

Criteria for Assessing Small and Medium Enterprises' Borrowers in Ghana

Daniel Agyapong

Department of Management Studies, University of Cape Coast, Cape Coast, Ghana

Tel: (233)-24-616-8010, 20-616-8010 E-mail: agyapongdan@yahoo.com

Gloria K.Q. Agyapong (corresponding author)

Department of Management Studies, University of Cape Coast, Cape Coast, Ghana

Tel: (233)-24-497-3086 E-mail: ritegloria@yahoo.co.uk

Kwabena Nkansah Darfor

Department of Economics, University of Cape Coast, Cape Coast, Ghana

Tel: (233)-24-410-3776 E-mail: kute207@yahoo.com

Received: March 12, 2011 Accepted: March 22, 2011 doi:10.5539/ibr.v4n4p132

Abstract

This study focused on developing an insight into the decision making process which lenders employ in granting loans to SME borrowers. Questionnaires were administered on selected bank branch managers of conventional banks, rural banks and savings and loans companies. Findings from this study has brought to the fore some interesting revelations. The results indicated that when loan managers are deciding on whether to accept or reject an SME loan application, intended purpose of loan, repayment of previous loan, repayment schedule, type of business activity, size of loan relative to size of business and availability of collateral, ranked highest on their criteria list. On the contrary, CVs of clients, government guarantee of loans, charges on assets and gearing ranked lowest on the criteria list in terms of importance. The relevant factors identified in this study showed that lenders took particular interest in risk when dealing with SMEs. This is not out of place, as every business seeks to make profit and thus they need to be sure of recouping their monies when they lend them out to small businesses. It is thus very necessary for SME borrowers to develop an understanding of the decision criteria used by financial institutions in order to increase the probability of getting their loan request approved by fulfilling the required criteria adequately.

Keywords: SME, Conventional banks, Lenders, Risk

1. Introduction

During the past decade, the financial sector in Ghana has undergone major changes mainly through the financial sector structural adjustment programme as part of the economic recovery programme. Moreover, globalisation, mergers and acquisitions, and the emergence of new technologies have contributed dramatically to stiffer competition and pressures on profitability. In such a competitive marketplace, attracting profitable customers is a priority of all the financial institutions' (FI) managers especially banks. Banks are profit-seeking institutions that must provide acceptable returns to shareholders or go out of business. However, they operate under the objectives of profit maximisation through appropriate risk management strategy (Sinkey, 1998). This means that they must be prudent in the application of sound lending practices to assess the credit risk of the borrowers. It is reported that earnings from the lending activities account for more than 80 percent or more of the bank's profits (Wong, 1997). To estimate the borrowers' probability of default, FIs focus on the borrower's creditworthiness through gathering, processing and analysing timely and accurate information and small firms are no exception.

The small business sector is now an increasingly important source of profitability for the banks. When lending to small businesses, the major task of lenders in reducing or avoiding credit risk is to overcome the problem of asymmetric information. This problem occurs when one party to a contract knows relevant information which has a material effect on the contract, but which is not known to the other party. The small business borrowers when approaching the banks for loans always have an information advantage over the bankers that sometimes lead the former to overstate the soundness of their business projects in relation to the funding sought (Storey, 1994). Banks usually end up making unprofitable loans. Furthermore, the action of these borrowers who successfully obtain bank loans is not directly observable by the bank. These borrowers might use the funds for other purposes than stipulated in the loan contract. Therefore, banks must not only investigate the creditworthiness of the small business borrowers but also monitor their activities once they have obtained the loans.

The work by Schumpeter (1911) revealed the important role played by SMEs in the economies of many countries – creating jobs especially for female, enhancing innovation and creativity, contributing to gross domestic product and export revenue. As a result, SMEs have and continue to receive attention from policymakers by way of business training, counselling, and some financial support and management. Despite such efforts, several empirical studies (Boachie-Mensah and Marfo-Yiadom, 2006; Beck, et al. 2002) have shown that venture owners access to funds continues to pose the biggest challenge to their firms' growth and survival. In Ghana, both private and public finance support institutions (Venture Capital Trust Fund, Micro-Finance and Small Loan Centre, Export Development and Investment Fund, Business Advisory Fund etc) have been established, yet a number of surveys (Poku and Frimpong, 2009; BoG Report, 2009; Mensah, 2004), still indicated that access to funding continue to pose a challenge to SMEs' operations in the country. Is the difficulty in accessing funds from financial institutions' due to the criteria used by FIs in assessing SMEs' loan applications?

