A Brief on Financial Management Issues Relating to Increased Access of Credit for Micro, Small and Medium (MSMEs) Enterprises in Ghana

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Sigma One Corporation

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Summary

Micro, Small and Medium Enterprises (MSMEs) in Ghana lack finance to purchase assets to be productive or to meet their working capital requirements. They must borrow and have not been served well by commercial banks. Today's lack of finance for MSMEs has its roots in the way Ghana's financial and banking sector evolved from its pre-independence period through a series of well-intended, albeit misguided, or incomplete government reforms to provide credit to the MSMEs. Financial management issues relating to increased provision of credit to MSMEs were mishandled. This brief looks at the history of such reforms and establishes how those reforms led us to where we are today: MSMEs deprived of finance. *Many MSMEs will not meet the criteria for loans. But that is only relevant after some overarching* ***issues of financial management*** *in Ghana are addressed.* In short, MSMEs are the residual and not the leading tool for poverty reduction in Ghana.

We begin by examining post-independence banking practices and their role in depriving MSMEs of credit. There was not a shortage of banks. A number of post-independence, financial sector reforms had the net effect of further depriving MSMEs of *access* to credit. Supply-leading finance measures led to further financial repression, resulting in a very weak and oligopolistic financial sector by the late 1980s. MSMEs were sidelined to the informal sector. As the banking practices were 'modernized', MSMEs were outside the circle of beneficiaries as they lacked the financial means to participate. Commercial banks found it more and more difficult to serve MSMEs, in part because they lacked an operational definition of MSMEs and did not understand the heterogeneous nature of the smaller firms. Recently, credit providers catering exclusively to MSMEs have had more luck, even at commercial interest rates. The government responded by setting up subsidized credit programs which have created moral hazard and adverse selection issues. In the meantime, interest rates remain high due to chronic fiscal imbalances that are funded by excessive borrowing by the government in the domestic credit market. T-bills have some of the best returns. This crowds out the private sector in general and further marginalizes MSMEs. Loan defaults of many MSMEs are linked to arrears owed by GoG. Exchange rates for certain products that MSMEs make may be overvalued, reducing their international competitiveness. The regulatory framework, despite (or perhaps because of) all the "attention" given to MSMEs is burdensome. More needs to be done to facilitate market access for MSME products. Financial instruments, land or real estate are not useful collateral for loans due to imperfect policies or markets that govern them. A useful first step making things better for MSMEs is to "crowd in" the private sector by containing domestic government borrowing.

Post-independence Banking And Indigenous Enterprises

The post-independence organization of Ghana's Banks was based on perceived shortcomings of the banking practices inherited from the colonial era, especially the belief of credit scarcity to indigenous enterprises (Trevor, 1951, Gockel, 1995). Most indigenous enterprises, owing to their small size, were subsequently categorized as micro, small and or medium enterprises or MSMEs for short. Primarily, the allegations of the indigenous population against the British

Bank for West Africa (which, through several stages, has now become the Standard Chartered Bank) and Barclays Bank suggest that they tended to act in concert regarding loan conditions and bank charges within a framework of a discriminatory credit policy. The general perception had been that inadequate finance was the over-riding constraint on enterprise growth in Ghana, particularly for indigenous micro-, small- and medium-scale enterprises (MSMEs)

Against the background of the perceived shortcomings of colonial banking arrangements there was an active and pervasive government involvement in monetary and credit policies, motivated in part by a belief that externalities and other market imperfections inherited, militated against desirable patterns of investment and economic growth. To rectify the perceived shortcomings, public ownership was encouraged and eventually dominated the banking system. All banks set up between the early 1950s and 1990 were wholly-or majority-owned by the public sector, while the government also acquired 40% shares in each of Standard Chartered Bank Ghana Ltd (SCBG) and Barclays Bank Ghana Ltd (BBG). In the case of the latter (in spite of majority ownership by overseas banks), their policies and operations were influenced by the Bank of Ghana, directly and indirectly, through the Banking Act of 1970. Consequently, the banking system in Ghana before the financial reforms in 1988 can be described as indigenized, largely owned, and/or strongly influenced by the Government. The government had chosen a supply-side approach to solving the credit problems of the MSMEs and provided guidance and incentives to the banking sector to reflect its supply-side policies.

No Shortage of Banks

The multitude of banks, their branches and their diverse character could be a potential strength in promoting the development of financial services and economic development. Besides Bank of Ghana, there were three (3) primary commercial banks, seven (7) secondary or specialized banks, three (3) merchant banks and one hundred and twenty three (123) unit banks designated as rural banks. A comparison using data from the late 1980s showed that Ghana's density of bank branches ranked third after Cote d§Ivoire and Togo in West Africa, but was far above that of Benin, Burkina Faso, Senegal and Niger, and above the average of all countries in the West African Monetary Union (Gockel, 1995).

As the pattern of credit allocation inherited from pre-independence banking culture was considered undesirable for rapid economic development, it became imperative for government to intervene in the financial markets (Gockel, 1995, Gockel and Akoena, 2002). A policy regime was put in place to enable the banks to offer more credit to designated micro-, small-and medium-scale enterprises. The focus was on a (Keynesian) framework that suggested an interactive mechanism between finance and economic growth, emanating from low interest rates leading to increased investment leading to high rate of output/income growth, and subsequently to higher savings rates. It must be emphasized that within this (Keynesian) framework, the main determinant of financial savings was income. *In particular, interest rates are not considered as important in determining financial saving.* This approach had consequences in the ability of the financial sector to rely on savings for capital formation and investment.

