CHAPTER TWO

LITERITURE REVIEW

2 Introduction

This section provides a review of past studies or review of the literature on access to finance in small and medium enterprises (SMEs). The chapter also explained the theoretical view of SME limited access to finance and how this problem actually evolved.

2.1 Financing forSmall and Medium Enterprise (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 emphasizes 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 behaviors of financial institutions which according to several authors have an adverse impact on previously disadvantaged groups who have limited access to resources. By credit rationing, lending institutions limit or deny credit based on the borrower's creditworthiness and overload of demands.Gorlorwulu (2011) discussed lengthy issues about Liberian Enterprise Development Corporation (LEDFC). LEDFC was established in 2007 as a private corporation by partnership consisting of the US Oversea Private Investment Corporation (OPIC) and the Liberian group of companies. LEDFC is considered due to the fact that majority of LEDFC companies falls into the SMEs category.In Liberia, LEDFC was licensed as a means to assist the development of domestic enterprises through financing to create a balance between the private, formal and informal business institutions in Liberia. Gorlorwulu (2011) argued that limited access to finance by LEDFC has created a serious challenge for living up to its mandate.

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. The lack of collateral thus limited SMEs owners' creditworthiness.

Furthermore, issues of optimal financing structures (another controversial issue in SMEs) are 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 attention in literature. However, the focus of this paper is more on access to finance for SMEs irrespective of whether its equity or debt financing. In Liberia, 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.

2.2. **Theoretical Framework**

The theory of collateral and Limited liability provides that when there is an excess demand for fund, banks will increase it collateral requirements (increasing the liability of the borrower in the event that the project fails), reducing the demand for funds, reducing the risk of default (or losses of the bank in the event of default) and increasing the return to the bank (*The Amaricn Economic review*). Increasing collateral requirement may increase the riskiness of loan if potential borrowers have different equity, and all projects require the same investment (*The Amaricn Economic review*). Wealthy borrowers may be those who, in the past have succeeded at risky endeavors. New borrowers who do not have such track may be denied of getting finance (*The Amaricn Economic review*).According to Stiglitzand Weiss (1981) banks cannot increase the collateral requirements as a means to reduce demand for fund and default risk. The reason is that higher collateral means firms can only finance smaller projects with higher risk and therefore result in adverse selection. SMEs, as riskier they are have the potential to benefit access to finance based on this argument, provided they meet the minimum collateral requirement of banks and regardless of the information asymmetry.

However, in situations of uncertainty where borrowers and lender's information and optimism are asymmetric, banks can classify lending by risk type. High risk borrowers can compete for loan funds with low risk borrowers by either insuring banks against this risk through the provision of collateral or by rewarding the bank for taking on extra risk by paying a higher rate on loan. Given this situation, borrowers who have insufficient wealth to offer complete insurance through collateral, have only the option of offering to pay higher interest rate.

Stiglitz and Weiss, (1981) argued that banks cannot compensate for risk and uncertainty when it is manifested in an information asymmetry where borrowers know more about the viability of the venture than the bank. Thus, they conclude that banks attempt to level the risk across borrowers by requiring that loans are secured through collateral.

Bester (1985) argued that as long as borrowers are not constraint by access to collateral, no credit rationing takes place. Besankso and Thakor (1987a; 1987b) also argued that binding collateral constraints prevent banks from enticing high and low risk borrowers to self-select into appropriate collateral parings. According to Boot et al. (1991), if a borrower posts sufficient collateral he will be unwilling to default, since in the event his security will be repossessed. Therefore, the entrepreneur will invest more time and effort in his project and his default probability will decrease.

According to Stiglitz and Wesiss (1981), Credit Rationing is defined as given loan to applicants that appear equal, where some receive a loan and some do not even when they offer to pay a higher interest rate and where some individuals are unable to get a loan under one supply schedule at any interest rate but would get a loan under a larger schedule. Stiglitz and Weiss (1981) argued that Information asymmetry is the potential cause of credit rationing. According to their argument, borrowers have different probability of repayment but banks can't identify "good" borrowers from "bad." Hence prices act as a screening device. Under this condition, SMEs, especially those with inadequate collateral do not qualify for loan thus leaves a gap which impedes their growth.