The major objective of the study is to investigate into the criteria used by lenders in assessing SMEs' loan applications. Specifically to develop an understanding of the basis for loan decision-making process in granting loans to the small business borrowers and to determine the factors that influence credit granting decision of financial institution

2. Literature Review

Traditionally, the approach to the assessment of creditworthiness of a small business borrower is based on the experience and skill of the bankers in applying basic lending principles, such as the 5Cs (character, capacity, capital, collateral and condition) or CAMPARI (character, ability, margin, purpose, amount, repayment and insurance). As the precise lending principles into specific assessment criteria vary considerably between banks, a number of studies were conducted to determine the relative importance of these criteria. Criteria considered important by bankers to accept or reject a small business loan proposition include collateral, guarantee, maturity and schedule of repayment (Ulrich and Arlow, 1981), collateral, credit history, initial capital, managerial experience and bank policy (Jones, 1982; Memon, 1984), security, financial strength, business ability and honesty (Fertuck, 1982), profitability, financial stability and liquidity (Berry, et al. 1993a), trading experience, equity stake, gearing and profitability (Deakins and Hussain, 1994; Fletcher, 1995), and quality of management and risk of default (Rosli, 1995).

Meanwhile, Berger and Udell (2002) assert that small business lending focuses on three major categories; financial statement, asset base and relationship. Financial statement lending emphasises on evaluating information from the financial statements, and the decision to lend is principally based on the strength of these statements. Under asset base, decisions are based on the quality of the available collateral; while in relationship lending, bankers focus their decisions in substantial part on proprietary information about the borrowers through a variety of contacts over time. Berry et al. (2001), and Binks and Ennew (1996) mention the use of secured lending by banks to control their exposure to risk. This approach is known as capital base, which lay emphasises on gearing and financial assets in risk assessment of small borrowers.

A number of studies also focused on negative factors resulting in the rejection of small business loan propositions. These include poor credit rating, lack of competence, poor cash flow and poor collateral (Fertuck, 1982), not enough owners equity, poor earning records, collateral of insufficient quality, and slow credit and loan repayment (Struck and Glassman, 1983), and bad timing, insufficient collateral, excessive loan request, lack of demonstration of critical management skills, insufficient market research, incomplete business plan, and lack of business experience and entrepreneurial skills (Buttner and Rosen, 1992). Desmond (1991) gives the reasons for small business loan rejection as no track record of business, too risky, performance factors and lack of personal investment. On performance factors, he cites the following reasons: gearing too high, cash flow record, creditor/debtor ratio, level of profits, incorrect assumptions, poor presentation and insufficient knowledge of finance. Another study by Read (1998) found that the main reasons for refusing finance to small businesses are lack of collateral, insufficient turnover and poor cash flow.

Clearly, an understanding of the decision-making process used by bankers in their assessment of small business loan propositions can provide crucial insights to small business borrowers when applying for such loans from the banks. This study focused primarily on key criteria used by financial institutions in determining the granting of loans to small business borrowers.

3. Research Methodology

The population of the study constituted all the formal suppliers of microfinance in Greater Accra Metropolis (rural and community banks, savings and loans companies and conventional banks). Accra was chosen because all the banks in Ghana are present there. Also, as the busiest commercial town, there is strong presence of SMEs activities there. The conventional banks were also chosen because they are usually the first point of call for most borrowers. In addition, apart from the conventional banks, the other financial institutions are not much developed to usually cope with the possible assumed high risk of SMEs lending. The rural banks and the savings and loans companies were also used because of their core functions to make credit available to MSMEs. The target respondents were branch managers and senior loan officers. The branch managers were selected because small business transactions are conducted at the bank

branch levels. The Senior Loan Officers were selected because they do the actual loan application evaluation, and are familiar and knowledgeable about the issue under study.