Bank of Ghana used all sorts of proxies for the beneficiaries of financial policy – Micro- and Small-Scale enterprises (MSEs), Small and Medium-Scale Enterprise (SMEs), small farmers, artisans etc. Irrespective of terminology, the intention to focus support on the pre-colonial, indigenous small firms was clear (Gockel, 1995, Gockel and Akoena, 2002).

Post-independence Financial Sector Reforms

- institution building - creation of development banks, specializing by sector;
- nationalization of foreign-owned banks or participation in such banks with majority share;
- government-determined interest rates, typically low and different for deposits and loans of different maturity and loans to different sectors and credit ceilings;
- sectoral credit controls;
- high reserve requirements;
- government directives to banks to lend to State-Owned Enterprises (SOEs);
- limits on lending to foreign-owned companies;
- increase in the level of investment undertaken by MSMEs;
- improve the allocation of investment among selected sectors of the economy, namely agriculture, manufacturing and exports;
- keep financial charges (artificially) down to avoid what were believed to be the inflationary effects of liberalized market rates of interest;
- maintain low and stable interest rates to countervail the perceived baneful effects of exorbitant rates in the informal financial markets.

Supply-Leading Finance Leads To Financial Repression

Despite, or perhaps as a result of, the efforts at institution building and "deliberate" credit programs to promote financial and economic development, *a growth process with both stunted economic and financial development ensued.* A major consequence of the public sector ownership of the banking system was the control and regulation of interest rates, which tended to distort the allocative functions of interest rates in any market economy. Government imposed ceilings on bank lending and borrowing rates, particularly with inflation running at double to triple digits, and caused the real rate of interest to become negative in the 1970's and 80's.

Although the policies of low lending rates, credit ceilings and sectoral credit controls were relatively easy to administer, their use engendered distortions in financial intermediation, especially in the mobilization of savings and credit allocation. The policies of low interest rates and credit ceilings in Ghana appeared to have caused more distortions than the market imperfections it was designed to overcome. As real interest rates became negative, savings and time deposits became unattractive to hold and funds were accordingly channelled into physical assets or foreign assets (Aryeetey and Gockel, 1990, Gockel, 1995).

Credit Ceilings

Furthermore, the credit ceilings produced a disincentive effect on the banking system, discouraging banks in the collection of savings once these banks had attained their ceilings. This tended to reduce the total amount of funds available for credit in the economy. In addition, negative real interests became a reality. *Under such disincentive conditions, banks had to invoke other criteria besides Bank of Ghana's directives in granting loans and advances, thus driving away marginal applicants.* Furthermore, the structure of lending rates and credit ceilings did not sufficiently discriminate between credits with different degrees of risk and maturity. In general, whilst the above policies, including the interest rate controls and credit ceilings, appeared to be largely ineffective in their intended objectives, they were quite successful in creating and exacerbating banks' passivity in intermediation. Ghana's experience has demonstrated that *credit ceilings are incompatible with the need for increased intermediation as they tend to encourage both intermediation outside the banking system and capital flight.* Credit ceilings tend to limit competition between banks as credit is allocated on the basis of historical market shares, not according to lending opportunities. Severe misallocation of resources ensued, competition among banks was inhibited and the development of an interbank market retarded. Similarly, credit ceilings limited the scope of borrowers to switch between banks (Gockel and Akoena, 2002).

Excessive Government Borrowing

Then there was the excessive borrowing by the government from the banking institutions. In order to induce the banking sector to provide loans to the government to cover its budget deficits, commercial banks were enjoined to hold short-term government instruments as part of their short-term liquid assets that could satisfy cash reserve requirements. Hence, many commercial banks preferred to hold large amounts of government, short-term instruments and very little assets in private loans. As was to be expected, this crowded out small-and medium-scale enterprises from the loans market since they were considered more risky, relative to investments in government papers or more established borrowers (Gockel and Akoena, 2002). Banking in Ghana became a mechanical process, through an incentive structure and specific guidance from Bank of Ghana as to how to micro-manage their portfolios. *Very little imagination went into assets and liability management*. There ensued an uncompetitive banking environment, leading to severe market inefficiencies in the banking system. A consequence was non-performing loans.

Bank managers did not share any risk of loss, or often the free choice, of who gets the credit. They developed a propensity to take on additional risk without proper due diligence, having no choice in the allocation of credit. Not surprisingly, the banks (especially the state-owned banks) accumulated huge amounts of non-performing assets. In fact, with the exception of those banks which retained foreign equity participation; i.e., Barclays, SCB and MBG, the banks all became insolvent as a result of bad debts resulting from bad investments in commercially-unsuccessful ventures or inefficiently-run public institutions. By the end of 1989, non-performing loans and other government-guaranteed obligations to state-owned enterprises totalled ¢431.4 billion and non-performing loans to the private sector amounted to ¢421.9 billion (NPART, Annual Reports, 1991, p24; and 1994, p15)

Characteristics of the Ghanaian Banking System, 1988

- low capital base;
- weak management and accounting systems;
- inadequate legal and regulatory framework, including ineffective supervision by Bank of Ghana;
- restricted banking products and undeveloped operational skills;
- overexposure to few customers and high risk concentration;
- huge, non-performing assets and ineffectual or non-existent recovery efforts.