2.3 Gaps inAccess 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 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 Organization 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 agreed 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 behavior 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 side of credit rationing is that financial institutions personnel/ managers may have to bear personal responsibilities for nonperforming 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.

New 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' behavior one can review the credit rationing behaviors which restrict access to finance for SMEs. Credit rationing is an action by leading institutions to limit or deny credit based on borrower's credit worthiness and an overload of loan demand. Interest rate trading either up or down can lead to credit rationing behavior.

2.4Credit Rationing Behaviors

It is important to note that substantial number of authors attempted to draw conclusions on various issues relative to credit rationing behaviors 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.

In Liberia, banks remind the major external financing source of SMEs. However, Bank branches outside of Monrovia (capital city of Liberia) and other bigger cities in Liberia 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 through 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 are more significant in Liberia.

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, analyzing their applications and monitoring their loans. For a number of reasons, these costs tend to be higher for small firm than for large firms. Small enterprises are often located away from the main urban centers, 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 loansize 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 their 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 cashflow projections is thus often abandoned in favor 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, new firms with new innovative products may be constrained in terms of access to finance due to the fact that they may fail to present collateral security and also due to information asymmetries, financial institutions may fail to see the profitability and viability ofthe proposals. Moreover, a collateral requirement is 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 Astebro 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 for knowledge-based firms to access debt. This argument assumed 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, new firms in technology based industry face substantial financial constraints.

Growth is 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 Liberia that makes it difficult to access finance as compare to other countries. The survival rate of SMEs in many countries 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 unclear and may face a greater degree of difficulty obtaining financing.

Risk factor is also another aspect that explains the credit rationing behavior 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 of 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). If SMEs in Liberia rely more on internal financing, the financial risk in the SME sector will continue to bevery high.

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 riskreward 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 often relatively young and consequently lack a financial history and a track-record of profitable projects. Additionally, SMEs lacks organizational and administrative best practice, lower quality management and a lack of appropriate accounting systems. As a result of these problems it is difficult to access reliable 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 labor 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 Liberia, the disadvantage of small firms in regard to risk perception is trigged by a number of factors. Many small medium enterprises (SME) 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 the Liberian economy are typically less skilled in keeping record, marketing and management than other in industrial countries.

The risk perception on SMEs in Liberia attributes to the high failure rates. Financial institutions view small and medium enterprises as having high level of default on repayment and bankruptcy. Therefore, it is reasonable for financial institutions to ration SMEs; particularly new SMEs who have little or even no credit history. Tough collateral security requirement is one of the ways through which financial institutions attempt to protect themselves against such risks. Such collateral discourages small medium enterprise because of lacking financial resources.

2.5. Financing Restrictions Facing SMES

Banks, like other businesses, focus on value creation, based on accepted and controlled risks, (OECD 2006; Pathrose 2005). Banks are reluctant to grant loans to SMEs, due to a number of reasons including informational asymmetry, resulting from the lack of standardized financial information and statements provided by SMEs, adding the bank's limited knowledge about the company seeking a loan (Badulescu and Badulescu 2010). The quantity and quality of information held by the entrepreneur in respect of its business activities cannot be accessed in the same measure by the potential creditor. Thus, the creditors, the banks or financial institutions are unable to make an effective discrimination between good projects and doubtful projects, and the cost of the loan will not be an efficient selection (discriminate), but rather will lead to a portfolio with many risky loans where some of them are viewed with interesting perspective and others with safe failures.

A second problem is moral hazard wherein once the loan granted, the control of using in accordance with the risk and opportunity assessment would be facing serious difficulties, and the loan could be used. To reduce this risk, the creditor will demand security such as business assets, receivables, personal assets, land or buildings, or will ask repayment of the loan.

Higher risks are associated with SMEs lending, due to limited assets that can be used as collateral, low capitalization and vulnerability to market risks. Lending institutions in Liberia consider the environment of SMEs as highly competitive and uncertain compared with large enterprises, which implies a considerable variability of results for similar SMEs working in the same sector and a high default rate. Limited market power, the high percentage of intangible assets, lack of relevant records of historical financial results and business, insufficient fixed or current assets, tend to create a higher risk profile of SMEs for potential investors, (OECD 2000 and 2004; Lin and Sun 2006; Toivanen and Cresy 2000). Insufficient collateral for creditors in order to overcome moral hazard risks are, probably, the most often explanations regarding the difficulties accessing a loan. Insufficient collaterals can be also an expression of an early stage of the business, unconsolidated yet, or even an excessive demand for credit, away from the real capacity of the business engaged in the proposed project.