Respondents were selected from the directories and database prepared by the Chartered Institute of Bankers, Association of Rural Banks of Ghana and the Savings and loans Association. The main instrument for data collection was the questionnaire that was administered through the help of some staff of the selected financial institutions. On the whole, out of the 100 Loan Officers visited, 50 completed questionnaires were collected. This is made up of 20 from the conventional banks, 15 from the rural banks and 15 from savings and loans companies in the Metropolis.

4. Analysis and Discussion of Results

Table 1 presents the ranking of the criteria used in assessing SME loan application. It is interesting to note that intended purpose of loan was the most critical factor in assessing SME borrowers. This suggests that the banks are highly concerned about what these SME borrowers will use the loans for. In other words, they are interested in ensuring that the intended purpose for which the loan is requested is adhered to. This finding confirms that of Mahmood and Rahman (2007); Faulkner et al. (1993b) who found that intended purpose of a loan is a significant variable in a lending decision. This is not surprising since FIs will first consider the purpose for which a loan is requested in order to determine whether the purpose will yield sufficient returns to facilitate the repayment of the loan and hence mitigate potential risk. The criteria ranked second was repayment of previous loan. The bankers seemed to be in agreement that if the borrowers had good records of their loan repayments, they would not encounter any difficulties in accessing further loans. This finding is in line with studies by Mahmood and Rahman (2007); Diamond (1984); Peterson and Rajan (1994); and Berger and Udell (1997) who advocated relationship banking to reduce the asymmetries of information when dealing with small businesses. If the past experience with the customer is positive, the banker may expect the loan to be less risky, and thus the likelihood of granting the loan will be higher. Repayment schedule and type of activity engaged in by the SME were ranked third and fourth respectively.

=INSERT TABLE 1=

On the other hand, size of loan relative to size of business and availability of collateral were ranked as fifth. This indicates that bankers were concerned about the amount of loan requested by small business borrowers relative to the size of business. Berry et al. (1993a) found out that the size of a business was influential in the lending decision because it has a significant effect on the FIs perception of risk. Most bankers may not grant any loans or advances exceeding the required amount needed or the borrowers' capacity to repay them. Again availability of collateral was deemed to be important criteria in determining whether small businesses could access loans from banks. This factor plays a vital part in the lending decision. This factor did not receive such a high rank in the work of Mahmood and Rahman (2007) who ranked this criterion as thirteenth.

Liquidity ratio was ranked as seventh indicating its importance in the lending decision of banks. Length of time doing business received a low rank. This finding is similar to that found by Mahmood and Rahman (2007). This is quite baffling and contradicts the literature that maintaining a continuous favourable relationship with a customer can increase the likelihood of the customer obtaining a loan from the bank (Diamond, 1984; Boot and Thakor, 1994; Berger and Udell, 1995). CV of clients as a criterion also was found to be of less importance. This implies that the credentials of SME borrowers were unable to exert the desired influence on lending decisions. Charges on assets as criteria also received a lower rank indicating that bankers are not too preoccupied with collateral in lending to SME borrowers.

What was really surprising though was the low rank of government guarantee of loan as criteria. It was actually the nineteenth ranked criteria out of the twenty in terms of order of importance. One explanation which can be adduced for this is the terms of claim on defaulting loans under government guarantee which serves as disincentive to bankers. Often, the terms are generally felt to be too troublesome and costly to comply with as it strictly requires the monitoring efforts to be made at prescribed interval and proper records be kept for regular submission to the central bank. Besides, government guarantee may not likely influence either the attitude or the ability of the borrower to pay the debts. This result is corroborated by that of Mahmood and Rahman (2007) who also found out that government guarantee of loans had the lowest rank.

4.1 Presentation of Factor Analysis Results

In order to ascertain which important underlying variables or factors were responsible for explaining the variance observed, we made use of exploratory factor analysis to achieve this aim. Factor analysis was performed on the data using the set of 20 important criteria of assessing SME borrowers. The results of the factor analysis are presented below. Table 2 shows the communalities which show the amount of variance in each variable that is accounted for. The initial communalities indicate that the estimates of the variance in each variable are accounted

for by all factors. The extraction communalities on the other hand indicate that the communalities are all relatively high which shows that the extracted components represent the variables well.