Ghana's experience with supply-leading finance and directed credit programs appeared not to have succeeded in making credit available to MSMEs as envisaged under the (Keynesian) framework. Rather, Ghana's experience suggests that, although MSMEs may lack access to credit, policies that were devised to make credit available by arbitrarily defining a demand for them through targeted programs (such as low interest rates and sectoral credit guidelines) did not address the complex issues involved in finance for economic growth. In particular, the approach to credit demand tended to ignore how banks and MSMEs actually relate to each other. *Finance is scarce, and it is this scarcity that gives it value.* This is especially the case with bank finance or credit for productive purposes. Finance only becomes a binding constraint only when other ingredients for successful investments are available, and when funds can conveniently activate these other ingredients for positive returns on the investment (Gockel and Akoena, 2002). In Ghana, non-financial constraints of MSMEs were ignored or were expected to be overcome with the provision of low interest rate loans.

Implications Of Financial Sector Reforms On Finance For MSMEs

It is intriguing to note that both institution building and elaborate credit programmes failed and an uneven growth process ensued with both stunted economic and financial development in Ghana by 1988. Against the background of financial distress, a program of financial sector reforms was started in the mid-1980s as part of the ERP (Gockel, 1995; Brownbridge and Gockel, 1996). The objectives of these financial reforms were to:

- undertake restructuring of financially-distressed banks;
- improve savings mobilization and enhance the efficiency of credit allocation through interest rate liberalization;
- enhance the soundness of the banking system through an improved regulatory and supervisory framework; develop money and capital markets; and
- establish a non-performing assets recovery trust (**NPART**):
    - reconstitution and strengthening of Board of Directors of affected banks;
    - closure of unprofitable branches;
    - reduction of operating costs through retrenchment of staff;
    - cleaning of balance sheets by offloading non-performing loans to state-owned enterprises (¢431.4 billion at the end of 1989), loans guaranteed by the government of Ghana, and non-performing loans granted to the private sector

(¢421.9 billion at the end of 1989) through the issuance of bonds. [Non-Performing Assets Recovery Trust (NPART) mandate was to realize proceeds from such assets to the extent possible. In return, the distressed banks were issued interest-bearing FINSAP bonds to be redeemed in annual instalments].

The enactment of financial sector reforms above and laws (see text box) appeared to have streamlined the emergence of financial institutions to add greater depth and diversity to the financial system. The number of banks increased from the pre-reform number of 11 to 21 by 2002 and new NBFIs were established by private entrepreneurs. The NBFIs' target categories of savers and investors were largely not accommodated for by the banking system with such services as equity finance, long-term credit for industry and real estate, and small-scale savings.

Financial Sector Legislative Actions (80s - early 90's)

- the Banking Law, 1989 (PNDCL 225)
- the Bank of Ghana Law 1992 (PNDCL 291)
- Financial Institutions (Non-Banking) Law 1993 PNDCL 328.

The establishment of new and private banks, privatization, and emergence of different types of non-bank financial institutions, means that a broader range of financial services can be extended to a more diverse population. This is one way of increasing competition and efficiency in financial intermediation. Nevertheless, the ***financial sector remains largely oligopolistic in character*****,** catering mostly to the needs of larger and urban firms at the expense of the micro and small enterprises (Gockel and Akoena, 2002).

Implications Of Modern Banking Practices On Credit For MSMEs

Bank practices and policies emerged to *react* to the reforms enacted and the resulting state of the financial sector competitiveness. To reduce total costs, implementation of modern banking practices required *closure of bank branches* that did not demand them or had clients - MSMEs - that were unable or unwilling to bear new fees and balance requirements to pay for them.

The total number of banks increased from 11 in 1990 to 17 by December 2002. Yet, total branch network has consistently declined within the period beyond that of pre-reform. The 17 banks have, among them, fewer branches than was the case with the 11 pre-reform banks. That is to say, bank diffusion has been reduced and the population per bank branch has increased so that *there is now less access to nearby banks for MSMEs in rural areas.*

Cost reduction Strategies lead to Bank Urbanization

The major players, Standard Chartered Bank, Barclays Bank, Ghana Commercial Bank and SSB Bank, have closed down many branches outside the major urban areas. For example, between 1989 and 1996, SSB Bank closed down 20 of its branches. In fact, between 1989 and 1990, 12 branches were closed down. Similarly, Barclays Bank had 42 branches in 1988 but, by 1998, had closed down 16 branches for cost-reduction purposes. GCB had 150 branches in 1987, but only 134 in operation by 1998. The state-owned banks' braches were closed down primarily in preparation for divestiture, and privately-owned banks closed down some of their branches for cost-minimization purposes. Most recently (in the last year), Standard Bank has closed down three of its branches (in Sunyani, Swedru and Koforidua). Similarly, Barclays had to close down two of its Kumasi, Zongo and Agogo branches to reduce costs.

The newer banks being established are just operating in the principal cities. Indeed, none of the banks established after 1990 has a branch outside Accra, Kumasi and Takoradi. Since these new banks are in the fore of the technological innovations taking place in Ghana's banking industry, they are not likely to open branches in the rural areas in the near future for lack of demand. In operational terms, therefore, banks are now targeting the more affluent groups - it is where the demand for their new products is. MSMEs are again marginalized.

Financial reforms have allowed introduction of competitive practices such as electronic banking. Banks are now trying to connect all their branches to a central, electronic network at the head office in Accra. Generally high infrastructure development costs make it expensive for banks to connect their countrywide branches. Yet the competitive banking environment dictates that banks move in the direction of automation such as online service and PC banking. These are all positive developments, but limit the banks to provide services in urban areas as the rural network branches cannot offer modern services competitively, nor are those services needed.

