

Assessment of the Acceptability of Personal Guarantees and Life Assurance Policies as Collateral for Loans in Ghana

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Abstract

Whenever a financial institution advances money to its clients, it has to take collateral so as to reduce and/or prevent a total loss of funds and revenue in case the borrower defaults. Thus collateral offered serves as a protection to the financial institution. Generally security accepted by financial institutions includes mortgages, pledges, stocks and shares, land, buildings, guarantees and life assurance policies. Traditionally, banks and Non bank financial institutions prefer the use of landed property as security for their loans, even though they find it difficult and long procedure to realize this Security. The use of movable collateral under Ghana law was a key constraint for SMEs, as bank lending was largely based on real estate collateral, while SMEs typically do not possess real estate assets. The objectives of this paper therefore are to establish the extent of acceptance of guarantees and life assurance policies as collateral for personal and SME credit in Ghana; to provide a basic understanding of life assurance policies and guarantees as collateral and to examine the qualification requirement for guarantors and life assurance policies if they are acceptable by financial institutions in Ghana. In order to achieve the above objectives, a survey was conducted amongst credit officers of financial institutions in Ghana. Participants were from banking and non-banking financial institutions. Questionnaires, comprising of both open-ended and closed questions were distributed to a sample of thirteen (13) banks and fifteen (15) non-bank financial institutions which were selected to constitute the respondents of this study. The results indicated that although most banks policies accept personal guarantees as collateral, the practice is of limited usage in these banks. In the case of the non-bank financial institutions, there is a high rate of usage of personal guarantees. The results also revealed that most banks do not accept life assurance policies as collateral. None of the non-bank financial institutions used for this study had ever accepted life assurance policy as collateral for a loan.

Keywords: Guarantee, Life Assurance Policy, Collateral, Ghana

1. Introduction

A key function of a financial institution is to serve as a financing intermediary. Financial institutions play their intermediary role by sourcing for funds from surplus units and on-lend to deficit unit/sectors. In the performance of this role financial institution pays interest to the surplus units, and refunds deposits taken from these units. For financial institutions to perform this role effectively, they would have to ensure that those funds they lend to the deficit sectors are entirely paid back and on schedule.

However in practice, financial institutions face the risk of non-payment, referred to as credit risk (Driga, 2004). When a bank extends credit to a customer, it must face the risk of non-payment due to the fact that some borrowers will be unable or unwilling to repay the loan at maturity. This represents the possibility that the bank will suffer a loss of income and principal because the borrower cannot exactly follow the lender's repayment terms for different reasons (Driga, 2004). In such cases, the account of the customer becomes overdue, the loan turns into a non-performing loan, and the lending bank will register a decline of its profit and or incur loss as a result of the fact that they still have to pay the money they borrowed to on lend to their customers.

As a result of the above situations, financial institutions take certain measures to reduce and or eliminate the risk of default. Most financial institutions undertake a detailed quantitative and qualitative analysis of the potential borrower's request.

In order to make proper lending decisions, financial institutions must build their lending policies around the six C's of credit management: Character; Capital; Capacity; Collateral; Conditions and Control (Driga, 2004). The emphasis of this paper is on the Collateral element of the six C's.

Various explanations for the widespread use of collateral in lending have been provided by writers and microeconomic theories of banking and financial contracting. Collaterals work as compensation in case the clients fail to repay their credit Hartungi, (2007). According to Westhead, (1996) the role of collateral is essentially twofold: in the first instance it provides the bank with insurance against loan default and second, it is intended to ensure that the borrower puts in the required effort to ensure loan repayments are made. Adams et al. (1983) wrote that collateral offered serves as a protection and ensures the sustainability of the financial institution. Collateral may, first, play a signaling role, solving the adverse selection problem ex ante, before a loan contract is signed Bester, (1995), and second, have positive incentive effects on the borrower, mitigating moral hazard ex post.

