden soared as a result of the depreciation in the value of the cedis. This was because of the fact that as the cedi depreciated, the borrowers had to repay more cedis for the same amount of foreign currency loan and, thus, the debt burden increased with depreciation of the cedis. This is explained by a simple example. Say, a male entrepreneur borrowed one thousand US dollars from GCB to buy spares from the U.S.A in 2008 at an exchange rate of GH¢1. When the value of Ghana cedis depreciated to GH¢1.45/US\$ 1990, his principal debt burden grew by 45 percent (i.e. to GH¢34,569 from GH¢15,454) at the end of the year, assuming that he repaid nothing within this period. In fact, the loan liability would grow more and more if the normal rate of interest on both original loans, and capitalized dues and penal interest - which have a cumulative effect - are taken into account. Even if borrowers repay loans in time, the loan liability will continue to rise with the depreciation of the cedi if they are required to repay loans in foreign currency rather than local currency. This is akin to Murinde's (1996) argument that 'where loans are denominated in foreign currency, depreciation of the exchange rate makes debt service almost impossible. It is evident from Table 4.15 that the Ghana cedi has been slowing down since 1970. Over the period between 1990 and 2000, the cedi depreciated by more than 149.69 percent. Between 2001 and 2010, the value of the cedi

fell by 84.12 percent and borrowers who received loans within those periods had to repay about double the amount of the principal loan as well as the interest burden.

Table 4.14 Annual Average Value of Cedi per US\$

Date	Cedi per US \$	Date	Cedi per US \$
<i>First cedi</i>			
1965	0.824	1967	0.714
<i>Second cedi</i>			
1970s	~1.000 (0.833 to 1.111)	1980	2.80 Bank rate (~20 Blackmarket)
1983	30.00 Bank rate (~120 Blackmarket) (Oct 83)	1984	35.00 (Mar 84); 38.50 (Aug 84); 50 (Dec 84)
1985	50 – 60	1986	90
1987	150 – 175	1988	175 – 230
1989	230 – 300	1990	300 – 345
1991	345 – 390	1992	390 – 520
1993	555 – 825	1994	825 – 1050
1995	1050 – 1450	1996	1450 – 1750
1997	1750 – 2250	1998	2250 – 2350
1999	2350 – 3550	2000	3550 – 6750
2001	6750 – 7300	2002	7300 – 8450
2003	8450 – 8850	2004	8850 – 8900
2005	8900 – 9500	2006	9500 – 9600
2007	9600 – 9300		
<i>Third cedi</i>			
2007	0.92 (July 2007)	2008	1.05 (June 2008)
2009	1.49 (June 2009)	2010	1.45 (December 2010)

Source: Bank of Ghana, 2010

Moreover, as the depreciation is equivalent to new taxes, it increases the price of imported capital goods, which increased the loan liability. It should be pointed out here

that borrowers were disenchanted with the persistent depreciation of cedi and its consequential effect on the rising debt burden.

4.4.2 Interest Rate Policy

Interest rates policy in Ghana is administered by Bank of Ghana (BoG) - central bank - which functions as the adviser to the Government of Ghana in respect of monetary policy and as an arm of the Ministry of Finance. As a policy-taker and as a publicly-owned bank, GCB is required to follow the interest rate policy directives of BoG.

Clearly, an unstable macroeconomic and policy environment is perceived as more risky and banks may compensate for it by requiring wider margins. Given that interest rates are determined by expected inflation and lending rate/prime rate by the central bank, GCB mostly depends on these variables to make their decisions.

The bank considers the central bank lending rate in setting their own lending rates. The central bank's lending rate can be conceived as an indicator of monetary policy. Quarterly values of this variable are given in Table 16. The overall trend has been downwards. With the economy appearing to be doing better one would expect interest rates to fall, which are evident.

It is also evident from Table 16 that most of the total loans due belong to firms paying higher interest rates. If their loan repayment performance is compared with the other firms, the above finding that a higher interest rate is positively related to a higher incidence of loan default is reinforced. From the foregoing analysis, it appears that loan

default could not solely be attributed to borrowers' unwillingness to repay loans; it was also an in-built problem of the interest rate policy. In other words, interest rate policy was both a cause and an effect of the high loan default rate among SMEs in Ghana.

