Working Paper

Credit Availability to Small and Medium Scale Enterprises in Nigeria: Importance of New Capital Base for Banks – Background and Issues

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Abstract

This Working Paper should not be reported as representing the views of the AIAE nor that of the BPS Project, Ebonyi State University or the Central Bank of Nigeria.
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The critical causes of the risk-averse behaviour of banks in funding Small and Medium Enterprises (SMEs) in Nigeria, monetary policy and financial stability implications of SMEs "Credit Crunch" were evaluated. This was done along the lines of inadequate capital base of the institutions in the sector vis-à-vis the effectiveness of Bankers Committees' Small and Medium Scale Industries Equity Investment Scheme (SMIEIS) Initiative. The work adopted a conceptual analytical framework that employs theoretical and statistical comparative cross-sectional data to analyze the SMIEIS Programme of Nigeria vis-à-vis capital base of banks in ascertaining whether it offers an effective means of solving the problem of funding small and medium scale businesses in Nigeria and its attendant implication for financial stability in the system. The analysis confirms that Government needs to urgently address the problem of financial intermediaries cum stability in the system as a national priority and build institutions that will drive the reform process. This incidentally is the major thrust of the Government's new economic blueprint. Banks could play more active role in actualizing the objectives of SMIEIS by re-capitalizing and setting up separate desks to manage the fund and vigorously conversing the idea such as any other bank product. Mega banks alone could provide the much needed funding for SMEs. This will mitigate the problem of weak asset-based and heavy collaterals. The macroeconomic environment should be stabilized through proper fiscal and monetary policy coordination to reduce interest rates, stabilize prices and reduce rent seeking behaviour among economic agents. This paper shows that capital matters for the response of bank lending to economic shocks and highlights the need for a sound, stable and efficient financial sector to assist SME's. This goes in tandem with a stabilization of the macroeconomic environment. Notwithstanding, it is difficult to draw what are the implications of this result with respect to the new directions of the capitalization to be implemented in 2005.

Introduction

For both developing and developed countries, small and medium scale firms play important roles in the process of industrialization and economic growth. Apart from increasing per capita income and output, SMEs create employment opportunities, enhance regional economic balance through industrial dispersal and generally promote effective resource utilization considered critical to engineering economic development and growth. However, the seminal role played by SMEs notwithstanding its development is everywhere constrained by inadequate funding and poor management. The unfavorable macro economic environment has also been identified as one of the major constraints which most times encourage financial institutions to be risk-averse in funding small and medium scale businesses. The reluctance on the part of financial institution to fund SMEs can be explained by the insufficient capital base of banks and information asymmetry that often exists between SMEs and lending institutions.

Financial systems, the world over, play fundamental roles in development and growth of the economy. The effectiveness and efficiency in performing these roles, particularly the intermediation between the surplus and deficit unit of the economy, depends largely on the level of development of the financial system. It is to ensure its soundness that the financial sector appears to be the most regulated and controlled by the government and its agencies. Generally, the stage of development and, thus, the efficiency of the system varies among countries and changes over time in the same country. The more developed and sophisticated financial systems tend to be associated with the mature economies, while under-developed financial systems feature in developing economies. As a process, the financial system adjusts to changes in the real economy just as the economy responds to developments in the financial sector. All over the world, size had become an important ingredient for success, the banking sector included. The last few years have witnessed the creation of banking groups through mergers and acquisitions. Re-capitalization of banks in Nigeria is intended among others to help mobilize domestic savings, deepening and broadening intermediation, improve allocation of resources and helping to mobilize foreign savings. These have attracted criticism from both the public and private sector. Some believe that this would lead to the collapse of most banks and the attendant unemployment would be grave for the economy; others believe that the capital base be structured in a way that would categorize banks as big and small players. There is also a view that the proposed policy is a welcome development

but if not well managed could send the wrong signals, as it could lead to a run on banks within the stipulated period, jeopardizing the three main functions of Banks: - Transforming short term liquid deposits held by households into illiquid liabilities issued by firms; Screening potential borrowers/Monitoring actual borrowers on behalf of depositors and Facilitating transactions between agents by providing payment service.