There are several studies about the relationship between collateral, riskiness of the loan and the borrower. Berger and Udell (1990) investigate the relationship between collateral and credit risk by estimating the difference in risk premium between secured and unsecured loans. If collateral serves as an incentive device that is designed to solve the problem of adverse selection, then the risk premium of the loan should be negatively correlated with the likelihood of collateral being pledged because a lower risk borrower would choose a contract with collateral, in order to take advantage of the lower risk premium. On the other hand, if the lender observes the ex-ante risk of the borrower and requires a higher-risk borrower to pledge collateral, then there should be a positive relationship between the risk premium and the presence of collateral.

Berger and Udell (1990) find a positive association between use of collateral and risk premiums, which is consistent with the hypothesis that collateral reduces debtor's moral hazard. Similarly, Berger and Udell (1995) find a positive relationship between the leverage of the borrower, which is a proxy for borrower risk, and collateral, and thus confirm their earlier result.

Salsa-Fumás and Saurina (2004) examine whether banks with a lower level of expertise in small business lending use collateral more intensively. Examining Spanish loan data from 1984 to 2002, they found that loans originated by smaller banks, which are deemed to have fewer resources for credit evaluation and by savings banks, which traditionally make loans mainly to households rather than businesses, are more likely to extend collateralized loans. The authors argue that their findings suggest collateral is used as a substitute for the evaluation of credit risk, and hence is compatible with the lazy bank hypothesis.

However, in order for the collateral to be acceptable, it ought to have certain characteristics. According to Rouse, (2002) the collateral has to be either stable or increasing in value, it should be easy to take and valued, it should not impose any liability on the bank and it should be easy to realize.

The minimum value of accepted collateral must cover at least 100% of the principal and interest (Driga, 2004). For a lender to be fully secured, the security margin should include a reasonable estimate of the effect of the cost of sale and other necessary costs relating to the need to keep the assets saleable, as well as the roll up of interest since the last charging date Rouse (2002). Banks can require and obtain collateral with a higher value than the value of the loan. It is however prudent for banks to avoid too high levels of margins, as this limits the customers' access to credit.

According to Rouse,(2002) Financial Institution, in lending to customers especially personal lending, should consider taking security mainly in the following instances: where the realization of specific assets represents the source of repayment, for example in a bridging loan; where the purpose of the loan is to acquire a specific assets for example, home loan; where the risks and consequences of the expected source of repayment failing are such as to make it necessary to have a clearly defined and controlled alternative source.

Generally security accepted by financial institutions includes mortgages, pledges, stocks and shares, land and buildings, guarantees and life assurance policies.

Traditionally, Banks and Non-Banks Financial Institutions prefer the use of landed property as security for loans (Domeher, 2012) even though it may be difficult and may involve relatively long procedures to realize this security. Most customers' especially small and medium enterprises, are unable to provide these landed properties as collateral and hence are unable to raise the needed funding to expand their business or augment working capital (Domeher, 2012; Narh, 2011).

The main objective of this paper therefore is to examine the extent of acceptability of guarantees and life assurance policies as collateral for personal and SME credit in Ghana. In particular the researchers seek to provide a basic understanding of life assurance policies and guarantees as good alternative collaterals. It further examines the qualification requirement for guarantors and life assurance policies if they are to be acceptable by financial institution in Ghana.

The researchers in order to achieve the above aims therefore pose the following questions for study: Do finance houses accept alternative collaterals like Life Assurance and Guarantees? What qualifications do they look out for before accepting a guarantor? Do they consider the insurance company that issues the policy, before accepting the policy as collateral? Is life assurance policy a good alternative instrument to be accepted as security for the finance house?

The rest of the paper is organized as follows: The next section provides an overview of guarantees and life assurance. The section after provides how data was obtained for the research. The section after discusses the results obtained and the conclusions are found in the last section.

