Asian Journal of Business Management 4(1): 58-67, 2012
ISSN: 2041-8752

Submitted: September 14, 2011 Accepted: October 24, 2011 Published: February 20, 2012

Access to Finance in the SME Sector: A South African Perspective

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Abstract: The study provides a comprehensive discussion on access to finance by the Small and Medium Enterprises (SME) sector in South Africa. Access to finance has been noted as one of the major challenges impeding the survival and growth of the SME sector in South Africa. The problems of access to finance, gaps and the reasons for the gaps in SME financing in South Africa are discussed. Gaps in SME financing were discussed in relation Stiglitz and Weiss (1981) credit rationing theory which advocates that agency problems and asymmetric information are the main reasons for the credit rationing behaviours of credit providers to SMEs. This paper is a review to identify gaps in literature regarding the financing of SMEs in South Africa. It is revealed that access to finance by SMEs is still a major challenge impeding the realisation of the full potential of SMEs as engines of poverty alleviation, employment creation and economic growth at large. Therefore it is recommended that policy recommendations aimed at solving access to finance challenges must be empirically tested on a regular basis and progress in that regard must be constantly monitored and revised to eradicate the problem.

Key words: Access to finance, credit rationing, SMEs, South Africa

INTRODUCTION

Access to finance had been singled out as one of the major challenge impeding the survival and growth of start-up SMEs in South Africa. Significantly low figures of start-up SMEs who apply for financing succeed in getting financing. According to Maas and Herrington (2006), quite a significant number of entrepreneurs are of the opinion that, although there seems to be sufficient funds available it remains difficult to access these funds, especially for start-up SMEs.

The ability of SMEs to grow depends highly on their potential to invest in restructuring and innovation. All these investments require capital and therefore access to finance. Against this background, the consistently repeated conception of SMEs about their problems regarding access to finance is a priority area of concern, which if not properly addressed, can endanger the survival and growth of the SMEs sector. Ganbold (2008) argued that Investment Climate Survey conducted by the IBRD/World Bank (2008) showed that one of the major impediments of nurturing firms is lack of access to financial services which would expand economic growth and employment generation as well as reducing poverty in many developing countries.

In South Africa it is evident that SMEs have constrained access to the financing they need to flourish (Maas and Herrington, 2006). Access to finance is therefore a priority issue for developing and supporting the SME sector as an engine for employment creation, poverty alleviation and socio-economic stability at large. The objective of this paper is to explore access to financing issues faced by SMEs in South Africa. This include a theoretical review of financing options for SMEs, financing gaps in the SME sector and exploring various approaches to close the gaps in SME financing.

FINANCING FOR SMES

There are various sources available for financing of SMEs. However, despite various breakdowns in names of these sources, they fall into either debt or equity financing. Although, equity as a source of financing for SMEs has received little attention in literature, it is an important source of financing for SMEs. Despite emphasises by several authors on fostering access to debt, Churchill and Frankiewicz (2006) argued that credit is not sufficient as a developmental tool. Therefore other sources of financing such as equity financing, and in particular venture capital, should be considered.

The challenge of access to finance has been thought of in terms of credit rationing behaviours of financial institutions which according to several authors have an adverse impact on previously disadvantaged groups who

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have limited access to resources. Correia *et al*. (2008) discussed an important issue of Black Economic Empowerment (BEE) entities financing. BEE entities are being considered here due to the fact that in South Africa the majority of BEE entities fall into the SMEs category. In South Africa, Black Economic Empowerment (BEE) legislation was passed as a means to redress past economic imbalances. Correia *et al*. (2008) argued that limited access to finance by BEE entities has created challenges for restructuring of ownership of companies. It was propounded that the result was complex and highly leveraged financing structures, some of which have failed and others of which have become highly successful as equity markets have rebounded. The following sources of financing for BEE entities have been suggested; Vendor financing in the form of loans or preference shares; loans or Debentures; preference shares issued to banks and assets securitisation or Initial Public Offering (IPO).

Despite the promising potential in fostering SME financing of the above mentioned financial arrangements, their relevance to SMEs, particularly start-ups, who in many circumstances to do not have assets to pledge as collateral security for these transactions is controversial.

Furthermore, issues of optimal financing structures (another controversial issue in SMEs) should be considered in SME financing. Correia *et al*. (2008) described the optimal capital structure as the debt-equity ratio that the company adopts so that its Weighted Average Cost of Capital (WACC) is at its lowest point. Correia *et al*. (2008) confirm that over the years, a number of theories have been developed to explain the relevance of capital structure. However, Modigliani and Miller (1958) as cited by Correia *et al*. (2008) presented a rigorous analysis in which he argued that there is no optimal capital structure. Their argument was based on the premise that, irrespective of the level of gearing (the degree to which the firm's activities are financed by owner's funds versus debt financing), a firm's weighted cost of capital will not change.