Besides the fact that small enterprise cannot provide adequate collaterals, they hardly convince the banks about their managerial and marketing abilities or technical skills, which are essential to generate adequate cash flows and a proper debt service. Often, SMEs are characterized by poor technical equipment, difficulties in ensuring qualified technical staff and an experienced management to adapt to multiple and rapid changes of today's economic realities. The accuracy of these characteristics couple with insufficient legal business protectionsisa barrier for financial institutions to determine the real profitability of the SMEs repayment ability, or the strength of guarantees.

2.6 Problems that Limit SMEs Access Finance in Liberia

In Liberia, the issue of limited access to finance has a serious impact on the progress of small and medium enterprises. Money for loan may be available, but small and medium enterprises may not meet the stringent credit security requirements imposed upon them by financing institutions. Poor management, poor financial record keeping and maintenance of new market and use of resources have led to business failure. High risk in terms of SMEs ability to pay debt posed a challenge to financial institutions that offer credit.

2.6.1 **Inadequate Financial Record Keeping**

Small and Medium Enterprises that are mainly in the informal sector fall short of keeping adequate financial record. These SMEs most often operate without financial record which implies that their operations are misguided by administrative policies and best managerial practices, thus impeding the ability to access external finance.

According to Ademola et al. (2012), record keeping is essential to business management. Record keeping involves identification, classification, storage and protection, receipt and transmission, retention and disposal of records for preparation of financial statements. He also included that in record keeping, policies, systems, procedures, operations and personnel are required to administer the records. Record keeping plays a key role in management of knowledge necessary for good business performance. Modern organizations are concerned with the capture, use and storage of knowledge. Laughlin and Gray, (1999) pointed out the following as the most important reasons to set up a good record management: to control the creation and growth of records to reduce operating costs, improve efficiency and productivity, to assimilate new records management technologies, and to ensure regulatory compliance. Accounting records include entries from day to day transactions of business for instance transactions in respect to receipts and expenditure. Records may include a list of organizational assets and liabilities. These help the enterprise to evaluate their performance in a particular period of time usually at the end of a financial period. Proper record keeping provides evidence of how the transaction was handled and substantiates the steps that were taken in order to comply with business standards. Record keeping is the foundation on which a compliance program should be built upon measures should be put in place to capture the documentation and events that take place throughout a transaction commencing from delivery and payment (Reed 2010).

2.6.2 Lack of Collateral

Small and Medium Enterprises (SMEs) in Liberia face the issue of collateral obstacle as credit security. Small and medium Enterprises (SMEs) without adequate collateral which meet the standard of the financial institution normally fail to receive finance/ loan form the banking/financial institution.

In Liberia, a new collateral registry has been launched to help facilitate more than $226 million in loans to small and medium enterprises in one year (Liberia collateral registry). The increase in access to finance is geared towards helping to the economy recovery from the effect of the economy crisis caused by a long civil war in the country, and to foster inclusive economic growth in the country.

Richard S. Klah, Associated Judge at the commercial Court of Liberia, said, the private sector is key to the development of any country, especially in a post-conflict country like Liberia. He cautioned that to achieve better Small and medium enterprise financing trend, the SMEs sector should take advantage of the new collateral registry system that have been launched in the country.

The collateral registry system in Liberia allows individuals and micro, small and medium sized enterprises that do not have access to traditional collateral such as land or real estate property to register movable assets as collateral in order to access loans from commercial banks. These movable assets can be car, motorcycles, crops, agriculture equipment, account receivable and other forms of credit instruments.

The collateral registry in Liberia allows banks to provide secured loans to individuals and businesses that would not otherwise be able to have access to financing. EuphemiaSwen-Monmia, Assistant Director, Collateral Registry at the Central bank of Liberia, said, “the Liberian Collateral Registry believed that the economy will boom, if the collateral the collateral registry is actually used as expected to be used”. The collateral is seen as a policy instrument that is leading to a very productive economy, where people are going to have access to finance.