=INSERT TABLE 2=

The variance explained by the initial solution, extracted components, and rotated components is presented in table 3. This first section of the table shows the Initial Eigenvalues. The total column in table 3 shows the amount of variance in the original variables accounted for by each factor. The percentage of variance column also indicates the percentage of variance accounted for by each factor to the total variance in all the variables. Thus, for the initial solution, there are as many factors as variables. The criterion for rotation was eigenvalues greater than 1.00. Thus, the first five principal factors formed the extracted solution. The extraction sum of squared loadings is also reported in table 3. The extracted factors explain nearly 76% of the variability in the original twenty variables, so we can considerably reduce the complexity of the data set by using these components with only a 24% loss of information. The rotation sums of squared loadings maintain the cumulative percentage of variation by the extracted factors, but the variation is now spread more evenly over the factors. The changes in the individual totals suggest that the rotated factor matrix will be easier to interpret than the unrotated matrix.

=INSERT TABLE 3=

4.2 Factor Analysis on Criteria used in assessing small business borrowers

Table 4 presents the results of the factor analysis. The results show that the variables were reduced and grouped into five factors. Variables were accepted as loaded factor if their factor loading solution was equal to or greater than the absolute value of 0.50. These five factors accounted for 65.6 per cent of the total variance. Factor 1 in Table 2 indicates the greatest variability in loan managers' perceptions of importance and is labelled as past experience. This factor is considered the most important factor in influencing the bankers' decisions in accepting or rejecting SME loan propositions. Factor 2 considers the credit policy of the borrowers business. The owner's knowledge or awareness of credits or debts was seen by bank managers as an important feature in the assessment of their ability to efficiently run their businesses. The variables with the greatest loadings on this factor were trade creditors and trade debtors.

Factor 3 is interpreted as financial soundness. The variables with high loadings in this factor include size of loan relative to size of business, liquidity ratio, intended purpose of loan, projected income and gearing. Factor 4 concerns banking relationships. Some of the variables in this factor had heavy loadings. CVs of client had a heavy loading of .849. Factor 5 is concerned with security. This factor is also the least most important factor determining the lenders decisions indicated in this study. The financial institutions scoring highly on this factor exhibit a need for more security when granting loans to SMEs.

Four of the five factors, that is past experience, financial soundness, relationship and security, are mostly associated with or attempt to measure credit risk in granting loans. This indicates that the bank managers were focused on credit risk when dealing with SME clients. It is furthermore noted that the variables in Factor 1 are mainly related to past or existing business activities, which means that lenders would give more weighting to established businesses rather than new ones. Most financiers or lenders would be reluctant to finance a newly set up business without a good track record.

5. Conclusion

The findings from this study has brought to the fore some interesting revelations. The results indicated that when financial institutions are deciding on whether to accept or reject an SME loan application, intended purpose of loan, repayment of previous loan, repayment schedule, type of business activity, size of loan relative to size of business and availability of collateral ranked highest on their criteria list. On the contrary, CVs of clients, government guarantee of loans, charges on assets and gearing ranked lowest on the criteria list in terms of importance. The relevant factors identified in this study showed that financial institutions took particular interest in risk when dealing with SMEs. This is not out of place, as every business worth its sort seeks to make profit and thus they need to be sure of recouping their monies when they lend them out to small businesses. It is thus very necessary for SME borrowers to develop an understanding of the decision criteria used by bankers in order to increase the chance of getting their loan request approved by fulfilling the required criteria adequately.

References

- Bank of Ghana. (2006, 2007, 2008 and 2009). *Annual Reports*. Accra: Buck Press,
- Beck, T, Demircug-Kunt, A. & Maksimovic, V. (2002). SMEs, growth, and poverty – Do pro-SME policies work? World Bank Policy Research Working Paper, No. 268.