Minimum Balances

Added to the closure of bank branches is the implementation in recent times of minimum balances and deposit guidelines by the banks in Ghana. Within the non-corporate sector, the banks have started introducing savings products that would marginalize not only the rural dwellers who have no access to such financial services but, more significantly, render even the formal sector worker impotent with regard to saving with banks or having access to banking services. Minimum deposit balances required for savings and demand deposits have been raised substantially beyond the capacity of MSMEs and the ordinary formal worker. The major banks have generally raised minimum deposit requirements to one million cedis for private individuals, while corporate bodies require not less than ¢50 million. Accounts with balances that fall below a certain level attract additional monthly fees. This has further added to the marginalization of MSMEs. The Bank of Ghana has recently made note of the multitude of new charges and taken action to get banks to reduce or eliminate some of them. *Commercial Banks willing to serve*

MSMEs must develop or enhance their SME desk operations in urban areas, and set up limited bank services in rural areas that serve MSME needs within their financial capacities using operational models that keep banks profitable as well.

An Operational Definition Of MSMEs

In generic terms, **micro-enterprises** have multiple definitions based on sector or type of activity, level of assets, number of employees, and scale of operation or output. Schreiner and Leon (2001) defined micro-enterprises according to the use of financial services on a size and scale unavailable from formal private financial institutions. Using this approach, micro-enterprises are confined to firms that use informal financial services, or what has become known in the literature as ‘micro finance'. References to numbers of workers, levels of output, or types of economic activities are therefore only complementary means of identification. In an operative sense, Schreiner and Leon (2001, P.2) defined micro-enterprises as firms owned by the self-employed poor that use micro finance or informal finance.

In the light of the unsettled nature of the definition of micro-enterprises it is not surprising that the *operational* definition of MSMEs varies in Ghana, deriving from the end-user’s perspective. The Ghana Statistical Service defines micro- and small-scale enterprises as those employing 29 or fewer employees. The Industrial Census conducted in 1987 defined micro- and small-scale enterprises as those employing up to 9 employees, medium-scale enterprises as those employing between 10 and 29 workers, and large-scale enterprises as those employing 30 or more employees. The National Board for Small Scale Enterprises (NBSSE) defines MSMEs in terms of assets in machinery, equipment, equipment and tools (excluding land, buildings and vehicles) estimated at not more than ¢10 million and/or whose employees are not more than 9 persons. The National Investment Bank defines MSMEs as those whose enterprises employing 9 or fewer workers or with fixed assets not exceeding ¢10 million, and medium-scale enterprises are those with between 10 and 30 employees or with fixed assets valued at between ¢10 million and ¢50 million.

A notable feature of MSMEs is their heterogeneous nature. Combined with definitional variations and government’s preferred role for them, *formal private financial institutions have found it cumbersome to compartmentalize MSMEs for any meaningful credit policy.* Banks find it difficult to issue general guidelines to their credit officers at their various branches regarding loan appraisal, processing and supervision. *The easier option for formal banks has been to ignore the loan requests of MSMEs altogether.* Yet, MSMEs cannot be ignored: they outnumber the larger firms several times over and must participate in the creation of nation’s wealth.

Relevant as these various definitions might be to the defining institutions, it is our view that they are all subject to a basic weakness that criteria of inclusion or exclusion that rely on financial measurements, such as the value of turnover or assets in Cedis, need to be revised often to keep up with the continuous depreciation of the exchange rate. To allow a common operational definition that is robust and can stand changes in the economy, <u>we propose the universal</u>

adoption of the Statistical Service definition of MSMEs provided for government industrial policy in 1993:

- micro enterprises are defined as those enterprises in both manufacturing and services sectors that employ up to 5 persons and/or whose fixed assets do not exceed $10,000 excluding land and building.
- small-scale enterprises are those which employ 5 - 29 workers or whose fixed assets have a value not exceeding $100,000
- medium-scale enterprises are those with 30 - 99 employees
- large-scale enterprises have at least 100 employees with fixed capital value in excess.

Why Commercial Banks Do Not Ordinarily Offer Credit To MSMEs

Recent survey findings (Gockel and Akoena, 2002) show that deposit money banks in Ghana are generally unresponsive to private sector loan requests, especially loans to the micro- and small-scale enterprise. To find out why the banks rejected the loan applications as not bankable, the banks were asked to rank 13 variables in descending order of severity. Out of the 11 banks that responded to the questionnaires, 3 banks had the following ranking as the 5 top reasons for rejecting loan requests:

i) lack of acceptable collateral;
ii) lack of a clear repayment plan or poor project reports and/or lack of comprehensive project plans;
iii) poor financial and/or managerial expertise;
iv) poor performance in relevant sector; and
v) end use of loan request not being bank's target market or suspicion of fungibility.

On the other hand, two banks did not consider collateral as very important among the top 5 reasons to warrant rejection of application. GCB ranked collateral as the 6th factor whilst ADB ranked it as the 8th factor. Table 1 shows the rankings of reasons for rejection of loan requests made to the other 6 banks that responded to the questionnaires submitted to them.