The collateral registry was established by the Liberian government through the Central Bank in collaboration with IFC and the World Bank Group’s Finance and Market Global practice. It followed the enactment of a commercial reform and the establishment of a commercial court dedicated to resolving disputes between lenders and borrowers.

The Collateral Registry program is supported by the UK Government and

IFC's conflict Affected States in Africa Initiative (CASA) and tis donor partners Ireland, the Netherlands, Norway, and Sweden. CASA support private sector growth, investment, and job creation in Africa fragile and conflict affected states.

However, what is important to note here is that the presence of collateral is not able to reduce credit risk (default risk). This results are consistent with the concept that view collateral as a credible commitment against informational asymmetries, and not as convenient coverage against credit risk

Collateral is viewed as a credit security that a borrower should present to secure loan from a bank or financial institution offering credit. Collateral impacts credit risk. From the theoretical stand point, there are two alternative interpretations that lead to different predictions.

The first interpretation is such collateral has adverse selection problem faced by a bank in financing activity, and therefore, the security offered by debtors can help alleviate this problem (Stiglitz and Weiss 1981:393-410; Chan and Thakor 1987:345-363). Thus, low-risk borrowers are willing to offer a better guarantee, considering their lower risk as a signal for their capabilities to fulfill its obligations under the credit agreement and, therefore, are less probability to lose the guarantee. According to Jiménez and Saurina, (2004) the guarantee is interpreted as a signal that allows the bank to reduce or eliminate the adverse selection problem caused by the existence of informational asymmetries between the bank and borrower, when the loan was approved. On the other hand, is the opinion, that even there is an ex ante symmetry between debtor and creditor, collateral is designed to mitigate the moral hazard problem once the loan was granted. Relative to this, the collateral helps to align the interests of both, creditors and debtors. The result of this is that the bank and the borrower make significant effort to ensure the success of the loan granted. Security(collateral) becomes a means to discipline the borrowers' behavior given the existence of a credible threat (Aghion and Bolton 1992:473-494).

Given these views, a direct relationship between loan quality and/or the borrower, and the size of collateral is assured. That is, the assumption that the guarantee is a signal of high quality borrowers. However, For SMEs, this argument is not agreed by the bankers, who tend to establish a direct relation between the level of credit risk and the volume of collateral.

The size and quality of collateral is linked to the banks behavior on the market,(Manove et al. 2001:726-744; Argentiero 2009). This scenario speaks about lazy banks vs. diligent banks. "Lazy banks "are defined as those banks that prefer to substitute a careful and efficient screening of projects with a high concern for the size and quality of proposed collaterals. Given this approach, safer borrowers offer more guarantees compared with risky borrowers, primarily to give a signal about themselves when they are evaluated by a bank, and secondly, to avoid the implications of carefully credit analyzing and screening, as for risky borrowers. Banks, in turn, will adapt to this process and, gradually, will reduce their analysis and monitoring activities for borrowers with substantial collateral. Therefore, risky but innovative projects tend not to be financed, thereby reducing the social welfare.

Although interesting, and certainly based on some market behaviors, a model of "lazy bank vs. diligent bank" does not seem to be confirmed by statistical data; the results suggest a rather different kind of diligent behavior of these banks (Argentiero 2009). In addition, research has shown that the presence of collateral is not able to reduce credit risk (default risk), these results are consistent with the theory that understands the collateral as a credible commitment against informational asymmetries, and not as convenient coverage against credit risk. In addition, there are significant differences in banks' policy on the role of collateral required in long-term loans (compared with the short term), because this collateral is a part of a risk, but also it may increase coverage as the borrower made systematic repayments.

2.6.3 High Risk Borrowers

High-risk borrower applies to consumers with low credit rate scores. This is common among small and medium enterprises (SME) owners in Liberia as compare to other developing countries. This mainly derives from poor saving record with banking institution from which these entrepreneurs would seek credit opportunities. The fact that small and medium enterprises owners are mainly sole proprietor, family member and or partner, the financial policies of saving in banks does not seem rewarding since they are not subjected to any financial regularity. As such, banking institutions that base their credit policies on scoring customers credit resolved not to offer loan to such customer with no saving record. More besides, small and medium enterprises owners that save with banks but fill to meet the banks required credit scores as criteria to benefit loan are not granted such credit opportunity.

