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Resourcing Small and Medium Enterprises: Owners Willingness to Seek Funding From Banks in Ghana

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ABSTRACT

One of the most important resources required by owners of Small and Medium Enterprises (SMEs) in their operation is capital. When internal funds become inadequate for the running of the business, the need arises for owners to seek external funding to support what is generated internally. Many SMEs in Ghana have not utilized the banks in their pursuit for external funding and that is a source of worry for both parties. This study was then motivated to find out the factors contributing to this action. A sample size of 125 SME owners was made to respond to questions pertaining to the objective of the study. The data generated was analyzed using an Econometric views regression model called the probit model and it turned out that, four out of the eight variables used in the study had significant effect on the willingness of SMEs owners to seek funding from banks. The study therefore concluded among other things that, firms prefer to deal with banks they are not familiar with and also innovative oriented firms are not necessarily large firms.

Keywords: Resourcing, willingness, funding, banks, SME, internal, external, funding

1.0 INTRODUCTION

In Ghana, the interest rate charged by the banks is considerably lower than other sources that Small and Medium Enterprises (SMEs) could draw funding from. Other sources such as non-banking institutions, traditional money lenders and investors offer funding assistance to SMEs at a rate slightly higher than the banks. Despite their lower interest rate, the banks continue to record low patronage from SMEs. According to the World Bank (2011) report, the domestic credit to private sector (as percentage of GDP) in Ghana was reported as 15.88% in 2008, 15.66% in 2009 and 15.23% in 2010. These figures refer to financial resources provided to the private sector in the form of loans for the years indicated. The percentage decrease from 2008 through to 2010 confirms the fact that SMEs' interest in seeking loans from the banks keeps declining. The decline may be due to the fact that, some SMEs have diversified their funding needs (search for funding) among the various bodies in the country that are capable of lending money. This trend has become a global concern because it has been experienced by other European countries including England. The Bank of England (2004) indicated that 65% of the firms in England used debt financing in the 1980s. This number reduced to 39% during the period 2000-2002 and further reduced to 23% by 2008. It can therefore be deduced from the trend of events that, it is not a lower interest rate alone that can motivate a firm to seek funding from a bank. As a result, this study sought to discuss other factors that could impact on the willingness of SMEs to seek loans from banks and not other sources. To support the basis for this research, the president of Ghana was captured by the May, 3 2012 edition of the Daily Graphic newspaper to have indicated that, SMEs are increasingly face with challenges of accessing facilities from the banks though they are the pivot of the economy.

In an attempt to check this menace, the Network for Governance, Entrepreneurship and Development in Geneva 2008 called for collateral base to be broadened to encouraged bank lenders to finance SMEs with insufficient collateral. In a similar attempt, Ghana enacted the Borrowers and Lenders Act 2008 to encourage the use of movable assets such as vehicles, furniture, goods etc as collateral in accessing bank loans in addition to the use of real estate. The C.E.O of Samba Foods in Ghana on November, 6, 2009 also recommended that, macro level regulations must be moderated to motivate the banks to foster healthy relationships with SMEs within the manufacturing sector. The Agricultural Development Bank in Ghana has also pledged to categorize SMEs to ensure fairness in loan approval so as to solve the problems of struggling SMEs in the country (ADB Research team, 2012).

2.0 LITERATURE REVIEW

The choice of a particular source of funding hinges on some factors including; the venture's stage of development and nature of assets for which finance was required (Stokes and Wilson, 2010: 403). Another issue that could arouse the SME's quest for optional funding is the inadequacy of internal funds to meet the demands of the business (Myers and Majluf, 1984). Usually, the extent of flexibility and willingness to try new approaches makes SME more innovative than larger firms, hence necessitating the need for more funding from optional sources to augment the current strength of the firm in terms of finance (Davis, 1991).