1.1. Overview of Personal guarantees

According to Ono, (2007), the role of collateral and personal guarantees differs completely, depending upon whether or not there is information asymmetry between creditors and borrowers. He made a precise distinction between the two as collateral been typically physical assets or securities that the creditor can sell in the event the borrower defaults. In many cases, the assets or securities pledged as collateral are owned by the borrowing firm and hence do not increase the potential losses that the borrower may suffer.

On the other hand, a personal guarantee refers to a contractual obligation of the business owner or other third parties, such as the relatives of the owner or directors of the borrowing firm, to repay the principal in the event of a default. If the borrowing firm is a limited liability entity, a personal guarantee functions as outside collateral, except that it does not give control over specific assets. Most of the theoretical literature, as well as Ono's 2007 exposition, explicitly assume collateral in empirical analyses due to the lack of information. Ono (2007) analyses situations of perfect information, and information asymmetry to conclude that collateral can serve as a screening device in order to discern the riskiness of entrepreneurs.

A guarantee is a written promise made by one person to be collaterally answerable for the debt default, or miscarriage of another (Gerrar, 2000). This means that a bank cannot, in effect, make a demand upon a guarantor without first calling upon the principal debtor; only if the debtor failed to meet the agreed obligations, would the guarantor be called upon (Gadre, 2010)

According to Gadre (2010), the guarantor must compensate the lender, in case of a default and usually acquires an immediate right of action against the borrower for payments made under the guarantee.

The liability of guarantor is discharged when the liability of the borrower is discharged. This means that liability of the guarantor continues as long as the borrower's liability continues. When the credit facility is fully repaid by the borrower, liability of both the borrower and guarantor is discharged. There are however other instances where the guarantor's liability is discharged. Some of these instances are where the guarantor can prove to the satisfaction of the court that he was unduly influenced to sign the agreement (Gerrar, 2000), such as was established in *Lloyds Bank Ltd V Bundy (1975)*. Mr. Bundy, a customer of the bank, gave a series of guarantees supported by a legal mortgage over his farm to cover the liabilities of his son's company. Later Mr. Bundy was called upon to pay and upon default the bank arranged to sell the farm. Mr. Bundy claimed non-liability due to 'undue influence'. The court held that the relationship between the bank and Mr. Bundy was one of trust and confidence, and that Mr. Bundy relied upon the bank. As such, there had been a conflict of interest on the bank's part and independence advice should, therefore have been insisted upon by the bank, when the final security had been taken. As such advice had not been given; the guarantee and the mortgage were set aside.

Another instance is where there are material changes in the terms and conditions of the loan (which amounts to novation of the contract). A case example was *Ellesmere Brewery Company V Cooper (1896)*.

According to Gadre (2010), it is pertinent to note that most guarantee agreements prepared by banks are always drafted and are only suited to them. Banks get such guarantee agreements executed by the guarantor. When guarantors execute the guarantee, they are certainly aware that they are liable to pay in the event the borrower defaults in making payments. However, they are unaware that most of the rights to claim discharge given to them by the Contracts Act are taken away from them in the guarantee agreement.

Usually, such agreement also declares that the guarantee given by them is continuing, irrevocable and unconditional. As there is no financial burden at the time of giving a guarantee, the agreement is often executed by the guarantor in a very routine manner, without reading and without properly appraising the future risk involved in giving such guarantee.

Guarantees can be executed under seal or under hand. In the latter case, a guarantee must be supported by some form of consideration (Gerrar, 2000). Such consideration in a bank's case will be the provision of a credit facility (Gadre, 2010) or the continuance of facilities for a further period.

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Parent companies, routinely guarantee the debt obligations of their subsidiaries, insurance companies, commercial banks and on occasions sovereigns offer guarantees in the return for fees on a broad spectrum of financial instruments (Bodies, 1992). Banks often takes personal guarantees from directors of a limited company when lending to that company. This is to reinforce the commitment of the directors to the success of the company, as they are less likely to walk away from the awkward situation, should one develop, if they are personally liable for the debt which may evolve (Gerrar, 2000).