The issue of capital structure in the SME sector received little in South African literature. However, the focus of this paper is more on access to finance for SMEs irrespective of whether its equity or debt financing. In South Africa, SMEs face constrained access to both debt and equity financing. Theoretically and in practice a problem of access to finance exist when there is a need for finances from a client with an investment project that warrantees financing, but are impeded access to external financing. This occurs due to the gaps that exist between the suppliers of external financing and the demand for financial resources.

GAPS IN ACCESS TO FINANCE

The financing gap, often defined as the difference between the demand for funds by SMEs and the supply of funds, occurs because of various reasons. Some argue that the fundamental reasons behind SMEs' lack of access to funds can be found in their peculiar characteristics, while others argue that SMEs suffer from financing gaps because of market imperfections on the supply side (Park *et al*., 2008). Park *et al*. (2008) further argued that SMEs face financing gaps probably because of a combination of reasons originating from both the supply and demand sides. The supply side refers to providers of finance (financial institutions and investors), while the demand side is composed of SMEs who require financing from financial institutions and other providers of finance. The financing gap for SMEs is most prominent in capital market financing. Most countries, including the developed ones, have problems in SME financing through capital markets (Park *et al*., 2008: 1).

Park *et al*. (2008) also reviewed that substantial financial gaps exists in a large numbers for both Organisation for Economic Co-operation and Development (OECD, 2006) and non-OECD countries. The results of their studies indicated an 80% financial gap in OECD countries and a 90% financial gap in non-OECD countries. Furthermore, a break-down of debt and equity also indicate significant gaps except for debt in OECD countries. Several authors and researchers have alluded to the financial gap, but a few of them attempt to find solutions to closing that gap.

One of the most important theories that focused on financing gap analysis is the credit rationing theory by Stiglitz and Weiss (1981). In their formulation, Stiglitz and Weiss (1981) argued that agency problems (a conflict of interests between management (agents) and the shareholders (owners) of the organisation) and information asymmetries are the major reasons why SMEs have constrained access to finance.

They argued that only SMEs know their real financial structure, the real strength of the investment project and the effective intention to repay the debt, that is, firms have superior private information (asymmetric information). Hence, the bank manager makes decisions under asymmetric information, and operates under a moral hazard and adverse selection risk. Therefore, government subsidies can be used by financial institutions as collateral against some projects.

Stiglitz and Weiss (1981) explained the choice among different financing sources under conditions of asymmetric information and credit rationing. Asymmetric information can lead to credit rationing conditions by modifying the risk-return distribution; this fact encourages banks to refuse capital for investments and produces divergence between capital demand and supply (Alfo and Trovato, 2006). Constrained access to finance derived from financial institutions' credit rationing behaviour might not be efficient because managers work under conditions of asymmetric information. This may result in less profitable investments getting financed while more

profitable investments are being left out and thus resulting in adverse selection and moral hazard risks. Therefore, asymmetric information can explain asymmetric distribution of credit among firms with identical characteristics, the lenders not being aware of the exact bankruptcy likelihood for the firms, know only that this likelihood is positive and therefore choose to increase debts' cost.

The firm accepts to invest only in riskier projects which can produce higher income levels, which are needed to cover debts. The result is that the lender cannot avoid selecting the riskier project and therefore must accept the risk of the firm. In the presence of excess demand, the lender has different maxima corresponding to the rates with the lower adverse selection likelihood for credit rationing (Stiglitz and Weiss, 1981). Furthermore, rationing conditions reduce access to financial resources not only for new investment, but also for employment creation and poverty alleviation. Another facet of credit rationing is that financial institutions personnel/ managers may have to bear personal responsibilities for non-performing loans if the loans are given to SMEs without government guarantees, hence agency problems exist. Managers have the responsibility to protect the depositors' interest hence will operate under credit rationing conditions.

Start-up SMEs are more likely to be affected by information asymmetry problems. Deakins *et al*. (2008) argued that information asymmetries are more acute in new and technology-based propositions. They argued that at an early stage, information is limited and not always transparent and assets are often knowledge based exclusively associated with the founding entrepreneur. Especially with manufacturing or technology based firms, entrepreneurs may be reluctant to provide full information about the opportunity because of concerns that disclosure may make it easier for others to exploit. There are also some categories of owners of SMEs that will face additional problems due to lack of security, such as young entrepreneurs or those from deprived areas. In addition, there may be asymmetries arising from location as well as sector. For example, owners of SMEs in rural environments may face difficulties with access to bank finance.