A sharp contrast exists between the banks and the SMEs when it comes to information dissemination. The two bodies place different values on information, hence the contrast. Banks are seeking information on SMEs to enhance loan approval decision but the SMEs are also making relentless efforts to conceal it. According to Berry et al., (1987), SMEs find it difficult to let out vital information. Meanwhile the banks stress emphatically on financial information and personal interviews as the most important source of information to enable them make lending decisions. The reluctance on the part of SMEs is attributed to the unprofessional manner they handle information in their businesses. As a result of this, information on SMEs was either unavailable (Berry et al; 1987); unreliable (Tomlinson and Knight, 1978) or was not useful under present conditions (Egginton, 1982). These conditions actually make it difficult to assess the risk factors prior to the approval of loans by the banks and so many SMEs are faced with difficulties in their search for loans (Stiglitz and Weiss, 1981).

There is a growing concern by SME owners that banks use unfair practices in their dealings with them. The European Commission (2003) discovered that across Europe, the cost of financing (interest rates and bank charges) tends to be higher for small firms than the larger ones. In the light of this, the Competition Commission in 2002 investigated and found that, the major banks in the United Kingdom (UK) were guilty of making excessive profits from their SME banking operations (Bank of England, 2002). It is therefore evident that, many SMEs would be reluctant to do business with the banks.

The building of strong relationships with SMEs by the banks has been identified as being crucial in the determination of the quantum of business SMEs can place at the door step of the banks. A research by Bharath et al., (2007) showed that, banks that have good relationship with SMEs have a 42% chance of securing loan request as against 3% for those not having any relationship with them. The first group can also gain easy access to information on SMEs to facilitate their decisions. It was supported by another research that, a client would willingly give out information to a bank he/she relates very well to (Allen, Saunders and Udell, 1991). In that way, the client and the bank reduces risk associated with searching for a credible bank and the risk associated with loan approval and disbursement respectively (Rajan, 1992).

Collateral request as a requirement for loan approval by the banks is perceived as a risk reducing practice whereas the SMEs see it as an inhibiting factor during loan application especially when it is beyond their reach

(Jimenez and Suarina, 2004). A study by Menkhoff et al., (2006) on 560 banks in Thai confirmed that collateral helps in reducing credit risk. The actions of banks in Ghana seem to have a root from this research, hence the demand for higher collateral from SMEs. They envisaged a significant positive relationship between collateral and loan default recovery (Dermine and de Carvalho, 2006). This was one of the reasons why the 'Borrowers and Lenders Act' was passed in 2008 to moderate collateral request from banks so that SMEs would be willing and prepared to do business with the banks.Banks in Ghana find it comfortable dealing with firms which are larger in size compared to the smaller ones. Their perception is in line with one of the research findings of Mitchell (1994) which indicated that larger firms tend to survive longer than smaller ones. The import of the research suggested an association with profitability and sustainability which was supported by Bercovitz and Mitchell (2007); Silverman et al., (1997) that, the size of a firm can directly affect profitability and sustainability of business. Consequently, smaller firms are likely to be rejected by banks and that can affect the SME's willingness to apply for funding from their outfit. The owner's share of investment in a business determines to some extent the firm's survival (Bates, 1990). Affirming this revelation, Chandler and Hanks (1998) claimed that, insufficient financial resources on the part of the owner could limit his/her commitment and that can lead to business failure. If the business owner injects more resources, the share of the business risk increases significantly leaving the bank with minimal risk to contend with hence the practical adoption by many banks as a criteria for loans approval (Vaughn, 1997).

2.1 THEORITICAL FRAMEWORK

The willingness of a particular SME to seek funding from a bank hinges on some factors. These factors can be viewed from two perspectives (the firm's specifics and bank's specifics). The factors showed in figure 1 below influence the SME's willingness to seek bank funding or loan.