Table 1 Reasons For Banks' Rejection of Loan Requests (selected Banks)

Reason For Loan Rejection	NIB	Trust Bank	Eco-Bank	Prudential Bank	Merchant Bank	CAL Merchant
Lack of acceptable collateral	5	2	2	5	1	1
Not enough information on potential borrowers	2	3	4	2	6	3
Poor project reports/lack of comprehensive business plan	1	1	1	1	2	2

Applicant does not show managerial competence	4	5	5	3	N/A	N/A
Lack of booking or inadequate compliance framework	3	4	3	4	7	N/A
Poor performance in the relevant sector	8	6	N/A	N/A	5	4
Physical remoteness of enterprise	7	8	N/A	N/A	N/A	N/A
Poor previous performance or unfavourable track record	6	N/A	N/A	N/A	4	N/A
High ratio of transaction costs to loan size	N/A	N/A	N/A	N/A	3	N/A

Source: Gockel, A F and S K Akoena, (2002) . Financial Intermediation For The Poor: Credit Demand By Small & Medium Scale Enterprises In Ghana - A Further Assignment For Financial sector Policy? The Impact Of Financial Sector Liberalization On The Poor (IFLIP) Research Paper No 02-6, March 2002, ILO Geneva, Switzerland.

Although the banks have different rankings for the variables cited for rejection of loan requests, an intriguing feature of the responses is that all the 11 responding banks have not considered high ratio of transaction costs to loan ratio as important in loan decisions. Furthermore, apart from Standard Chartered Bank, Barclays Bank and SSB Bank, Cal Merchant and Merchant Bank who have ranked collateral as the number one factor in loan decisions, all the other banks consider lack of a clear repayment plan or poor project reports and/or lack of comprehensive project plans as the overriding factor in making loan decisions. In short, major banks are catering to the few customers that provide the bulk of the profits (excluding returns from lending to the government) by revising minimum balances upwards whilst targeting affluent customers in urban areas. Banks have not dedicated the time or resources to understand the MSMEs' needs, which has led to information asymmetry.

Information Asymmetry

Whilst the above factors for loan rejection are undoubtedly relevant, ***a general lack of information about micro enterprises or information asymmetry is also evident.*** The reasons for rejection of loan requests from MSMEs indicate a lack of information about their operations by the banks. Information asymmetry has been heightened by the fact that branch banking tends not to take into account local and peculiar conditions, especially as general directives and operational frameworks for the deposit money banks emanate directly from the head office in Accra. Historically, deposit money banks in Ghana have borrowed the practices and traditions of the developed market economies, especially British banking practices and conventions that banks must lend for short-term, self-liquidating purposes only. In operational terms, this implies preferences for entrepreneurs who can offer good collateral against loans or at least an assurance of marketability of the product or capacity to generate income to repay the loan. As has been demonstrated by survey findings, not only can MSMEs not offer the traditional security acceptable to the deposit money banks but, more fundamentally, the banks know very little about the operations of the MSMEs to appreciate their cash flow problems. Thus, when banks no longer have access to easy income from treasury bills, they will have to devise means to make loans to MSMEs. This would mean the creation and strengthening of MSMEs credit desks in the banks. Banks would have to re-orient their human resources, training and developing the necessary human resources who are conversant with issues and problems peculiar to MSMEs. Eventually, market and customer information would flow both ways and perhaps a credit reference bureau of some sort may deserve some support.

Indeed, impediments to MSMEs financing range from the general characteristics of MSMEs and the perceptions of the lending institutions. MSMEs:

- tend to perceive the banks as apathetic to their needs, understandably from the lack of coherent policies by the banks to meet their needs. This stems from the heterogeneous character of MSMEs.
- lack experience in dealing with formal banking system
- are generally not able to prepare business plans acceptable to the banks;
- owners equity is often difficult to mobilize even when viable business plans are prepared; some expect total funding from banks without equity commitment from the enterprises themselves
- have not shown sufficient managerial competence to elicit the confidence of bank managers, thus reducing their creditworthiness.

The **alternative** to relying on commercial banks to service MSMEs is the development of financial institutions that cater only to smaller or micro-enterprises. The Grameen bank in Bangladesh is now an icon of such financial institutions. The common feature of such institutions is that they all contain their overhead, have low transaction costs, usually lend for short periods of time (2 weeks to 9 months) and are always community-based, even when in urban areas. In Ghana, Sikaman in Accra is one such example (see text box). Sikaman has recently appeared in the newspapers as a successful approach to engaging the MSMEs and it may be, up to a point. It is clearly targeting

The Sikaman Approach

An MSME can get a quick evaluation of its application (which can be received verbally) and get a short-term loan at prevailing interest rates. Transaction costs are minimal. Sikaman will refuse to serve a potential client, no matter how good the business model may seem in preliminary discussions, if its loan approval team has to spend more than the specified time or resources to investigate the claims made. Customers are usually near the physical office of Sikaman and usually fit the profile of the formal businesses that fall below the VAT threshold or informal businesses. A case manager will get to know the person's business and personal life and habits quite intimately, looking for signs of bad business judgements or risky spending behaviour. As a result of these measures, loan recovery rates exceed 90% and repeat customers are common.

short-term borrowers and charging commercial rates and making operational profits on transactions enacted. But is has run into currency conversion losses against its initial capital from abroad. The fact that it must restrict its offerings to short term to make a profit is indicative of the risk associated with long-term loans under current financial conditions. Other financial institutions that are trying to serve the MSME only include the Citi Savings and Loan Company and the Women's Banking World, to name just two.

Package Credit Programs At Subsidized Rates Of Interest

As we noted earlier, the institutional framework of banking development in Ghana was based upon *perceived notions of credit shortage* to MSMEs. Accordingly, credit programmes were put in place to make loans for MSMEs at subsidized interest rates. The Business Assistance Fund (BAF) and Export Development and Investment Fund (EDIF) are examples of such programs. EDIF offers credit to MSMEs at an interest rate of 15% compared to the 40% to 45% that banks would ordinarily charge. Such a practice is based on the misguided assumption that the cost of bank credit is prohibitively high for MSMEs and other, poorer borrowers.