From Stiglitz and Weiss (1981)'s credit rationing theory discussed herein, two most important gaps emerged as the major reasons why SMEs experience constrained access to financial resources. These are information asymmetry gap and agency problems.

Furthermore, from an analysis of the financial markets' behaviour we can review the following bases for credit rationing behaviours which restrict access to finance for SMEs.

Bases for credit rationing behaviours: Quite a substantial number of authors attempted to draw conclusions on various issues relating to credit rationing behaviours of financial institutions. One of the notable contributions is by Green (2003). In his study, Green (2003) argued that limited access of small enterprises to formal credit in developing and emerging economies is largely due to the relatively underdeveloped nature of the financial system, the lack of liquidity, and inexperience in small-scale lending in many of these countries. Bank branches outside the capital cities frequently provide only cash and do not have the authority to make loans, leaving small enterprises in rural areas disproportionally disadvantaged. If commercial banks do extend credit to small firms, it may take up to several months to process applications.

Banks advance four main reasons for their reluctance to extend credit to small enterprises viz, high administrative costs of small-scale lending, asymmetric information, high risk perception and lack of collateral. Although the reasons apply to industrial as well as developing and emerging economies, they tend to be more significant in the latter.

SMEs typically require relatively small loans compared with large firms. The transaction costs associated with processing and administering loans are, however, fixed, and banks often find that processing small SME loans is inefficient. They lack the techniques, such as credit scoring, to increase volume and lower costs (Malhotra *et al.*, 2007). Since most of the administrative costs of lending are fixed, that is, they are independent of the size of the administered loan, economies of scale arise; the larger the loan, the lower the per unit costs of extending credit.

Furthermore, administrative costs also include information gathering costs, for example visiting borrowers, analysing their applications and monitoring their loans. For a number of reasons, these costs tend to be higher for small than for large firms. Small enterprises are often located away from the main urban centres, their accounting skills and standards are usually lower, and banks lack experience in servicing them. In the case of developing and emerging economies, these difficulties, and therefore the costs involved, are multiplied (Green, 2003). However in a study by Cziraky *et al*. (2005) it was concluded that, among all SME loan requests, banks preferred smaller firms that requested smaller loans. The results suggest that individual banks differ in their criteria and in their loan-size preferences and that there is no positive correlation between the bank's size and its loan-size preference.

Another basis for credit rationing is asymmetric information. A prerequisite for the efficient allocation of resources by market forces is that all participants share the same relevant information. This is not the case in financial markets. Borrowers will always know more about the viability of their projects and their ability and willingness to repay than lenders. The lenders are thus faced with uncertainty both with respect to the expected rates of return of the project they are financing and with respect to

the integrity of the borrower. This uncertainty increases with the length of the loan. Borrowers face difficulties in transmitting information about their projects to lenders, as lenders will suspect them of underestimating the risks of failure. The problem of asymmetric information will be more acute for small businesses than for larger ones because of lower information standards and the greater variability of risk; small, privately owned firms face no legal reporting requirements and are more vulnerable than large firms (Green, 2003).

Asymmetric information makes it impossible to accurately distinguish between "good" and "bad" borrowers. The two main problems associated with asymmetric information are adverse selection and moral hazard, both of which may affect the quality of the loan. Adverse selection refers to the fact that the probability of default is increasing with the interest rate: the quality of the borrower pool worsens as the cost of borrowing rises. A higher interest rate will attract risky borrowers and drive out good borrowers for two reasons. Firstly, worse risks are willing to borrow at higher interest rates, because they know that their repayment probability is low. Secondly, if riskier projects are associated with higher returns, a rise in the interest rate will drive out low-risk projects as borrowers try to compensate for the higher cost of the loan by earning a higher return with a risky project. An optimal interest rate may therefore exist, beyond which additional loans are not made available despite excess demand. Consequently, a backward-bending credit supply curve and equilibrium credit rationing will exist because raising the interest rate above the optimal level would lower banks' profits as the amount of risky projects in their portfolio rises (Stiglitz and Weiss, 1981).

Small firms are more likely to be rationed because they are seen as particularly risky. Although they might be willing to pay more to compensate for this additional risk, the banks will refuse to raise the interest rate sufficiently to equate supply and demand.