As a universal financial credit requirement, borrower should be credit worthy to access loan from financial institution. Failure to meet the financial regularity of said bank, it is rare that the customer to attain credit be it short term or long term loan. According to the Federal Deposit Institution Corporation Website, if credit score of a borrower/customer fall below 660, that borrower may not meet the criteria for a high-risk loan.

2.6.4 Micro-Lenders

One of the most popular businesses in Liberia is Micro lender service. The micro lenders service is a business initiative under taken by individuals who provide capital that is not considered cost-effective to a traditional leader. This service enables disadvantaged individuals in the country to have access to small amount of credit. In Liberia, money lenders access financethrough banks andprovide short-term lone service to both SMEs and individual entrepreneurs. Micro lenders service, though SMEs, serves are a backup for banks by providing loan at affordable rate.Micro-lenders failure to access needed funds from banks contribute to their failure to respond to demand of short-term loan by SMEs that are not qualify to access bank loan.

Micro lenders use both private and external financing means to run their enterprises. The concept of micro lending is consistent with money market. The concept of money market alludes to the use of financial instruments with high liquidity and very short maturities in trading. The money market is used by participants as a means for borrowing and lending in the short term in support of bridging the gap of access to finance problem facing SMEs in Liberia.

2.7 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. According to Holtmann et al. (2000) Such methodologies include a Loan analysis that focuses on the prospective client's ability to pay (cash flow), less emphasis should be placed on collateral, standardized analysis, minimum loan processing times, entitle repeated 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. This suggests that banks play a crucial role in limiting SMEs access to finance.

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.

Brierley (2001) argued that 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 (interest rates), but must also satisfy the bank that the principal (capital loaned) will be returned (Brierley, 2001). Notably, one can think of suppliers of capital as the purchasers of risky promises to pay. This argument suggests that some SMEs or firms will be, and should be, denied financing based on their failure to furnish sufficient information or if the information supplied indicates that they are a risky investment.

The observation that some firms cannot obtain capital is therefore not the first evidence of a gap. A gap or imperfection may however be implied ifSMEs or firms that ought to receive financing are unable to obtain it. Therefore, investigation is required as to whether an actual gap or a perceived gap exist to ensure that policy makers do not direct 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. In regards to policy issues on this matter, 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 Liberia, policy debates for the past have failed to close the financial gap between SMEs and providers of financial resources. This is evident in under performance SMEs throughout the country because of their lack of access to finance and 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 (Herrington et al., 2008).

2.8 Principal Sources of SME Financing in Relation to SME Financing Life Cycle

It is important to note that the source and the availability of financing for small and medium enterprises (SMEs) are viewed as the potential factors as it relates to development and growth. The need for financing as well as options available to SMEs, vary depending on the life circle stage of the SMEs. The number of factors that influence SMEs access to financing include level of development, availability of finance, the nature of the business and its marketing capitalization, and the professional connections of the entrepreneur who is in charge of the of the business operation.