The Manufacturing (including Micro, Small and Medium Enterprises) sector is acknowledged to have huge potential for employment generation and wealth creation in any economy. Yet in Nigeria, the sector has stagnated and remains relatively small in terms of its contribution to GDP or to gainful employment. Activity mix in the sector is also quite limited – dominated by import dependent processes and factors. Although there is no reliable data, imprecise indicators show that capacity utilization in the sector has improved perceptibly in the period since 1999, but the sector is still faced with a number of constraints with lack of credit availability as the principal constraint. Credit is the largest element of risk in the books of most banks and failures in the management of credit risk, by weakening individual banks and in some cases the banking system as a whole, have contributed, to many episodes of financial instability. A greater understanding of the nature of credit risk, leading to improved measurement and management, would help to strengthen the international financial system vis-à-vis the small and medium enterprises in the long-run. An increasing amount of research on credit risk is being carried out within financial firms, central banks, regulators and universities.

Stiglitz and Weis (1981) observe that small and medium scale firms with opportunities to invest in positive net present value projects may be blocked from doing so because of adverse selection and moral hazard problems. Adverse selection problems arise when potential providers of external finance cannot readily verify whether the firms have access to quality projects. Nonetheless, the liquidity ratio of the financiers plays a major role. Moral hazard problems are associated with the possibility of SMEs diverting funds made available to them to fund alternative projects or develop the propensity to take excessive risks due to some pervasive incentive structure in the system.

On the other hand, because SMEs do not have access to public capital markets they naturally depend on banks for funding. Dependence on banks makes them even more vulnerable for the simple reason that shocks in the banking system can have significant impact on the supply

of credit to SMEs. Thus, SMEs are subject to funding problems in equilibrium and these problems are exacerbated during periods of financial instability.

Berger and Udell (2001) further note that shocks to the economic environment in which both banks and SMEs exist can significantly affect the willingness and capability of banks to lend to small and medium scale firms.

These shocks come in a variety of forms such as technological innovation, regulatory regime shifts, and shifts in competitive conditions and changes in the macroeconomic environment. Financial institutions respond to these shocks in a number of ways, one of which is to develop stringent lending rules that not only avail them of full information about the firm and the owner, but also ensure that their investment in such firms are guaranteed in both the short and the long-run.

In less developed countries where there is a dearth of information on the operations of SMEs, the situation degenerates into total risk-aversion by financial institutions in funding SMEs. Such risk-averse behaviour can ultimately affect the performance of monetary policy through the credit channel of policy transmission and perhaps snowball into financial instability in the system. In this paper we assess major Bank Lending rules and their impact on funding SME's and analyze two surveys in Nigeria, one by the World Bank and another by the Central Bank of Nigeria to explain the banks' risk-averse behaviour in lending to SMEs, as well as the implication of such risk-averse behaviour on financial stability via credit channel of monetary policy.

1.1 The Nigerian Situation

Since the attainment of independence in Nigeria, every known regime recognizes the importance of promoting SMES as the basis of economic growth. As a result, several micro-lending institutions were established to enhance the development of SMES. Such micro credit institutions include the Nigerian Bank for Commerce and Industry (NBCI), National Economic Reconstruction Fund (Nerfund), the People's Bank of Nigeria (PBN), the Community Banks (CB), and the Nigerian Export and Import Bank (NEXIM), and the liberalization of the banking sector. Howbeit, the banks in operation in the country are about 89 with more than 50% having capital base of less than US$10 million and about 3,300 branches. This compared to 8 banks in South Korea with about 4,500 branches or with one

bank in South Africa with larger assets than all the 89 banks shows that the banking system is very marginal relative to its potentials and in comparism with other countries.

Unfortunately, records indicate that the performance of SMES in Nigeria has not justified the establishment of this plethora of micro-credit institutions. Odedokun (1981) notes that in spite of the quantum of credit made available to the manufacturing sector; the contribution of the index of manufacturing to GDP was only 7 percent between 1970 and 1979.

In 2001, a study identified poor access to finance as the most critical constraint on small and medium scale enterprises in Nigeria. In fact, 50 percent of the surveyed enterprises received external finance while 79 percent indicated lack of financial resources as a major constraint (see Guardian, Nov, 26, 2001). The foregoing study confirms the risk-averse behaviour of banks in funding SMEs in Nigeria. This scenario naturally provokes some research questions such as:

- What are the critical causes of the risk-averse behaviour of banks in funding SMEs in Nigeria?
- Does lack of funding for SMEs by banks affect efficient monetary policy outcomes with implications for financial stability?