The problem with such logic is that formal credit institutions typically perceive poor borrowers as being high-risk borrowers, so that they have strong incentives to avoid lending to the MSMEs even at the best of times. This is much more so when the return the banks receive fails to cover their transaction costs. Since it is *access to bank credit* which is the real problem for MSMEs *rather than the cost* of that credit per se, *enforcing subsidized interest rates is likely to reinforce rather than reverse bank discrimination against marginalized borrowers like MSMEs*.

The meticulous nature in which participating banks tend to administer the Export Development and Investment Fund shows that the banks have become more conservative with EDIF. This is because the EDIF program has enjoined the banks as collaterally liable to non-performing loans. As a result of being overly meticulous, the banks' transaction costs to administer the EDIF have increased, making it very unattractive to offer credit to MSMEs, even using EDIF funds. Transaction costs are higher because it is difficult and time-consuming to obtain the information required to appraise loan requests. Furthermore, the loan procedures are highly-centralized and MSMEs have to satisfy the EDIF Board in addition to the participating bank to fulfill all the requirements to obtain concessional loans. This also adds severe cost and time burdens on MSMEs, especially if they have to make several journeys to the Board and the banks. Indeed, risks are high because of the high mortality rates among MSMEs, and the lack of risk-sharing arrangements. Banks are constrained to serving the needs of existing creditworthy firms, even with EDIF funds, that are larger and often multinational in character, rather than devising products to serve MSMEs. It will be more useful to contain inflation (through prudent fiscal measures) so that interest rates can gradually fall to enable banks to make loans to MSMEs at affordable rates.

Fiscal Imbalances And Their Implications For MSMEs' Credit

The public sector dominates financial markets in Ghana today. Financial institutions are used primarily to finance government deficits and SOEs at the expense of the private sector. Banks hold the bulk of their assets in securities issued by the public sector. *Public securities provide the best returns with the least risk.* The limited credit to the private sector is short-term and rationed to larger, preferred clients. Thus, once again, MSMEs are marginalized.

Not only are the nominal returns on treasury bills high in spite of falling inflation but they are exceptionally high in real terms. Because of these high positive real rates of return on treasury bill holdings, they are better instruments to be invested in by any rational economic agent who considers the risky environment in Ghana compared to other instruments offered by the deposit money banks. Consequently, the banks in Ghana have tended to invest their "loan portfolio" in treasury bills. As a result, financial intermediation is reduced and such funds are not available for the private sector to access for capital formation.

Added to the fiscal imbalances are, the intractable inflationary pressures unleashed on the real sector, and the attendant tight monetary policy by Bank of Ghana. Attempts to control inflation have, in turn, produced high treasury bill rates which serve as benchmarks for the lending rates of banks to the private sector. *Once banks put their risk premiums on the treasury bill rates, the interest rate structure becomes distorted, making lending to the private sector or MSMEs unattractive.* For example, current lending rates are as high as 40%. For MSMEs such high borrowing costs jeopardise their profitability. Borrowing at such a rate would mean that an enterprise must earn about 50% to 55% on their investments to be profitable. With the prevailing macroeconomic instability and irreversibility of investment decisions, it is unrealistic to expect formal MSMEs to earn such high returns on their investments to be able to pay back loans borrowed at 40%. Firms in the **informal sector** (or those that fit the profile of Sikaman clients) may be able to earn such high returns with their limited overheads *but run into huge costs when they try to formalize,* partly explaining the prevalence of informal markets.

The financial reforms have introduced elements of deregulation into the financial system. Interest rates controls have been relaxed and blanket credit controls have been abolished. Banks are relatively free to manage their own portfolios in the best way to maximize profit. This has created the environment for increased competition and increased lending to MSMEs. In practice (at least in the short run), liberalization has resulted in the increased marginalization of MSMEs as the banks compete for the more wealthy customers. Indeed, in the current financial environment, banking has become relatively easy and very lucrative for banks (very high secondary reserves, holding government paper).

Government must pursue a reduction in fiscal imbalances so that inflationary pressures are reduced and in turn lead to falling interest rates. A reduction in the level of fiscal deficits would increase the amount of liquid funds available to the banks. This will enable MSMEs to be 'crowded in' when banks are devising their lending policies. Coupled with the fall in interest rates, banks will no longer have access to inexpensive and easy income sources such as investing in treasury bills: they will have to cater to the private sector and the private sector today (as in most places in the world) is made up mostly of MSMEs.

Government Arrears Owed To MSMEs

Government payment arrears, for services performed, are a major driver of loan defaults among MSMEs that are linked to government-funded projects. Ghana adopted a practice whereby private enterprises pre-finance public expenditures before payments are made to them. However, delays in Government payments have put cash flow financing pressures on the prime contractor who, in turn, delay payments to the small subcontractors who are then forced to default on their borrowings, contributing to further questions about their creditworthiness. This is particularly so with construction supplies for educational and health facilities. MSMEs that directly benefited from such government finances borrowed funds from the banks with letters of credit from the Government. Consequently, failure of Government to make timely payments for work done has tended to increase the indebtedness of MSMEs. In several cases, the MSMEs have lost on such transactions when payments are eventually made as the financing cost of the loans they had to take out to cover their expenses outweighed the benefits.