Guarantees as securities have several advantages to the bank. For example, it is easy to take and perfect as a security, and provided a guarantor remains financially sound, the guarantee has a stable value. There are some guidelines and responsibilities that are vital for all guarantors to be aware of before accepting to guarantee.

An individual, who wishes to function in the capacity of a guarantor, will not be allowed to act as a guarantor if he or she is currently a guarantor on an existing loan. Guarantors cannot be current beneficiaries of any loan. This means that an individual, who receives as a loan and has not finished repaying, cannot be a guarantor for another applicant. Also, guarantor must know the applicant, and plan to maintain some measure of contact in the future. This will provide assurance that borrower is held accountable for repayment when the time arise. A guarantor cannot guarantee for more than one person at a time. In extreme cases where applicants are unable to find more than one guarantor, the single guarantor, if assessed as being financial sound and who is also able to

satisfy other requirements as specified by management will be allowed to stand as the sole guarantor for the beneficiary (Jackson, 1997).

Guarantees might be personal or corporate. With corporate guarantees, the bank should check the guarantor's company regulation, to ensure that it is not exceeding its powers by providing a guarantee and that the transaction is commercially justified. Guarantees might either be supported or not supported by the security. Where a second mortgage is to be taken on the borrower's home, the financial Institution must make enquiries into the co-occupancy and obtain the consent of co-occupants for example spouse to the mortgage. A third party guarantor should be advised to obtain independent legal advice before signing the guarantee to avoid later charges of undue influence (Nyarko, 2009).

1.2. Overview of Life Assurance Policy

Life Assurance policies are contracts by which an insurer undertakes to pay sums of money on the death of the insured person or if it is a policy of endowment assurance, on his attainment of a specified age or at the death before that age (Gerrar, 2000). According to Jackson (1997), life assurance is a protection against the loss of income that would result if the insured passed away. The named beneficiary receives the proceeds and is thereby safeguarded from the financial impact of the death insured. Life assurance provides a cash lump sum in the event of the death of the life assured.

This benefit, which is the right to receive the sum payable at maturity, can be transferred either outright or as security for a loan from a financial institution. This is known as an assignment (Rouse, 2002).

Life assurance policies provide unique advantages to the financial institution and these include the fact that it is an appreciating security (as the customer pays the premium, the surrender value of the policy increases) and also the fact that in the event of the death mortgagor, the repayment of any borrowing can be met from the capital value of the policy concerned (Gerrar, 2000). Life policies are simple and cheap to change as security and easy to realize as well. There are various forms of life assurances, such as whole life assurance policies and endowment policies, however these are not within the scope of this paper.

Life assurance policies are contracts of 'Uberrimae Fidei' (of the utmost good faith) and as such, any misrepresentation or non-disclosure of material facts would seriously affect the validity or value of any policy concerned (Gerrar, 2000).

Normally when the customer defaults in repaying its borrowing, the financial institution will take one of the following three steps to recover:

1. The mortgagor will arrange a loan from the life assurance company against the surrender value of the policy (normally up to 90%). The financial institution will ensure that the proceeds are paid to it, in exchange for the discharge assignment form.
2. The Financial institution could sell the policy to a specialized company.
3. The Financial institution could surrender the policy. In this case, the bank will forward the policy and form of assignment to the assurance company which will then draft a form of receipt to be executed by the bank. This is the most common procedure and is quick and simple.

Where a bank's charge is an equitable one and the assignor dies, it will be necessary to obtain the help of the executors or administrators in order to obtain maturity proceeds, as they will have to join in the receipt required by the assurance company Gerrar,(2000).

While it is well documented that small and medium enterprises, had to rely on land and building as collateral for borrowing in Ghana (Abor,2007;Narh,2011; Domeher,2012), to the best of our knowledge, no research was found as regards the use and acceptability of life Assurance and guarantees as collateral in Ghana. The paper therefore contributes to literature by examining the extent of acceptability of guarantees and life assurance policies as collateral for personal and SME credit in Ghana. In particular the researchers seek to provide a basic understanding of life assurance policies and guarantees as good alternative collaterals. It further examines the qualification requirement for guarantors and life assurance policies if they are to be acceptable by financial institution in Ghana.