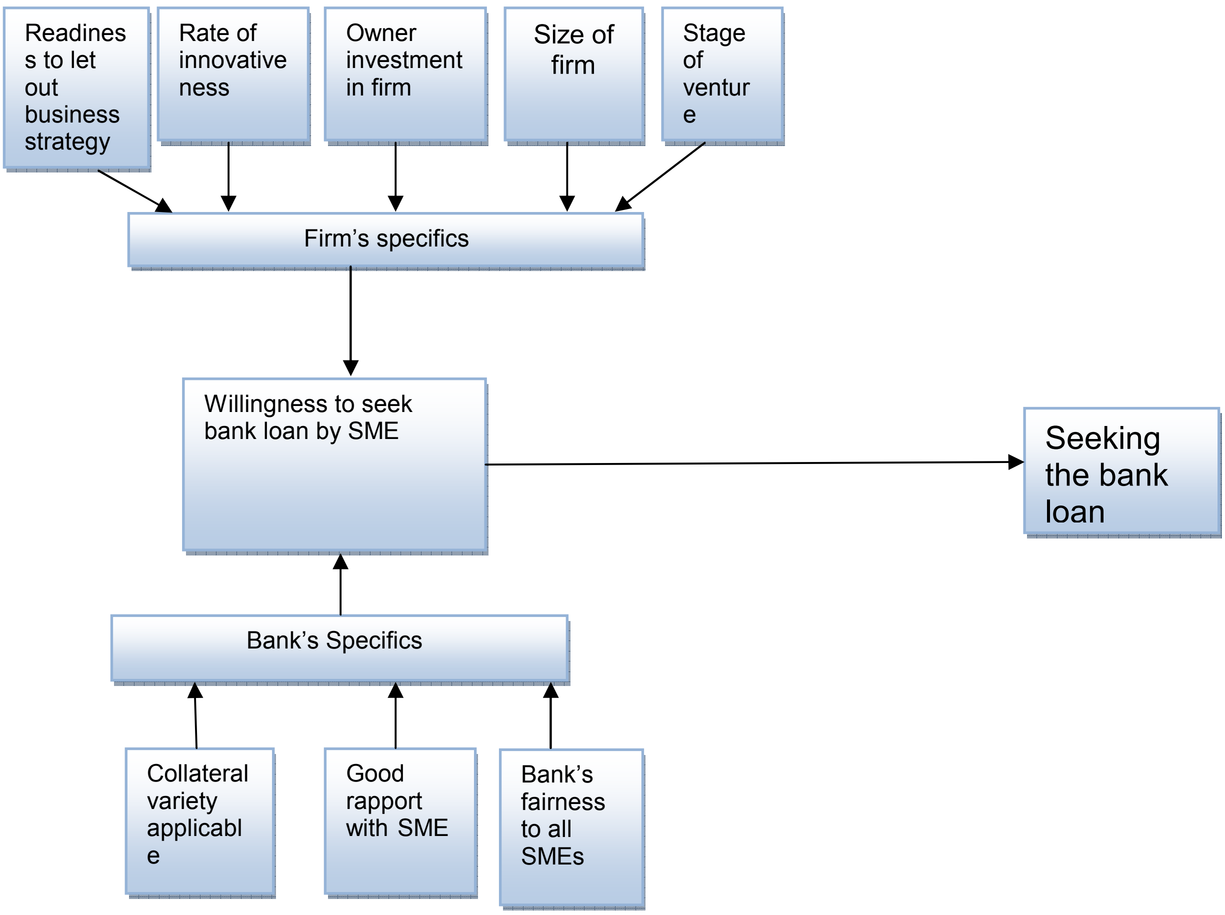

Fig 1: Framework of factors influencing SMEs to seek bank funding/loan

Source: Developed from literature

2.2 RESEARCH VARIABLES

The dependent variable according to the topic was "Willingness to seek bank Loan" and was represented by WTSBL.
The independent or explanatory variables from the literature included;

- ''Preparedness to let out business strategy" (PBS)
- "Size of the firm" (SOF)
- "Owner investment in business" (OIB)
- "Collateral varieties applicable" (CVA)
- "Bank fairness in dealings" (BFD)
- "Good rapport with firms" (GRF)
- "Rate of innovativeness" (ROI)
- "Stage of Venture Development (SVD)

3.0 RESEARCH METHODOLOGY

The study sought to establish casual relationships between explanatory variables indicated above and the dependent variable. This rendered the research an explanatory one.