Exchange Rate And Call For Protection Or subsidized Interest Rates

Nominal and real exchange rates often moved in different directions during the 1990s and since 2001. The cedi appreciated in real terms since cedi prices of goods and services in Ghana rose faster than prices in major trading partner countries, measured in their own currencies. That is, although stability was gained in terms of nominal exchange rates, especially in 2002 and 2003, the cedi exchange rate did not depreciate substantially to offset the inflation differential of the rest of the world. The exchange rate may have been used as a nominal anchor, both from monetary policy and foreign inflow points of view. Consequently, the US Dollar-Cedi bilateral real exchange rate shows that Ghana's exchange rate during the year has been overvalued. This real exchange rate appreciation indicated a loss of competitiveness, with both short- and long-term consequences for Ghana's economic health as foreign goods and services gained a competitive advantage over Ghanaian products, particularly plastic and rubber products manufactured by MSMEs. This tended to erode the profitability of Ghanaian producers of exports and import substitution goods as the exchange rate serves as a tax on exports and a subsidy on imports. For competitors and importers, costs abroad became lower, thus putting the import substitution firm at a disadvantage in Ghana, with the Cedi appreciating in real terms. It is therefore not surprising that MSMEs in the import business have *relative* access to bank credit whilst those in manufacturing an export are typically denied credit.

Real exchange rate appreciation increases the call for protection, as local producers are currently demanding. The introduction of tariffs on rice and poultry (later withdrawn), inter alia, are classical responses to such demands for protectionism. Although import tariffs can give import substitution firms some level of protection from imports besides the revenue they give to the treasury, the effects of the higher tariffs can be quickly eroded by the effect of currency appreciation. Thus, even if tariffs are raised, with real appreciation in the exchange rate, it may not be long before the firm or industry is returning for more protection. This generates a belief that the firm or industry cannot compete, when it may be government policy that is making them uncompetitive.

If MSMEs are to be the engine of growth in the Golden Age of Business, then greater attention needs to be given to the analysis of how macroeconomic decisions can severely damage the prospects for their growth. *Nominal exchange rate stability itself is good and allows for forecasting but it encourages dead weight loss.* The challenge for policy-makers is to balance the competitiveness aspect of exchange management, which tends to be more related to firm or microeconomic level decision, than with the macroeconomic aspect. We wish to endorse Bank of Ghana's position that it will continue its flexible exchange rate policy so as to provide incentives for increased production of exportable goods, and enhance competitiveness on international markets. Consequently, monetary and fiscal prudence must play a complementary role to slow down the rate of depreciation of the cedi and make the economy more stable for productive activity to flourish[1].

Regulatory Framework For Micro-, Small- and Medium-Scale Enterprises

Recent attempts and public campaign to support MSME growth notwithstanding, clear policies that support MSME growth need to be put in place. A single operational definition of MSMEs would be a good start. Legislative and legal practices have impacted negatively on the day-to-day operations of MSMEs. Licensing requirements generally tend to work against MSMEs as larger enterprises have the means to work through the bureaucratic maze and red tape. Typically, for example, an entrepreneur in Tamale that wants to register a company would have to travel to Accra to register the enterprise with the Registrar General's Department. This is changing and a branch of the Registrar General's Department is to be opened in Kumasi soon. Decentralization and simplification of such processes (especially for MSMEs) should be supported.

Similarly, there is the need to review, repeal or amend aspects of existing labour and exchange control regulations that tend to penalize MSMEs. Examples of such laws and regulations are Exchange Control Act 1961 (Act 71) as amended, the Labour Decree 1967 (NLCD 157), the Industrial Relations Act 165 (Act 299 as amended). These laws tend to impose higher costs on MSMEs, especially as labour costs become fixed costs in some respects. The passage of the Labour Act in Parliament will help create a more flexible labour market in Ghana, by addressing some of these concerns.

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[1] 2003 Budget Statement, Page 44 Paragraphs 166 and 167.

Market Access Linkages For MSME Products

A major constraint on MSMEs' access to credit is the restricted nature of markets they serve. It is an understatement that viable credit schemes rely heavily on MSMEs having ready access to markets for their products. Without assured market outlets for the sale of products, MSMEs would be ill-advised to use loans for any inputs required to raise productivity. This is particularly so when markets are localized or production arrangements are forced within an import substitution framework. Consequently, trade policy should be competitive both within and outside the confines of Ghana.

The dissemination of market information must be promoted, particularly regarding district or regional markets. This could be achieved through the creation of the necessary infrastructural base that would link district or regional production centres to marketing centres, something the new agricultural policy proposes to do. Open market policies go hand in hand with credit schemes so that MSMEs can productively use the loans obtained. It is in this vein that the African growth and Opportunities Act (AGOA) is particularly important. Once MSMEs have been able to confirm the demand for their products, banks would readily take steps to ensure that their credit needs are provided for. The activities of the Ghana Export Promotion Council, The Gateway Project and a host of other such institutions must be made functional and, if necessary, brought under one umbrella to capture the advantages of economies of scale and scope.

Lack Of Acceptable Collateral

Generally, asset-based lending hinges on credit extension against collateral or specific property that a borrower pledges as security for the repayment of a loan. The borrower agrees that the bank will have the right to dispose of the collateral for the purpose of liquidating the debt if the borrower fails to repay the loan at maturity or otherwise defaults under the terms of the loan agreement. Examples of acceptable collateral are real estate, machinery and equipment, bonds, stocks or share certificates, notes, bills of lading, warehouse receipts and assigned debts. Whilst asset-based lending transfers a substantial fraction of the risk to the borrower, and may force the borrower to use the loan productively if the collateral is not to be lost, such lending strategy appears not to be successful in Ghana. Both banks and borrowers have in many instances not gained from the credit transactions as the borrowers' were not able to pay back the loans and the banks were not able to redeem the collateral. This is due to a number of factors.