2. Research Method

In other to achieve the aims of this research, a survey was conducted amongst credit officers of financial institutions in Ghana. Participants were from banking and non-banking financial institutions. The researchers distributed questionnaires, comprising of Open and close-ended questions. A sample size of thirteen (13) banks out of a total of twenty seven (27) licensed commercial banks in Ghana, as at April 2012 was used. In addition Fifteen (15) non-bank financial institutions (Micro-Finance and savings and loans Companies) were selected to constitute the respondents of this study. Personal interviews with selected credit officials of the sample organizations were also used to gather data. The survey was designed to study the attitude and views of the credit officers towards the acceptability of guarantees and life Assurance policies as security for personal, SME and corporate credit. One questionnaire was given to each credit officer to complete on behalf of their institution.

Participants were randomly selected.

3. Analysis of Results

The researcher sought to find out the extent of acceptability of guarantees by the banking respondents. Nine respondents out of the thirteen banks sampled representing sixty nine percent (69%) of banks accept guarantees as collateral for loans, whilst four (4) respondents representing 31% do accept limited rate of guarantees as collateral for loans. From their responses, those that accept limited guarantees as collateral pointed out that they accept guarantees as secondary security. By that, it meant that primary security in the form of fixed assets is taken, but where the margins on this security are not high, they take additional security in the form of guarantees. On the other hand, the sixty nine percent pointed out that the guarantees are normally accepted as primary security when they lend to the corporate sector where mostly they take joint and several guarantees of the directors. The majority of them further pointed out that they do not accept personal guarantees regularly. In situations where they have to accept it, then they ought to be a high net worth customer of their bank, operating an account at any branch of the bank. A few of the banks also accept guarantees for personal or consumer loans.

All the banks have an SME department that is in charge of funding to this sector. Some of them pointed out that they have a group guarantee scheme which is accepted as sole security for the provision of credit to groups, under microfinance and small loans schemes. They pointed out that guarantees are however not accepted for mortgage loans, documentary credit and salary loans. In terms of salary backed loans, the bank demands only confirmation from the borrower's employer. Some of the banks also have a limit for guarantees as collateral. Some of which are; two guarantors are required for loan amounts of GHc10, 000 and above while a guarantor is required for amounts below GHc10, 000. For some banks, guarantees are limited to a maximum of GHc10, 000.

The research also sought the extent of acceptability of guarantees with the non-bank financial institutions. All the non-bank Financial Institutions surveyed accepts guarantees as security. Those who specifically operate as micro finance institutions indicated that guarantees are a key source of security for them. Most of their clients shy away from banks because they are not able to provide the necessary security demanded by the formal banks. These non bank financial institutions thus accept individuals who can prove they own a store, or kiosk for trading, to serve as guarantors for funding up to Twenty Thousand Ghana Cedis. They further form groups for some of their customers, and use group guarantee schemes, as security to provide funding for large number of their client. They pointed out that they themselves sometimes had to use institutional guarantors like Exim Guaranty Limited to serve as guarantor for some funding they use.

The researcher sought to find out the qualification requirements of guarantors accepted by both the Banks and Non-Bank Financial Institution. The result is summarized in the list below:

1. The guarantor(s) has to be salary worker(s) preferably with government institutions.
2. The personal guarantor must provide a financial statement or pay slip.
3. The guarantor(s) must sign a loan guarantee form.
4. The guarantor must be of sound mind.
5. The guarantor must have a regular income
6. The guarantor must guarantee freely.
7. The guarantor must provide a valid identity card
8. The guarantor must provide proof of residence
9. The guarantor must be gainfully employed
10. The guarantor must sign an agreement to pay the balance in case of default
11. The guarantor cannot guarantee for two borrowers
12. The guarantor must not have too many liabilities

In the case of self-employed guarantors, they must produce documents which include a valid business registration document, a valid business operating permit and a current evidence of income tax payment.