SMEs operating in Ghana were the target for the research. Three different stages were targeted along the Project Life Cycle (PLC) with groups at each stage. The stages constituted the developmental, maturity and decline stages of a project life cycle. Firms were selected at random from predetermined strata according to the following conditions. The number of years of existence in a particular stage of the PLC, the industries to which firms belong, the size of firm with respect to the number of branches and number of products offered, the number of innovations embarked upon in a year and frequency of encounters with bankers. These conditions were used for the groupings so that the research objective was addressed appropriately.

A sample of 125 SMEs across the country was used for the study. Since in a particular stratum, all the firms had similar characteristics, few firms were selected to represent the entire group. This actually restricted the sample to 125 but did not affect the representativeness of a population size of 326.

The research used two familiar tools for the data collection. An interview guide was designed for the owners who were prepared to take some time off their busy schedule to interact with the research team. A questionnaire was also designed for those owners who could only respond to the same set of questions in their own time. That was done so that the quality of the research was not compromised. Eventually, the data collected turned out to be predominantly primary since secondary data could not be very relevant to the course of the study.

3.1 DATA ANALYSIS

The dependent variable was dichotomized into two mutually exclusive alternatives. That is, whether the SME wanted to seek bank loan or not. Due to this characteristic in the dependent variable, it was appropriate to use version 3.1 of the Econometric views (E-views) for the analysis according to (Gujurati, 2006).

3.1.1 *ANALYTICAL FRAMEWORK*

The decision by the SME to seek bank loan was dichotomized into two mutually exclusive issues. The SME may either be willing to seek bank loan (to be denoted by 1) or may not be willing (denoted by 0). Models for estimating such phenomenon where the dependent variable is binary or dichotomized include the Probit model (Gujarati, 2006). This binary phenomenon yields a binary dependent variable, y_i which takes on the values of 1 and 0 as indicated above. The probability of observing the value 1 is:

$$P_r\,(y_i = \frac{1}{xi\beta i} = 1 - F\,(-\chi_i\beta_i)) \qquad (1)$$

Where F is a cumulative distribution function. It is continuous, strictly increasing function that takes a real value and returns a value which ranges from 0 to 1. It follows that, the probability of observing a value of 0 is:

$$P_r\,(y_i = \frac{0}{xi\beta i} = 0 - F\,(-\chi_i\beta_i)) \quad \ldots.. \qquad (2)$$

Given such a specification, the parameters for estimating this model by using the maximum likelihood estimation approach can be determined. The dependent variable y_i is related by the equation:

$$y_i = \beta_i x_i + \mu_i \qquad \ldots\ldots\ldots \quad (3)$$

Where μ_i is the random disturbance term. The dependent variable is determined by whether the threshold value of y_i is exceeded or not.

$$y_i = \begin{cases} 1 \; if \; y_i^* > 0 \\ 0 \; if \; y_i^* \le 0 \end{cases} \qquad (4)$$

Where y_i* is the threshold value for y_i and is assumed to be normally distributed.

The Probit model is preferred to the other models because of its superior advantages. It is able to constrain the utility value of the SME's decision to seek bank loan to lie between 0 and 1 and its ability to produce realistic probabilities and also distribute the error term (Nagler, 1994).