As high interest rates increase costs of borrowing, debt burden grows which leads borrowers to default and, as loan default becomes persistent, GCB loses income and becomes undercapitalized. In order to recover its financial position, it resorts to high interest rates and the cycle is complete.



Table 4.15 End of Quarter Inflation, Treasury bill and Central Bank Rates

Year	Quarter	Inflation (%)	91-day treasury bill rate (%)	Central bank rate (%)
2001	Q1	41.9	43.47	27
	Q2	36.8	46.68	27
	Q3	28.3	38.8	27
	Q4	21.3	29.7	27
2000	Q1	16	23.37	25.5
	Q2	13.7	23.42	25.5
	Q3	12.9	24.44	25.5
	Q4	15.2	24.96	25.5
2003	Q1	29.9	26.91	27.5
	Q2	29.6	32.41	27.5
	Q3	26.8	24.36	26.5
	Q4	23.6	23.16	24.5
2004	Q1	10.5	22.41	20
	Q2	11.9	21.51	19.5
	Q3	12.6	19.42	19.5
	Q4	11.8	17.08	19.5
2005	Q1	16.7	17.23	19.5
	Q2	15.7	16.5	16.5
	Q3	15	13.9	15.5
	Q4	14.8	11.77	15.5
2006	Q1	9.9	9.8	14.5
	Q2	10.5	10.19	14.5
	Q3	10.8	11.15	14.5
	Q4	10.5	10.7	12.5
2007	Q1	10.5	9.64	12.5
	Q2	10.7	9.68	12.5
	Q3	10.2	9.83	12.5
	Q4	11.4	10.33	13.5
2008	Q1	13.8	10.88	14.25
	Q2	18.4	15.42	16
	Q3	18.1	24.64	17
	Q4	17.6	24.67	17

Source: Bank of Ghana Quarterly Bulletins (various issues), Accessed from www.bog.gov.gh

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary of Findings

The study examined the determinants of loan default among SMEs in Abossey-Okai in Accra. These findings, gathered from the opinions and concerns of the borrowers and bankers answer the research questions relating SME loan defaults in Ghana. The results show that the majority of respondents experienced delayed disbursement of credit, secured inadequate working capital, and could not generate enough income to service debt obligations due to delay in firm set-up. A large segment of respondents registered their indignation over the inadequate supervision of GCB over implementation work of their firms.

Most respondents favored extended loan repayment periods, training by GCB and opposed any public policy that adversely affect profitable operations of firms. The loan officials interviewed expressed concerns about borrowers' inability and delay in equity investment, low level of response regarding lodgment of operational reports and data regularly and lack of coordination among lenders. They also agreed that borrowers should get adequate working capital, loans at low rates of interest and admitted lack of adequate manpower in GCB which constrained sufficient entrepreneurial guidance.

The assessment of firm's credit need was flawed since loan appraisal reports were incomplete and full of inconsistencies. These feasibility studies provided cosmetic

justification for sanction of term loans to the would-be defaulters. Rampant political interference and frequent government policy intervention in loan intermediation process reduced the efficiency and quality of term lending activities.

It transpired that credit disbursement delayed due, partly, to the inability of borrowers to mobilise the necessary equity and, partly, to the slackness in the GCB's loan processing work. Such delay, which increased costs of borrowing, was found to be an important factor which contributed to SME loan default. It was found that a higher rate of loan default was associated with the lower level of borrowers' equity investment in the project and vice versa. An identical experience was reported for the term and variable loan ratio; firms struck by the shortage of working capital loans were not able to utilize their productive capacity. This caused them to suffer low cash flow which reduced their ability to repay loans. The loan default problem was compounded by the stringent loan conditions requiring the firms to repay loans even when they were under implementation. Loan burden escalated due to failure of GCB to match the borrower's ability to repay loans or firms' cash flow sequence with the repayment installment.

These indicate that the financial role played by GCB was flawed. These imply that most financial firms are technically insolvent and undercapitalised. Sometimes, some of the banks will have to survive on bail-out programs or continuous fund injections by the BOG. From these, it can be concluded flawed financial role was responsible for financial insolvency of GCB.