Another aspect of credit rationing is moral hazard. Moral hazard refers to a situation in which an agent (the borrower) takes an action that adversely affects the return to the principal (the lender). It occurs if the parties involved have diverging interests and the action taken by the agent cannot be monitored accurately by the principal. A borrower may, for example, be tempted to exert less effort or to secretly switch to riskier projects in order to increase his return. Because of a higher probability of default, the return to the bank will be reduced. Banks can resort to two methods to reduce moral hazard which are through making it profitable to tell the truth, for example through the promise of renewed credit in the future and/or by including penalties for low effort levels, for example collateral which is lost if the firm becomes insolvent. Due to information imperfections and costly control mechanisms, the superior selection criteria based on cash-flow projections is thus often abandoned in favour of loan selection according to firm-size and collateral (Green, 2003).

Financial institutions are more likely to approve loans to firms that are able to provide collateral and to those firms that have established long term relationships with lenders. Due to the existence of asymmetric information, banks base their lending decisions on the amount of collateral available. Collateral acts as a screening device and reduces the risk of lending for commercial banks. By pledging his assets, a borrower signals the quality of his project and his intention to repay. In the case of default, collateral serves to put the lender into a privileged position with regard to other creditors (Green, 2003). Small firms are disadvantaged in this regard, due to the fact that they lack collateral security and also they lack a proven credit track record. Therefore, start-up firms with new innovative products may be constrained access to finance due to the fact that they may fail to furnish collateral security and also due to information asymmetries, financial institutions may fail to see the profitability and viability of the proposals. More intensively, collateral requirements militate against technology based firms. This is mainly because many technology-based small firms usually begin as small conceptions and may not yet have developed relationships with providers of financial services.

In addition, as Åstebro *et al*. (2000) note, "…intellectual assets of high technology firms are more difficult to value than the brick and mortar of low technology firms". This "information opacity" may well make it relatively difficult (at least in theory) for knowledge-based firms to access debt. This argument, of course, begs the question of the extent to which debt is an appropriate source of capital for knowledge-based businesses. Brierley (2001) suggests that debt is not the most appropriate source of early-stage capital. Therefore, start-up firms in technology based industry face substantial financial constraints.

Growth may be another dimension that forms a basis for a gap based on capital rationing and for which a gap may be claimed. There is a wide controversy about the growth of SMEs in South Africa; the survival rate of SMEs is significantly low, less than 20% (Herrington *et al*., 2008). Therefore due to doubts about the possibility of growth in SMEs, financial institutions are inclined to tighten their requirement to approve a loan and may require a lot of information about the investment. This information may not be furnished clearly and thus potentially successful business ideas may fall into the credit rationing trap. High growth and innovative firms may be more informational opaque and may face a greater degree of difficulty obtaining financing.

Gender and race may also be dimensions where gaps may be present. According to the International Finance Corporation, (IFC, 2006), race is still a primary driver of financial access in South Africa. A gender gap also exists which cuts across all races. The combination of race and gender disparities work largely, however, to the detriment of black women who register the lowest levels of income and of formal access to economic opportunity and financial services.

Despite having a higher rate of participation in the labour force than white women, (73% against 59%), black women at only 14% of the formally employed have the lowest level of formal employment rates. This is contrasted with 43% for white men, 34% for white women and 21% for black men. Black women also have the lowest level of earnings (IFC, 2006). Furthermore, Talavera and Shafer, (2008), in their study using the cross-country Business Environment and Enterprise Performance Survey (BEEPS), found some evidence that compared to male-managed counterparts; female-managed firms are less likely to obtain a bank loan. In addition, the results suggest that female entrepreneurs are charged higher interest rates when loan applications are approved. This suggests fundamental gender based constraints in accessing finance.

Furthermore, a study that was done by the International Finance Corporation (IFC, 2006) review that women, who represent 52% of the South African population, still suffer from historical and cultural prejudice in accessing opportunities. While access to financial services continues to be largely racially defined in South Africa, the gender gap between men and women does exist, and is likely to grow if special efforts are not undertaken to address the underlying issues.

Risk factor is also another aspect that explains the credit rationing behaviour of financial institutions. Total risk (both business and financial risk) may be a dimension across which a financing gap might exist. A firm's business risk (which focuses on a firm's operations), represents the uncertainty of the firm's return on its assets (Correia *et al*., 2008:3.3). Whereas, financial risks occurs when a firm makes use debt (that is, financial leverage). In such instances, the firm takes on additional responsibility of financing the debt (paying interest payments on time). The inability of the firm to pay the interest payments (or repay the principal) will result in a default that might lead to bankruptcy. As the amount of debt used by the firm increases, the chances of it defaulting will also go up (due to more constraints on its cash flows as a result of the interest payments). SMEs rely more on external financing, thus the financial risk in the SME sector is most likely to be very high (Correia *et al*., 2008).