The probability that a SME in Ghana would wish to seek a loan from bank P_i is given as;

$$P_i = P\,(y_i^* < y_i)$$

$$Pi = P\,(y_i^* < \beta_0 + \beta_i x_i) = F\,(y_i)$$

$$P_i = F(y_i) = \frac{1}{\sqrt{2\pi}} \int_{-\infty}^{zi} exp\left(\frac{s^2}{2}\right) ds \qquad (5)$$

s is a random variable normally distributed with mean zero and variance one: yi represents the decision by SME owner to seek bank loan and is dichotomized into 0 and 1: y_i* is the threshold value for the dependent variable. The inverse of the cumulative normal distribution function gives the estimate of the index z in (5).

$$y_i = F^{-1}(P_i) = \beta_0 + \beta_i x_i + \mu_i \qquad (6)$$

The empirical model is then stated as;

$$WTSBL_i = \beta_0 + \beta_1 PBS + \beta_2 SOF + \beta_3 OIB + \beta_4 CVA + \beta_5 BFD + \beta_6 GRF + \beta_7 ROI + \beta_8 SVD + \mu_i \qquad (7)$$

Where β_0 is a constant and β_1……………….. β_8 were coefficients of the independent variables and

WTSBL is the Willingness of SMEs to seek Bank Loan which is a dummy variable (1 for making a decision to seek bank loan and 0 for deciding otherwise).
PBS stands for the Preparedness to let out Business Strategy to the bank (1 for decision in favour and 0 for decision against).
SOF represents Size of Firm (1 for SME to seek bank loan when firm is small in size and 0 for otherwise).
OIB stands for Owner Investment in the Business (1 for SME to seek bank loan when owner has low investment in the firm and 0 for not seeking bank loan when owner has huge investment in business).
CVA stands for Collateral Varieties Applicable (1 for SMEs to seek bank loan when banks accept many types of collateral and 0 for not seeking if banks do not accept many varieties of collateral).
BFD stands for Banks Fairness in their Dealings (1 for SME to seek bank loan if banks treat firms fairly and 0 for otherwise).
GRF stands for Good Rapport between bank and Firm (1 for SME to seek bank loan if there exist a good rapport between bank and firm and 0 for otherwise).
ROI represents Rate of Innovativeness (1 for SME to seek bank loan if there is increased rate of innovativeness and 0 for otherwise).
SVD stands for Stage of Venture's Development (1 for SME to seek bank loan if the firm is at the foundation stage and 0 for otherwise).

4.0 RESULTS AND DISCUSSIONS

From the results in table 1 below, a Likelihood Ratio (LR) statistic of 5.296885 with Chi-squared (χ^2) distribution of 8 degrees of freedom was highly significant at 10% level. This was an indication that at least one of the independent variables in the model had a significant effect on the willingness of a SME to seek bank loan for business activities and the combined effect of all the explanatory variables was also significant and consequently had influence on the dependent variable.

Table 1 gives the values of all the coefficients in the empirical model derived above. A positive sign attached to a coefficient indicates that, a higher value of the variable increases the probability that a SME will seek bank loan to finance its activities. On the contrary, negative values of coefficients indicate that, higher values of the variable decrease the probability that a SME will seek bank loan for its operation. From the result table, 50% of the variables used in the regression analysis were highly significant in determining the willingness of SMEs to seek bank loans for their operation. Owner investment in the business, collateral varieties applicable at the bank and Banks fairness in their dealings with SMEs were all highly significant in determining the willingness of firms at 5% level whiles the firm's rate of innovativeness was significant at 10% level. Though the rest of the variables were not significant in determining the willingness of firms in seeking bank loans to finance their business, each of those variables showed a trend in relation to the dependent variable. As an addition to knowledge it was discovered that, the more the variety of collateral a firm could tender in as security for a loan, the higher the probability that the firm would prefer to apply for a loan from the bank to finance business operation. Similarly, if banks improve on the fairness in their dealings with SMEs, the willingness to source funds from the banks would also increase, hence confirming the finding of Bharath et al.,(2007). The research further discovered that, as the owner's share of investment in the business goes up, the business become reluctant to seek funding from the bank hence indicating an inverse relationship between the explanatory and the dependent variable. This discovery adds up to the body of knowledge propounded by Bate (1990); Chandler and Hanks (1998). Finally, as a firm becomes more innovative, the quest for external funding like the bank diminishes significantly. This was a contradiction to Davis (1991) accession that firms' continual innovation calls for their quest for external funding.