5.2 Conclusions

In view of the findings of this study and given the implications of loan default on the financial sector of a country, the government should collate and analyze information on SMEs, so that an informed decision could always be made on the full understanding of the problems of the sector. There is also a necessity for serious collaborations by the key stakeholders of the economy to reduce those factors militating against banks' lending to SMEs, and put in place a strategy by which the perceived friskiness' associated with the sector can be eliminated. Lastly, bank support to the SMEs through National Board for Small Scale Industries should be properly coordinated to reduce costs and possible chance of default. However, the measures suggested in this study are of importance to policy planners, not only in Ghana, but in other developing countries in their similar situations of growth process.

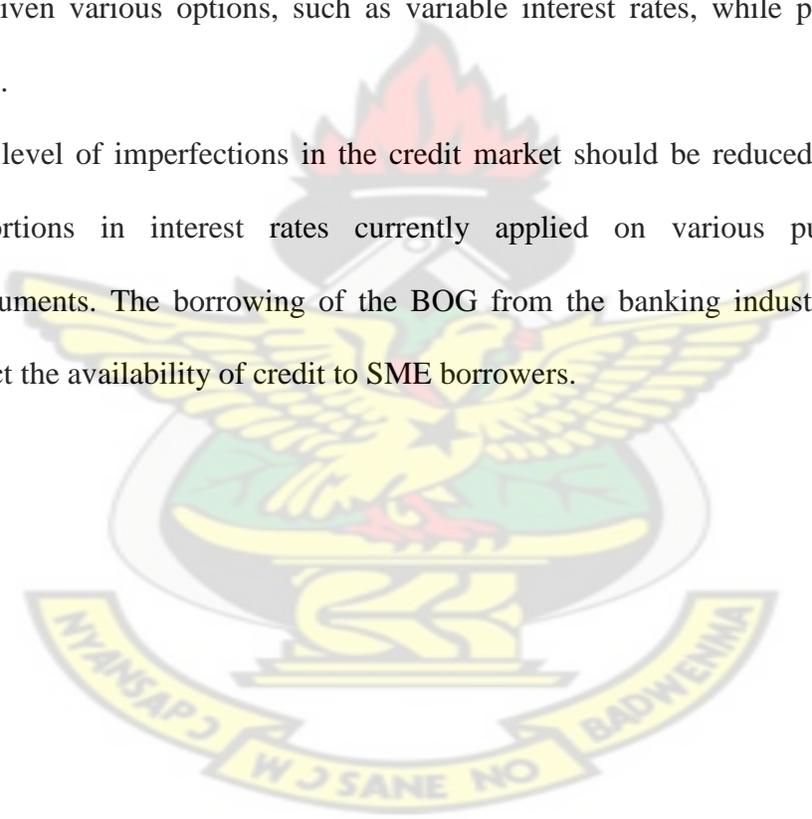
5.3 Recommendations

The study provides the following recommendations to reduce, if not to eliminate, loan defaults among SMEs in Ghana.

1. An efficient and transparent borrowers' screening mechanism should be employed as a pro-active measure to deter the entry of credit unworthy borrowers to term loan regimes. In order to increase the efficiency of borrower screening device through reducing information asymmetry between GCB and borrowers, a provision asking the borrower to make all pre- and post-sanction transactions through GCB should be included in the loan contract.

2. Term loans should not be provided to over-saturated SME sector and to repeat defaulters.
3. The loan repayment performance of the old firms should be assessed before loans are sanctioned to new firms.
4. Complete project appraisal reports should be prepared by appropriate and experienced professionals. The present practice of cosmetic justifications for sanctioning loans should be discontinued. GCB should have a resourceful Research Department staffed by highly experienced professionals to conduct applied research on technical, financial, commercial and economic aspects of the firms and all lending activities should be conducted as per research findings.
5. Delays in pre-disbursement inspection of the firms and loan processing should be reduced to speed up the implementation of the firms so that commercial production can be commenced in time.
6. The debt-equity ratio should not fixed by any public policy intervention. It should be determined on the basis of the proven financial worth of the borrowers as well as the talent of the entrepreneurs. Special care should be taken so that firms do not become highly geared due to high debt obligations. It is recommended that GCB should get involved in credit guidance to stop credit leakage and to reduce scope for loans diversion by the recalcitrant borrowers to non-industrial activities.
7. GCB should provide adequate permanent working capital to the firms and should discontinue the practice of directing firms to other banks for such capital.