Furthermore, theories of information asymmetry suggest that credit rationing may reflect risk. Brierley (2001) argued that the willingness of financial institutions to provide finance to venture capital firms that invest in small firms (SMEs) will depend ultimately on the risk-reward relationship, that is, the extent to which such investments are likely to provide returns commensurate with the risks involved. Moreover, it can be argued that the role of the banks is in fact to discriminate based on risk. Thus, it is not clear whether a gap based on the dimension of risk is material to a societal efficient allocation of financial resources. Based on the arguments put forward in the credit rationing theory, information asymmetries derived from failure to ascertain the relative riskiness of a proposed investment will result in a financial gap.

Green (2003) argued that Commercial banks tend to impute a high risk to small enterprises and are therefore reluctant to extend credit to them. Due to their small size and inherent vulnerability to market fluctuations, the mortality rates of small enterprises are relatively high. These firms are, by their very nature, often relatively young and consequently lack a financial history and a track-record of profitable projects. In addition, organizational and administrative deficiencies, lower quality management and a lack of appropriate accounting systems may compromise the accessibility and reliability of information from small firms on their repayment capacity.

Also, small loans to industry are often classified as personal loans. Banks therefore may lack concrete figures of how profitable loans to small enterprises are and what costs they entail. Finally, the relative labour intensity of small firms implies a high debt-to-asset ratio if loans are made. The associated vulnerability and lack of sufficient and adequate collateral further limits the amount of finance that banks are willing to grant to SMEs (Green, 2003).

In developing and emerging economies, the disadvantage of small firms with regard to risk perception is aggravated by a number of factors. Many small enterprises have evolved in the informal economy, making it difficult for them to document their business history and demonstrate their economic potential. Additionally, small entrepreneurs in emerging economies are typically less skilled in book-keeping, marketing and management than their counterparts in industrial countries, adding to the risk perception with regard to their projects. This is exacerbated by inadequate legal frameworks which make the enforcement of contracts difficult for lenders.

In South Africa; the risk perception on SMEs in attributed to the high failure rates. Therefore, it is

reasonable for financial institutions to ration SMEs; particularly start-up SMEs who have little or even no credit history. Tightening collateral security requirements is one of the ways through which financial institutions attempt to protect themselves against such risks. Such collateral militate against potentially viable small, emerging enterprises because of lacking financial resources.

Bridging gaps in access to finance: Malhotra *et al*. (2007) contends that, experience from the microfinance industry shows that one way to successfully bridge the gap between the demand for and supply of credit is through innovative lending methodologies. Such methodologies include; according to Holtmann *et al*. (2000) the following:

- A Loan analysis that focuses on the prospective client's ability to pay (cash flow). Less emphasis should be placed on collateral. The analysis should be highly standardized, and loan processing times kept to minimal;
- Entitle repeat borrowers to increasingly larger loans;
- Loan officers should bear full responsibility throughout the entire life of the loan and should be paid performance based salaries. If payment problems occur, there should be a powerful incentive structure in place for immediate follow-up;
- Appropriate decision-making and control mechanisms should be in place and supported by a strong Management Information System (MIS) and information technology (IT) to assist in the management and administration of the loan portfolio (Holtmann *et al*., 2000).

In another study, Park *et al*. (2008) argued that many banks have developed tools, such as credit scoring models and other sophisticated techniques, to discriminate between high-risk and low-risk borrowers, thus reducing the risk of lending to SMEs.

Despite, the potential for the above mentioned methodologies of being effective in addressing the access to finance challenge for SMEs, applying these approaches fail to provide a clear path to closing the information asymmetry gap, a major reason why SMEs cannot adequately access financial resources. Therefore, there is a need to find effective ways to ensure that the information gap between financial institutions and SMEs is closed.

It is also paramount to ascertain whether an actual gap really exists or not. According to Brierley (2001) it is essential to distinguish between actual gaps or imperfections, and perceptions of gaps. The issue of gaps in the financial markets is therefore complicated because in financial markets it is an accepted industry practice for suppliers of capital to refuse to sell to some potential buyers. Furthermore, a potential buyer of a loan must not only be willing to pay the going price of the loan (for example, interest rates), but must also satisfy the bank that the principal (capital loaned) will be returned (Brierley, 2001). For example, one can think of suppliers of capital as the purchasers of risky promises to pay. This argument suggests that some firms will be, and should be, denied financing based on their failure to furnish sufficient information or if the information supplied is evident that they are a risky investment.