First, the common types of assets accepted by banks (stocks, bonds, insurance certificates etc.) are not developed in Ghana. It is only now that the monetary authorities, including Bank of Ghana and the Ministry of Finance, have created a Financial Sector Desk to co-ordinate the development of long-term savings plans and to promote the formation of bond markets within the framework of the Financial Sector Strategic Plan. The limited existing financial instruments are not popular with the people of Ghana, including businessmen. This stems from macroeconomic instability, especially high and variable rates of inflation and depreciating exchange rates, that have spurred increasing dollarization of the economy instead of the development of cedi-denominated financial instruments. Most importantly, MSMEs are not likely to own financial assets, even in the best of times. Consequently, the only alternative assets that can serve as credible collateral are land and real estate.

Land as Collateral

Unfortunately, however, with land the cadastral laws and title deeds are not clearly defined. Like the French experience in the 18th century (but unlike the British where the right of primogeniture was clearly defined and land was used to command more resources to acquire further wealth), Ghana's land tenure system is complex and not properly defined to accord any one individual the title deeds to readily use land as collateral (Gockel, 1995). *Generally, no one person has exclusive title to the land of a deceased's estate*. The eldest person in the family or lineage holds the title deeds of the land or other property on behalf of all the members of the family, **including the dead and those yet to be born**. In such instances, although a person may have access to the land for farming or other socio-economic activity acceptable to the lineage members, he has no clearly defined ownership right to dispose of it without consultation and approval of the entire members of the family or lineage. Consequently, if a bank should accept a pledge of such asset and advance credit against it, should the borrower default, the bank would be sure to be embroiled in land litigation for a long time to come. To use "title" deeds as collateral the bank must therefore investigate the borrower's claims to the property, and such investigations are seen by the banks to be time-consuming, cumbersome and not very fruitful. In several instances, the bank managers we contacted noted that some of these properties have already been pledged to other local persons for usufruct. This was particularly the case of cocoa farmers whom the bank managers thought were relatively creditworthy and less risky to loan to.

Real estate as collateral

In the case of real estate where there are clearly defined ownership titles (and hence the ability of the bank to foreclose on defaulted mortgages), socio-cultural considerations tend to weaken the bank's rights in disposing of pledged items. Foreclosure on a debtor's property by a bank is regarded as morally repugnant and there is no ready market for such property. Seized land, building or other property may not attract buyers because of the solidarity of neighbours, or clients and workers. The bank would be regarded as an "outsider" wanting to destroy the cohesion of the society. The moral reprehension of such actions was echoed in the Parliamentary Debate on "Private Members' Motions: The Ghana Commercial Bank", when Mr Baah in tabling the motion noted as follows;

> I beg to move, That the conditions upon which the Ghana Commercial Bank grants loans and overdrafts should be made less restrictive...The Bank is more prepared to give loans to foreign firms than it is prepared to give loans to Ghanaians. How many Ghanaians have not lost their property through auction sales by the Ghana Commercial Bank? In fact, the Ghana Commercial Bank must change its attitude in granting loans to Ghanaians. Before the establishment of the Ghana Commercial bank, Ghanaians had been taking loans from foreign banks such as the Barclays Bank and the Bank of West Africa Ltd, and yet they had not lost their

> property as a result of these loans. But our Bank which should help us as far as loans are concerned, is now depriving people of their property. Whither are we drifting? Whenever one takes up a daily newspaper. 'sale of property by auction by the Ghana Commercial bank' very often forms the leading article. Is the Ghana Commercial Bank out to help the people or to ruin them?" (Parliamentary Debate, 24 August 1960).

Although this statement was made in 1960, it is still very relevant. It has become apparent that collateral in the form of pledged real estate was mere routine. Such assets were not necessarily realizable as alternative sources of repayment if loans went bad.

Ghana has recently embarked on a process of land reform (Land Administration Project, IDA Loan) to address the many issues highlighted. First results are several years away. It will not be an easy task, but nevertheless needs to be done. The visit of President Clinton and De Soto in 2002 to launch the Capital for the Poor is a worthy beginning to the debate. Government must acknowledge the authority of traditional rulers over land and woo them so that amicable land policies can be developed as a basis of acceptable collateral and part of production process.

Key Recommendations

There is the need for policy consistency and fiscal discipline. In so far as banks have high return treasury bills to buy, they will not lend to private sector groups, especially MSMEs. Banks need not exert any imagination in their portfolio management: T-bills are a good business.

The exchange rate regime is also very important. Without a realistic policy, the cedi can become overvalued, serving as a disincentive to local products with greater demand for protection and subsidized credit.

Policy makers will also encourage the decentralization process to ensure that MSMEs are not unduly burdened in having to travel long distances to meet bureaucratic criteria in complying with the conditions to obtain a loan.

Savings and Loans Associations (S&LAs) that are practically banks but, by law, registered as non-bank financial institutions, currently mobilize funds from micro-, small- and medium-scale enterprises which are, in turn, lodged with deposit money banks. Effective linkages between S&LA and the formal banks can promote a flow of funds to the former. Indeed, such a linkage, emerging at the instance of the market, is a bottom-up demand driven approach and policymakers can lay claim to effective credit policies and programs for marginalized entrepreneurs. S&Las, in turn, will have to devise carefully-designed credit programs that target eligible MSMEs.

Credit providers that cater to MSMEs *exclusively* (e.g. Sikaman), and are community-based, may be a good fist step to increasing credit access to eligible MSMEs.

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