- Berger, A.N. & Udell, G.F. (2002). Small business credit availability and relationship lending: The importance of bank organizational structure. *The Economic Journal*, 112, 32-53. doi:10.1111/1468-0297.00682, <http://dx.doi.org/10.1111/1468-0297.00682>
- Berry, A.J., Faulkner, S., Hughes, M. & Jarvis, R. (1993a). Financial information, the banker and the small business. *The British Academy Review*, 25(2), 131-149.
- Berry, A.J., Grant, P. & Jarvis, R. (2001). Can European banks plug the finance gap for UK SMEs. Paper presented at the 24th. ISBA National Small Firms Policy and Research Conference, Leicester, 14-16 November.
- Binks, M. & Ennew, C. (1996). Growing firms and the credit constraint. *Small Business Economics*, 8(1), 17-25. doi:10.1007/BF00391972, <http://dx.doi.org/10.1007/BF00391972>
- Boachie-Mensah, F.O. & Marfo-Yiadom, E. (2006). Entrepreneurship and small business management. Accra: Universities Press
- Buame, C.K.S. (2004). Entrepreneurial and innovative management, SOA, UG
- Buttner, E.H. & Rosen, B. (1992). Rejection in the loan application process: Male and female entrepreneurs perceptions and subsequent intention. *Journal of Small Business Management*, 59-65.
- Deakins, D. & Hussain, G. (1994). Risk assessment with asymmetric information. *International Journal of Bank Marketing*, 12(1), 24-31.
- Desmond, J (1991). The image of banks and other financial institutions: with special reference to small firms. PhD Thesis, University of Manchester.
- Fertuck, L. (1982). Survey of small business lending practices. *Journal of Small Business Management*, October, 33-41.
- Fletcher, M. (1995). Decision making by Scottish bank managers. *Int. J. of Entrepreneur Behaviour and Research*, 1(2), 37-53. Available at: www.emeraldinsight.com/journals.htm?articleid=872001&show
- Hallberg, K. (2001). A market-oriented strategy for small and medium-scale enterprises. International Finance Corporation, Discussion Paper, No. 48.
- Jones, N. (1982). Small business commercial loan selection decision: An empirical evaluation. *American Journal of Small Business*, 6(4), 41-49.
- Mensah, S. (2004). A review of SME financing schemes in Ghana. UNIDO Regional Workshop of Financing SMEs, 15-16 March, Accra.
- Parker, R.L., Riopelle, R. & Steel, W.F. (1995). Small enterprises adjusting to liberalisation in five African countries. World Bank Discussion Paper No.271, African Technical Department Series
- Poku, K. & Frimpong, F.A. (2009). The assessment of the prospects of venture capital finance in Ghana: The views and perception of some selected SMEs in Ghana. Ninth Annual IBER and TLC Conference Proceedings 2009 Las Vegas, NV, USA
- Read, L. (1998). *The financing of small business: A comparative study of male and female business owners*. London: Routledge. doi:10.4324/9780203024942, <http://dx.doi.org/10.4324/9780203024942>
- Rosli, M. (1995). Bankers credit evaluation of small businesses. *Bankers Journal of Malaysia*, 89, 26-32.
- Schumpeter, A. J. (1934). *The theory of economic development*. Cambridge: Harvard University Press
- Schumpeter, A.J. (1911). *The theory of economic development*. Cambridge, MA: Harvard University Press: (English translation, 1934)
- Sinkey, J.F. (1998). *Commercial bank financial management*. New York: Macmillan
- Storey, DJ (1994). New firms growth and bank financing. *Small Business Economics*, 6, 139-150. doi:10.1007/BF01065186, <http://dx.doi.org/10.1007/BF01065186>
- Struck, PL and Glassman, CA (1983). Commercial banking and small business sector: Observations from a survey. *Journal of Commercial Bank Lending*, 65(2), 21-31.
- Ulrich, TA and Arlow P (1981). A multivariate analysis of commercial bank lending to small business. *American Journal of Small Business*, 6, 47-57.
- Wong, K.P. (1997). On the determinants of bank interest margins under credit and interest rate risks. *Journal of Banking and Finance*, 21, 251-271. doi:10.1016/S0378-4266(96)00037-4, [http://dx.doi.org/10.1016/S0378-4266\(96\)00037-4](http://dx.doi.org/10.1016/S0378-4266(96)00037-4)