The observation that some firms cannot obtain capital is therefore not prima facie evidence of a gap. A gap or imperfection may however be implied if particular categories of firms that ought to receive financing are systematically unable to obtain it. Therefore, it should be borne in mind whether an actual gap or a perceived gap is in question to ensure that policy makers do not channel resources towards addressing a perceived gap which might not be of any relevance. Public sector initiatives to support the financing of small firms are best justified if market imperfections result in the private sector not providing finance to deserving firms adequately (Brierley, 2001).

Conversely, in the absence of market failure, such initiatives may themselves cause distortions. Non-viable firms may be subsidized, at public expense, and may compete with other viable firms. It is therefore essential to determine the extent to which, if any, particular categories of small firms are systematically disadvantaged, rationed, with respect to access to capital. For policy issues on this matter to be most effective, it is necessary to develop a widely accepted and empirically supported framework around the notion of capital market imperfections. Otherwise, unfounded perceptions of specific types of financial market "gaps" may inappropriately drive public policy (Equinox Management Consultants Ltd., 2002).

In South Africa, policy debates for the past have failed to close the financial gap between SMEs and providers of financial resources. This is evident in a widespread outcry by SMEs because of their lack of access to finance and unacceptably low levels of entrepreneurial activities in the country. Various authors have revealed that access to finance challenges is the main reasons for low entrepreneurial growth and SME survival in the country (Herrington *et al*., 2008).

Quiet substantial factors are a major reason why SMEs are denied access to finance. Although these factors centre much on the asymmetric information problem, it is paramount to discuss them separately at this juncture in

Table 1: Applications for finance and outcomes, 2002

	Entrepreneurs applying for finance (%)	Applicants who were successful (%)	Applicants who accepted the offer (%)	Applicants who received finance (%)
Bank loan	84.4	25.0	85.2	18.0
Bank overdraft	18.2	62.5	76.7	9.0
Bank credit card	2.3	83.3	60.0	1.2
Micro lenders	3.1	0.0	-	0.0
Stokvel	1.2	33.3	100.0	0.4
Mortgage	0.8	100.0	100.0	0.8
Venture capital	0.4	0	-	0.0
Average	-	33.2	82.4	27.3

Foxcroft *et al*. (2002)

order to gain a clear picture of the access to finance challenges facing SMEs. The following section discuses access to finance challenges facing SMEs in South Africa.

Access to finance challenges facing South African SME: Significantly large numbers of entrepreneurs fail to gain access to finance. Foxcroft *et al*. (2002) Wood, Kew, Herrington *et al*. (2008) and Foxcroft *et al*. (2002) revealed the rates at which entrepreneurs who have applied for financing get financed. The results of their study are shown in the Table 1.

From an analysis of the above figures it is apparent that bank loans are the most preferred sources of external finance by entrepreneurs and a significant proportion of applicants to banks failed to get financed. Although a proportionally large amount of entrepreneurs has made an effort to access finance, on average a small proportion (27.3%) succeeded in getting financed.

There is a wide difference between the percentage of applicants who were successful in their applications and those who subsequently received the finance. Foxcroft *et al*. (2002) could not provide clear reasons for such differences. However, the reasons could be that some successful applicants could not agree to the terms and conditions of the loan and therefore did not take up the loan. The other reason might be, some applicants despite being successful in their application got put off by the process and did not succeed in receiving the finance. This is an arguable issue and several responses can be obtained.

Angela and Motsa Associates (2004) reviewed that entrepreneurs face several problems in their efforts to access finance, particularly from banks. These include:

- Lack of collateral security
- Refusal to use own collateral
- Failure to make a remarkable own contribution
- Blacklisting
- Failure to review attractive financial records and/or Business plans
- High risk of small entrepreneurs

Foxcroft *et al.* (2002) also considered challenges hindering entrepreneurs from borrowing money for business purposes. In their report, Foxcroft *et al*. (2002) explicates that lack of collateral is the most widespread problem, particularly if the entrepreneur is applying for working capital. Other issues affecting the decision to provide finance include blacklisting, and inadequate financial records. The report concluded that, based on international comparisons, for a significant proportion of unsuccessful applicants, the failure of the application would not seem to be entirely unreasonable (Foxcroft *et al*., 2002).