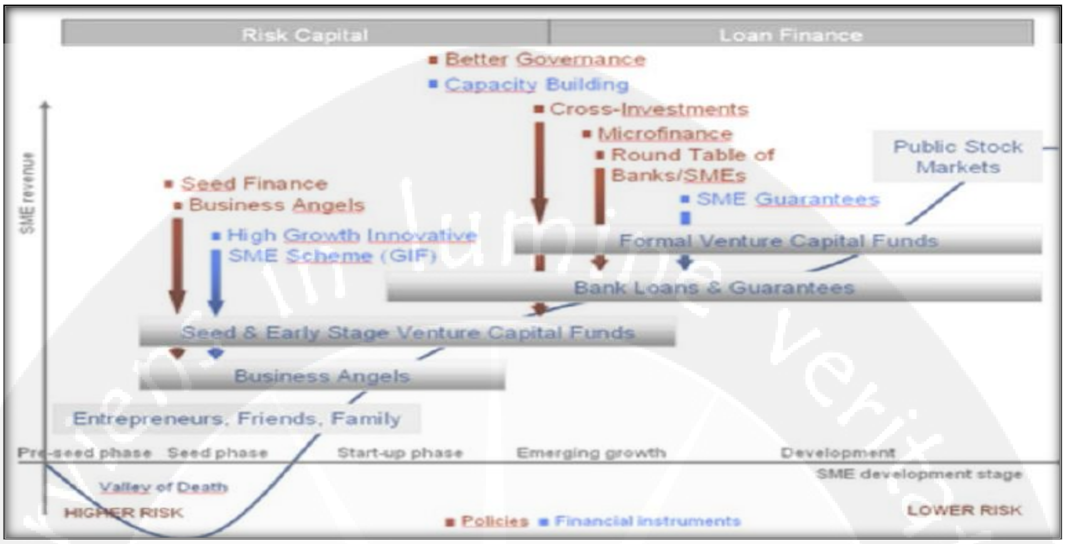
Small and Medium Enterprise demand for finance depends on the stage of growth in its life circle. Business use this approached to grow and reach the capital markets, at which time it’s capable to raise long-term capital and sustain its growth.

According to the European Bank, SME Finance Forum 2015, small and medium enterprises should apply holistic approach by using specific and different financing approaches during their life cycle, as this leads to growth and survival. The life cycle cannot be applied to every SME especially the once operating in the informal sector. However SME that adopt this approach realize good benefits. The type of financing source that are used on average by SMEs during their life cycle include internal financing which represent owners or manager personal savings and internally generated profits, venture capital, external equity, debt financing, trade credit, bank loan and security market.

These financing options are beneficial provided that they are used in the appropriate stage of the small and medium enterprise life cycle. The stages that exist in SME life cycle are indicated in the graph one and include see-sage, start-up stage, emerging stage and expansion stage.

Graph1

SME Life Cycle and Financing Need



Source: DG Enterprise, 2007

Relative to the option of finance, graph one depict the type of financing requires at each stage of a small and medium enterprise life cycle. Small and medium enterprise owners used personal savings, family and friends financial contribution as important source of finance at the start of the business. At this stage the SMEs are highly risky with intangible assets, lack of trading record and lack of information. As a result of these risky features, small and medium enterprises are unable, if not at all, to secure loans from financial institutions.

During the start-up stage, small and medium enterprises personal fund become depleted and the second option of funding is the use of external source. During this stage, the investment in SMEs is still considered high risk and the business is not large enough to attract the attention of venture capital investment.

Still considered high risky business, it becomes difficult for external investors to take on the opportunity to invest in the business. However, venture capitalist plays a role in alleviating such financing obstacles faced by the new SME at this stage. Small and medium enterprise that enter the emerging and the developed stages have established a track record and the ability to provide collateral and pertinent information relative to its performance. At this stage, the SME has become so transparent where banks can ably evaluate its activities to determine as to whether the SME is credit worthy.

Empirical studies on literature support the concept the umbrella the life cycle financing approach. Myers. (1984) and Myers and Majlut. (1984) proposed the Packing Order theory, which states that firm will meet investment and financing requirements in a hierarchical fashion , where priority is given to internal financing first, external financing (debt) and external financing (equity) as a last option. Chittenden et al. (1996) suggest that, relative to Pecking order Theory, there is a positive relationship between a firm's size and its source of financing, as smaller firms are likely to rely on internal funds.

To date, the traditional approach to SME financing through application of proportionate regulation with less burdensome disclosure and listing requirements - initial and ongoing – has not always proved to be sufficient. Similarly, although multi-tier exchange structures can have an important role to play, they cannot be the only solution to the SME financing gap. New ways and alternative methods of financing should be considered through the involvement of more innovation and use of technology.IOSCO recently published its research note on *Market Based Long Term Financing Solutions for SMEs and Infrastructure*. The research note describes innovative structures and products in equity capital markets, debt capital markets, securitization and pooled investment vehicles that provide practical solutions to broadly recognized challenges for financing of SMEs and infrastructure projects.