For the variables which were found to have insignificant effect on the dependent variable, the size of the firm and the preparedness to let out business strategy showed insignificantly positive effect. This implies that, as the size of a firm increases, the probability to seek bank loan also increases and as the firm becomes increasingly fearless in divulging business strategy by way of supplying the bank with the needed information, they would seek for loans from banks. On the contrary, the stage of a venture and setting up good rapport with the firms showed insignificant negative effect on the dependent variable. Additionally, as firms progresses from the developmental stage towards decline on the life cycle, the motivation to seek bank loan reduces.

Table 1: Result of the regression of factors influencing SME willingness to seek bank loan.

Dependent Variable: WTSBL
Method: ML Binary Probit

Variable	Coefficient	Std. Error	z-Statistic	Prob.
C	0.433107	0.591116	0.732693	0.4637
BFD	0.404725	0.298190*	1.357274	0.0147
CVA	0.182660	0.298855*	0.611199	0.0211
GRF	-0.073967	0.285065	-0.259473	0.7953
OIB	-0.057992	0.294190*	-0.197124	0.0437
PBS	0.103755	0.283838	0.365544	0.7147
ROI	-0.328065	0.299313**	-1.096058	0.0731
SOF	0.225566	0.255874	0.881550	0.3780
SVD	-0.169767	0.289434	-0.586550	0.5575

Mean dependent var	0.728000	S.D. dependent var	0.446781
S.E. of regression	0.451021	Akaike info criterion	1.272101
Sum squared resid	23.59672	Schwarz criterion	1.475739
Log likelihood	-70.50630	Hannan-Quinn criter.	1.354828
Restr. log likelihood	-73.15474	Avg. log likelihood	-0.564050
LR statistic (8 df)	5.296885	McFadden R-squared	0.036203
Probability(LR stat)	0.065424		
Obs with Dep=0	34	Total obs	125
Obs with Dep=1	91		

Note: (*) indicates significance at 5% level and (**) indicates significance at 10% level

Source: computed from the data generated for the study

CONCLUSION AND RECOMMENDATION

Based on the discussions above and the field interactions, it can be concluded that banks in Ghana will find it extremely difficult to attract SMEs whose owners are capable of supplying their business needs. Banks are therefore entreated to reorganize their strategies and start financing those without adequate capital. Since an increase in rapport rate between any SME and the bank reduces the SME's willingness, firms preferred to deal with banks they were unfamiliar with such as new banks springing up in the country hence defying the notion that SMEs are willing to deal with banks they interact with regularly as portrayed in the literature. Owners of firms were likely to be assisted by many bodies if they continued to be innovative. Some of their innovations could help broaden the business collateral base making the business lucrative to many investors. As a result of this, many innovative driven SMEs tend to have less taste for bank loans because many stakeholders including customers chose them. It was then recommended to SMEs, to embrace the act of innovativeness so that they could catch the eyes of interest free lenders and the like if they want to avoid dealing with the banks. From the discussions, it could be concluded that the size of firm has no relationship with the number of innovations to be embarked upon. It could be inferred that, if a firm embarks on frequent innovations it hardly seek bank loan but at the same time, it was discovered that as a firm becomes larger, their quest for loan increases. This means that innovation oriented firms are not necessarily large firms. Another revelation from the discussion was that, when the owner's investment is high in business, it is likely to translate into huge collaterals and so the issue of banks opening up to accept many forms of collateral as indicated in the literature becomes insignificant to that firm when it wishes to seek for a loan.

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