Table 2: Obstacles hindering SMEs from accessing finance

Problem	Proportion of applicants who Indicated the problem (%)
Black listed	12.9
Do not keep adequate financial records	11.7
Lack of collatera	45.0
Seeking working capita	28.1
One or more of the above	74.9
High risk: (1 or 2 or 3 and 4)	32.7

Foxcroft *et al*. (2002)

According to Foxcroft *et al*. (2002), of the total number of loan applicants who were denied access to finance in 2002, 11.9% were unsuccessful due to the fact that they were blacklisted, 11.7% because they do not keep adequate financial records, 45% due to lacking enough collateral security and 32.7% because they presented themselves as high risk borrowers. Seventy four percent (74%) were denied access due to more than one factors mentioned above. These results are presented in the Table 2.

Lack of collateral security (45%) emerged a major impediment hindering access to finance for SMEs. However it is reasonable for banks to refuse financing entrepreneurs who does not furnish adequate ability to repay. While SMEs may need funds for starting and growing their businesses, financial institutions, particularly banks have a duty to ensure the safety of depositors' money and naturally are risk averse.

In another study, the Organisation for Economic Co-operation and Development (OECD, 2006) argued that the difficulties that SMEs encountered when trying to access financing can be due to an incomplete range of financial products and services, regulatory rigidities or gaps in the legal framework or a lack of information on both the

bank's and the SME's side. Banks may avoid providing financing to certain types of SMEs, in particular, start ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibilities of high returns but at a substantial risk of loss (OECD, 2006).

Furthermore due to the particular nature of various SMEs, it can be difficult for potential financiers to distinguish the financial situation of the company from that of its owners. The entrepreneur may have re-mortgaged his or her house to acquire the start-up funds for the company, for example. If there are two cars in the driveway, can one or both be considered part of the company's assets? SMEs also fail to operate as a going concern; they usually die with their owners (OECD, 2006). Therefore, financial institutions and potential investors find it difficult to invest in such risky businesses.

In an effort to address access to finance challenges facing SMEs in South Africa, the government of South Africa, through the Department of Trade and Industries, has put in place several institutions to help SMEs gain access to finance for both start-ups and for growth purposes. The effectiveness of these institutional arrangements in addressing challenges particularly on access to finance remains a controversial issue. SMEs face several impediments in their effort to access finance (Rogerson, 2008). The questions that remain are whether government interventions are necessary to address challenges facing SMEs or should the market forces be left to determine access.

Several policy reforms have been suggested and efforts have been put to implement them, however the challenges remain unsolved. The finding that lack of finance is a key problem are a common feature of research on problems facing entrepreneurs and is apparent in both developing and developed countries (Foxcroft *et al*., 2002). The following sections is depicts some discussion of policies and institutional arrangements attempted at addressing access to finance challenges facing SMEs in South Africa and the world at large.

Towards addressing access to finance challenges: The high risk associated with providing credit to SMEs is a major reason or impediment to coming up with a sound intervention to address access to finance challenges. To mitigate risk, government intervention in form of credit guarantee schemes may be an effective step towards addressing access to finance challenges facing SMEs. The government of South Africa, through its Department of Trade and Industries has put in place such a guarantee scheme, under Khula Enterprise Finance Limited, a government initiative to address challenges facing SMEs.

Malhotra *et al*. (2007) revealed that a number of commercial banks around the world have learned the lending and pricing strategies that allow them to compensate for the high transaction costs of making many small loans and have adopted risk management techniques commensurate with the higher risk profiles of their SME clients. Many of the innovations originated in serving clients at the lower end of the private sector range using microfinance technologies. These innovations consisted of providing small, uncollateralized working capital loans; promising access to larger amounts for longer terms based on repayment performance; and permitting small savings accounts that were safe, convenient, and flexible in terms of withdrawal.

Nigrini and Schoombee (2002) suggested that guarantees can be used to share the risk between the bank and the guarantee institution in an agreed ratio. Thus the bank's risk and operation costs are lowered and its returns increased. This encourages banks to lend to SMEs who are unable to provide adequate collateral. In their analysis of Khula's Credit Guarantee Scheme, Nigrini and Schoombee (2002) propounded that, regarding the sharing of risk, should borrowers default on their loans, must provide the necessary incentives to encourage banks to participate in guarantee schemes. The risk-sharing proportion usually depends on the track record of the financial institution's SME loan portfolio, the adequacy of the guarantee fund, and the general culture of debt repayments in the country.