2.8.1 Bank Loan

Bank loan is the most common form of loan capital for business been offered to business institutions, and entrepreneurs. A bank loan provided medium or long-term finance. In the contest of micro-financing, banks in Liberia offer shot-term loans to SMEs and other business firm that qualified for such loan. The banks setthe fixed period over which the loan is provided, the rat of interest and the timing and amount.

Banks will usually require that the business provide some security (collateral) for the loan, although in the case of a start-up SME this security often comes in the form of personal guarantees provided by the entrepreneur.

Bank loans are well suited for financing in fixed asset. However, for start-up SME, bank loans are commonly used for the running of the business day to day activities. Bank loans generally charge at lower rate making it easy for small and medium enterprise to venture in accessing it. The rate of bank loan in Liberia varies from bank to bank. Banks charge interest on micro-loans depending on the credit risk of the borrower.

In Liberia it rare for banks to give loan to start-up SMEs since these SMEs lack of business financial records and highly risky. Similarly, banks tents not to offer loan to businesses with a track record of poor profitability and cash flow. These businesses are considered as been high-risk by the banks that, as a result of the credit church, are cautions about the kind of lending they offer.

2.8.2 Venture Capital

Venture capital is money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan, and the investor hopes the investment will yield a better average return. Venture capital is an important source of funding for start-up and other companies that have a limited operating history and don't have access to capital markets. A venture capital firm (VC) typically looks for new and small businesses with a perceived long-term growth potential that will result in a large payout for investors.

Due to the challenges many SMEs face in obtaining risk capital from the public equity market and the formal venture capital, attention is increasingly being focused on the informal venture capital market. Business angels (also known as angel investors, informal investors, and private investors) are increasingly making a strong impact both in term of value and volume of investment in developed and developing countries. Typically, these investments are in sectors that are complimentary to those in which institutional venture capital firms focus and are particularly important for start-ups and early-stage firms (Freear and Wetzel, 1988). Small and medium enterprises in Liberia are yet to boost the performance through the use of venture capital. Most are owned by family members, single individuals and partners who bear the sole liabilities, risk and as well benefit the profits earned.

The informal venture market comprise individuals who provide risk capital directly to new and growing businesses with which they had no previous relationship. Venture capital is mainly suited for small and medium enterprises because these are businesses that are not formal, not regulated in term of audits, and have no formal connection to the formal business world. However, in the Liberia, venture capital has not gain the attention of entrepreneur/ SMEs owners. SMEs operators in Liberia function as independent business practitioners. But in the US for instance, this market has been identified as the single most important source of risk capital for SMEs. In a pilot study conducted within the Ottawa-Carleton Region, Riding and Short (1987) confirm that the informal venture capital market plays an important role in Canada and estimate that active informal investors comprise approximately 0.05 percent of the population of the Ottawa-Carleton Region. This implies that with venture capital, small and medium enterprises are opportune to access finance and achieve their higher growth and development.

More recently, Farrel(1999) estimated that one in five owners of new businesses in the Atlantic Region had also made arm's length private investments in other businesses. These literatures proved that venture capital has gained more attention and thus save as a means to finance SMEs from start-up to growth.

If small and medium enterprises in Liberia must achieve growth and high performance as well as ease the problem of access to finance, one way is to seek venture capital investors. Private investors, financial institutions and banks alike have the potential to play such role. This form of accessing finance will although transfer equity ownership of the SMEs to investors and financial institutions, if adopted, it eases the problem of access to finance, offset the burden of collateral requirement and result to a better than average return on the investment.

Furthermore, a range of advantages are associated with venture capital. Venture capital leads to business expertise, additional resources and connections. Aside from the financial backing, obtaining venture capital financing can provide a start-up business with a valuable source of guidance and consultation. This can help with a variety of business decisions, including financial management and human resource management. Making better decisions in these areas can be vitally important as the business grow.

Venture capital leads to the creation of better financial record keeping, compliance to financial regulations including legal, tax and personal matter in the growth of the business. Faster growth and greater success are two potential key benefits for venture capital.

Venture capitalists are well connected. SMEs that tips into this connection, stands to benefit speedy growth and benefit. However, loss of control is a major drawback when a business adopts venture capital financing. The reason is that venture capital is a form of equity financing where the financier has total ownership of the business. Nevertheless, SMEs that provide a portion of the capital has ownership in the business and do benefit from the return.