8. Loan repayment schedules should be tagged not with the hypothetical but with the real cash flow situations of the firms and be extended more than the present number of loan repayment installment.
9. The interest rates should be aligned with other macro-economic fundamentals such as the inflation rate. The fixation of the rates should be in conformity with the development role of GCB. The present practice of applying fixed interest rates to the firm until loans are liquidated should be discontinued and borrowers should be given various options, such as variable interest rates, while paying interest rates.
10. The level of imperfections in the credit market should be reduced by removing distortions in interest rates currently applied on various public savings instruments. The borrowing of the BOG from the banking industry should not affect the availability of credit to SME borrowers.



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Appendix A

Survey Questionnaire

A. Introductory

1. Name of the Firm
2. Address

KNUST

B. Choice of Project

3. Why have you chosen this firm? Please circle one, if not told otherwise)

- You have industry experience Yes No
- There was market prospect for this firm Yes No
- You heard that GCB was entertaining such firm Yes No
- Others such as motivation by friends Yes No

C. Loan Disbursement

4. Was disbursement of loans installment in time? Yes No

If Yes please go to question no. 8

5. What was the reason(s) for delayed disbursement of loans

(Please Tick)

- Delayed pre-disbursement inspection and loan processing by GCB-officials
- Bank's demand for more documents regarding equity investment
- Inadequate equity capital to meet pre-disbursement conditions
- Others such as inability to meet financial demands or bribes

6. Do you think that delayed loan disbursement was responsible for (Please Tick)

- Cost over-run
- Delayed implementation
- Accumulation of debt burden

7. If there was cost over-run, was it due to increase in the price of (Please Tick)

- Building materials
- Imported machinery

8. Has the pre-disbursement inspection occurred before you asked for it? Yes No

9. If No, reasons for asking the GCB to inspect your firm (Please Tick)

- Loan installment disbursement
- Seeking advice for building construction
- Looking for assistance regarding machinery installation

10. Are you satisfied with GCB regarding

- response to your request for inspection? Yes No
- inspection of the project? Yes No

D. Project Implementation

11 Did you experience delayed set up (implementation) of your firm? Yes No

If no, please go question no 16.

12. If Yes, which of the followings was responsible for this (Please Tick)

- Delay in foreign currency allocation
- Delay in machinery selection
- Delay in imported machinery arrival
- Delay in building construction
- Delay in machinery installation

13. Who selected firms machinery? (Please Tick)

- GCB
- Private consultants and sponsors
- Both GCB and the sponsors
- Private consultants

14. Have you received assistance from GCB regarding:

- Machinery installation or assembly
- Building construction
- None of these

15. Do you think that delayed implementation of the project was responsible for loan default? Yes No

E. Project Supervision and Monitoring

16. What were the reasons for firm visit by GCB's officials? (Please Tick)

Pre-disbursement inspection

Attending Board meeting

Attending operational problems

Fill out inspection form

Follow-up visit

Loan recovery

Advice implementation

G. Working capital

20. Have you got adequate working capital from GCB? Yes No

21. If yes, was in time? Yes No

22. Do you think that inadequate working capital was responsible for low cash slow which caused loan default? Yes No

H. Project Management

23. Do you send following reports to GCB?

- Monthly operational data and cash flow statement Yes No
- Quarterly progress report at the time of project implementation Yes No
- Audited annual balance sheet Yes No

24. If No for any item, list the reason(s) for non-compliance (Please Tick)

- Unnecessary
- Time consuming

25. Would you send those if there is penalty for non-compliance? Yes No

26. How many times you held Board of Directors' meeting (Please Tick)

- Quarterly

- Half yearly
- Annually
- Over a year

27. Do you support GCB's presence in the Board meeting Yes No

28. Do you think that training provided by GCB to the firm would be helpful in its overall efficient management Yes No

29. Do you think that loan repayment period should be longer than those fixed by GCB? Yes No

I. Government Policy

30. Which of the following factors affected the firm most (Please Tick)

- High interest rate
- local currency depreciation
- High tax on imported raw materials or inputs