Evidence from schemes in Japan showed that loans are guaranteed up to 100 per cent (Levitsky and Prasad, 1987 in Nigrini and Schoombee, 2002). It must, however, be noted that these schemes operate in an environment where loan defaults may seriously affect future business and credit prospects, and consequently the incentive not to default is very high. Other schemes allow banks to decide what proportion of the loan – up to a certain maximum – will be concluded at their own risk. If conducted in such a way, most loans tend to be guaranteed to the maximum allowed. However, the conditions found in Japan do not exist in developing countries; it is therefore important to make sure that banks use guarantee schemes prudently and accept some of the risk involved. In China, credit guarantee schemes emerged as an important tool through the central and local governments used to ensure access to credit by SMEs (Yibin, 2002).

Although Khula states that it takes an 80 per cent risk of the indemnity amount when loan default occurs, it is not the case if collateral is available. Khula will then only pay 80 per cent of the value of the loan minus the collateral. The potential risk for banks is then the unsecured portion of the loan plus the collateral value, as the collateral may not yield its full value in the case of a

forced sale. Some banks are unhappy with this situation. SAlthough they are not compelled by Khula to take up security from SMEs, banks often undertake this on their own free will (Nigrini and Schoombee, 2002).

Nigrini and Schoombee (2002) concluded that despite the problems associated with the government's credit guarantee scheme, it is a viable way for the government to lower the normally high risk involved for banks in dealing with SMEs and, in this way, to entice them to serve SMEs. This will help reducing access to finance challenges facing SMEs.

Despite the potential for the guarantee scheme in solving in part collateral and risk problems it remains a challenge for some of the SMEs, particularly start-ups, who cannot even have the capacity to present even the minimal collateral required to qualify into the guarantee scheme. Furthermore, access to such guarantee schemes by SMEs is a controversial issue, since despite such schemes; there is still a huge outcry from SMEs, particularly start-ups, failing to access financial resources. Angela and Motsa Associates (2004) argued that the large majority of South African households that live on the very fringes of the formal economy, are not easily able to reach institutional arrangements to help them in accessing financial resources.

There have also been initiatives by banks to help SMEs with their crippling financial access problems. Banks are instrumental in facilitating access to finance for SME by providing savings and transaction services particularly for micro and survivalist enterprises. For example, the FNB's People Benefit Scheme which linked the bank to informal financial intermediaries, in this instance to stokvels, is one such an important initiative. Loans, in the range R1500 to R20000, were also linked to borrower savings. Savings were used for both screening and for collateral purposes. However the scheme was operational for approximately 5 years and was shelved in 1997, due to a lack of demand for loans as members mainly used the scheme for savings purposes while the intention was as a credit programme. Possible reasons for its failure to attract credit seeking clients is the absence of the Non-governmental Organisation (NGO) that could identify and train prospective borrowers as is commonly done in linkage schemes (Angela and Motsa Associates, 2004).

Over and above the guarantee schemes, quite a number of institutional arrangements has been established to help in addressing challenges facing SMEs in South Africa (DTI, 2005). These institutions operate hand in hand with private sector institutions designed to assist SME development, survival and growth. These in this paper are termed Business Development Services Providers (BDS). Again the effectiveness of BDS in addressing challenges facing SMEs, particularly on access to finance is subject to debate. Therefore an enquiry should be made from both the supply side and the demand side of SMEs financing to find strategies that works towards alleviating the access to finance challenge facing the SMEs at the same making it sustainable and attractive for the financial institutions to provide credit to the SME sector.

CONCLUSION

The study provided a concise discussion on access to finance issues. Issues surrounding the definition and measurement of access to finance were discussed. Furthermore, the paper provided the financial gap analysis, whose foundation has been discussed in this paper with specific reference to Stiglitz and Weiss (1981)'s credit rationing theory. Gaps in financial access has been noted and discussed, including reasons and attempts to close these gaps.

The study revealed that SMEs are victims of the credit rationing behaviours of financial services provider and hence face challenges in their attempts to access credit financing. Therefore resolutions by both the private and public sector to address these challenges should be sought. One such notable attempt is in the form of both private and public institutional arrangements supported by the central government in South Africa in the form of BDSs. The central government must work hand in hand with the private sector financial services provide to curb the problems facing SME sector in terms of access to financing. The effectiveness of these BDSs and government subsidies in addressing access to finance challenges facing SMES is a controversial issue that need to be empirically investigated. It is therefore paramount to assess the effectiveness of the policy recommendations in the South African literature as well as monitor progress in as far as improving access to finance by SMEs is concerned.

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