Do finance houses accept life assurance policies as collateral for loans?

One percent (1%) of banks sampled confirmed that they had accepted life assurance policy as security for loans. This security was accepted as additional collateral offered by the borrowers. Eighty seven percentage (87%) of the sample said that though they are aware that life assurance policies could be used as security for credit, they do not have it as part of their company's policies to accept it as a security. Eleven percent indicated that though they have it as part of their policies to accept life assurance, as at May 2012, when this study was carried out, they had not yet had any customer proposing to use it as a security.

The response of the non-banks financial institutions is not different from that of the banks. Almost all of them have not accepted life assurance policy as a security before. Twenty-seven percent (27%) pointed out that it is not part of their policy to accept it, but it is something they would consider, if the need arose.

It is interesting to note that the few individuals with life assurance policies the researchers spoke to, did not even know they could only be used for partial loans for a term not exceeding six months, from the insurance company

that sells the policy.

Despite the minimal acceptability of guarantees and the virtual non acceptability of life assurances, according to Millison Narh, Deputy Governor of the Central Bank of Ghana, Ghana embarked on reforms in lending through the creation of a collateral registry at Bank of Ghana in February 2010. Before the reform, the use of movable collateral under Ghana law was a key constraint for SMEs, as bank lending was largely based on real estate collateral, while SMEs typically do not possess real estate assets. After creating a new law 'Borrowers and Lenders Act, 2008, the registry was set up as a temporary solution, and is currently being updated into a web based electronic registry. This reform has culminated into some success. For example, there has been an increased volume of financing for SMEs: more than 20,000 loans have been registered by banks and NBFIs in the collateral registry since its creation in March 2012. These loans account for more than US\$800 million in financing secured with movable property.

Furthermore, there is wider use of movable assets as collateral by businesses and SME's beyond real estate. These types of collaterals include: inventory and accounts receivable (32% of the loans); household assets (13%); motor vehicles (10%); real estate property (10%); and machinery, equipment, all enterprise assets, other (16%). Wampah, (2013) in a speech delivered during the lunch of collateral registry in Ghana stated that by the end of March 2013, a total of 49,096 charges (secured loans) with 104,308 collaterals had been registered. Of these, 80.6 percent were movable assets, 13.3 percent were immovable assets and the rest consisted of both movable and immovable types. The establishment of the collateral registry and the credit reference bureau is expected to reduce information asymmetry in credit allocation in the banking sector, and in the long-run help lower the risks associated with increasing non-performing loans in the banks' portfolio and reduce the requirement of immovable assets as collaterals.

4. Conclusion

The results show that collateral is mostly requested both in the formal banks and non-bank institutions before a loan is given out. This is done to reduce the level of risk involved in lending. The responses also show that the collaterals accepted or requested for differs from each bank but are all in accordance with the policies that govern these daily businesses.

On whether banks accept guarantees and life assurance policies as collateral for loans, the researcher found out that most banks accept guarantees as collateral however this is of limited usage in these banks. In the case of the non-bank financial institutions, there is a very high rate of usage of guarantees and this is mainly because the customer base of these non banks are characterized by individuals and businesses without fixed assets collaterals mainly requested by the mainstream banks. The researcher also found out that most banks do not accept life assurance policies as collateral mainly because it is not included in the securitization policies of their banks. Non of the non-bank financial institutions used for this study had accepted life assurance policy as a security for loan. However, other movable assets such as inventory and accounts receivable, investments instruments such as shares, cash, bonds, deposit accounts, household assets and motor vehicles are gradually been accepted as collateral in Ghana. Insurance companies will need to market their life policies, emphasizing on the added advantage of its role as acceptable collateral for loans in Ghana. When this is done, it is expected that the life assurance market will develop, and it will ultimately lead to easy acceptability of these policies by the banks and non-bank financial institutions.

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