Table 1. Ranking of Criteria used in assessing SME borrowers

Rank	Criterion	Mean	SD	CV
1	Intended purpose of loan	4.5600	.86094	0.188803
2	Repayment of previous loan	4.5400	.78792	0.173551
3	Repayment schedule	4.5200	.57994	0.128305
4	Type of business activity	4.3600	.80204	0.183954
5	Size of loan relative to size of business	4.3200	.89077	0.206197
5	Availability of collateral	4.3200	.89077	0.206197
7	Liquidity ratio	4.2200	1.34453	0.318609
8	Net profit to sales	4.1800	.74751	0.17883
9	Existing profitability	4.0800	1.02698	0.251711
10	Projected income	4.0400	.92494	0.228946
11	Loan activity at other banks	3.8200	.89648	0.234681
12	Equity stake in business	3.8000	1.08797	0.286308
13	Trading experience	3.7800	1.32926	0.351656
14	Trade debtors	3.7200	.72955	0.196116
15	Trade creditors	3.6200	1.32311	0.3655
16	Length of time doing business with bank	3.5000	1.09265	0.312186
17	Charges on assets	3.4200	1.24687	0.364582
18	Gearing	3.3200	1.47690	0.444849
19	Government guarantee of loan	2.4800	1.23288	0.497129
20	Cvs of clients	2.3400	1.33417	0.570158

Table 2. Communalities

	Initial	Extraction
Intended purpose of loan	1.000	.793
Repayment of previous loan	1.000	.857
Loan activity at other banks	1.000	.539
Size of loan relative to size of business	1.000	.745
Gearing	1.000	.709
Liquidity ratio	1.000	.874
Repayment schedule	1.000	.591
Trading experience	1.000	.896
Existing profitability	1.000	.939
Net profit to sales	1.000	.837
Type of business activity	1.000	.784
Projected income	1.000	.897
Availability of collateral	1.000	.862
Trade debtors	1.000	.756
Equity stake in business	1.000	.817
Trade creditors	1.000	.508
Length of time doing business with bank	1.000	.555
Charges on assets	1.000	.711
CV's of client	1.000	.647
Government guarantee of loan	1.000	.827
Extraction Method: Principal Component Analysis		

Table 3. Total Variance Explained

Factor	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	7.382	36.910	36.910	7.382	36.910	36.910	4.919	24.594	24.594
2	2.670	13.352	50.261	2.670	13.352	50.261	3.274	16.372	40.966
3	2.239	11.194	61.455	2.239	11.194	61.455	2.568	12.841	53.808
4	1.672	8.362	69.816	1.672	8.362	69.816	2.265	11.325	65.132
5	1.180	5.900	75.717	1.180	5.900	75.717	2.117	10.585	75.717
6	.942	4.712	80.429						
7	.911	4.556	84.986						
8	.657	3.283	88.269						
9	.495	2.475	90.743						
10	.424	2.122	92.865						
11	.382	1.910	94.775						
12	.262	1.309	96.084						
13	.217	1.086	97.170						
14	.178	.891	98.061						
15	.130	.649	98.710						
16	.123	.617	99.327						
17	.079	.394	99.720						
18	.034	.171	99.892						
19	.021	.103	99.995						
20	.001	.005	100.000						

Extraction Method: Principal Component Analysis.

Table 4. Factor Analysis on Criteria used in assessing small business borrowers

Factor	Loadings	Statistics
Factor 1: Past Experience		
Trading experience	.742	Eigen value=7.382
Repayment Schedule	.709	% of Variance explained=36.910
Type of business activity	.646	Cronbach alpha =.785
Repayment of previous loan	.635	
Loan Activity at other banks	.559	
Factor 2: Credit		
Trade Creditors	.806	Eigen value=2.670
Trade Debtors	.645	% of Variance explained=13.352
		Cronbach alpha =.882
Factor 3: Financial Soundness		
Size of loan relative to size of business	.846	Eigen value=2.239
Liquidity ratio	.797	% of Variance explained=11.194
Intended purpose of loan	.795	Cronbach alpha =.887
Projected income	.768	
Gearing	.594	
Factor 4: Relationship		
CVs of client	.849	Eigenvalue=1.672
Length of time doing business with bank	.637	% of Variance explained=8.362
Government guarantee of loan	.636	Cronbach alpha =.787
Factor 5: Security		
Availability of collateral	.832	Eigen value=1.180
Charges on assets	.814	% of Variance explained=5.900
		Cronbach alpha =.708