In 1999, the Bankers Committee at the initiative of the CBN developed an interventionist strategy called the Small and Medium Industries Equity Investment Scheme (SMIEIS). This scheme requires banks to set aside 10 percent of their profit before tax to fund SMEs in an equity participation framework.

The purpose of this paper is to analyze the results of this programme so far and to ascertain whether it offers an effective means of solving the problem of funding small and medium scale businesses in Nigeria, whether banks can play the intermediary role and the implications for the financial stability in the system.

Table 1 Ratio of loans to SME's by Commercial banks[4] {= N =' m}

Year	Loans to SME's	Banks Total Credit	% of Total Credit
1992	20,400	41,810.0	48.8
1993	15,462.9	48,056.0	32.2
1994	20,552.5	92,624.0	22.2
1995	32,374.5	141,146.0	22.9
1996	42,302.1	169,242.0	25.0
1997	40,844.3	240,782.0	17.0
1998	42, 260.7	272,895.5	13.6
1999	46,824.0	353,081.1	13.3
2000	44,542.3	508,302.2	8.8
2001	52,428.4	796,164.8	6.6
2002	82,368.8	954,628.8	8.6

Source: Central Bank of Nigeria Statistical Bulletin, Volume 13, December, 2002, P. 57.

Table 2 Ratio of loans to SME's by Merchant Banks[5] {= N =' m}

Year	Loans to SME's	Banks Total Credit	% of Total Credit
1992	3,493.9	11,188.8	31.2
1993	4,9000.0	25,189.8	19.5
1994	5,489.3	30,185.1	18.2
1995	9159.6	30,612.2	29.9
1996	5,595.8	41,139.5	13.6
1997	7,137.9	54,491.5	13
1998	7,800.8	60,290.6	12.9
1999	6,389.1	49,257.7	13.0
2000	51,001.1	565,871.7	9.0

Source: Central Bank of Nigeria Statistical Bulletin, Volume 12, December, 2002

The above tables depict the levels of commercial and merchant banks loans to small scale enterprises as percentage of total credit. Similar trends were observed for both banks. The analysis focus on commercial banks loans to entrepreneurs from 1992 to 2002. In 1992, the

[4] The abolition of mandatory bank's credit allocations of 20% of its total credit to small scale enterprises wholly owned by Nigerians took effect from October 1, 1996.

[5] Commercial and Merchant Banks' Figures have been combined from 2001 following the adoption of the Universal Banking Practice in Nigeria. Merchant banking activities was abolished in 2001.

loan was 48.8%. It declined to 22.9% in 1995, while it recorded a slight increase to 25% in 1996. Since then, it fell continuously to 8.6% in 2002.

Table 3 Contribution of SME's in Selected Asian Economies in percentage

Industrial characteristics	Malaysia (1985)	Singapore (1990)	Rep. of Korea (1991)	India (1994)
Contribution to total number of establishments	92.1	88	97	94
Contribution to total number of insurance establishment	49.4	40	63.5	31
Contribution to industrial production	46.7	26	44.5	40
Contribution to industrial value added	30	23	45.8	35

Source: Confederation of Asia pacific Chamber of Commerce and Industry – Journal of Commerce and Industry; Vol. II. 1998 pg 6-18

- Even though the above table shows experiences of some selected Asian countries in terms of contributions of SMEs to some industries in Asia, Nigeria data that describes these industries are not available. However, the contribution of the index of manufacturing to GDP has been low. The risk-averse behavior of banks in funding SMEs in Nigeria has constrained the contribution of this sub-sector to GDP.

2. Analytical Framework

The work adopted a conceptual analytical framework that employs theoretical and statistical comparative cross-sectional data to analyze the stated objectives. This approach is considered relevant because of the paucity of firm level data on the operations of small and medium scale firms in Nigeria. The hypothesis will be tested by theoretical analysis and intuitive analysis of the historical evidence on the performance of SMEs within the period under study. We will evaluate the SMIE programme by comparing the programme guidelines and

performance index and determine whether it has information on the solution to the problem of funding small and medium scale business in Nigeria.

2.1 Bank Rules and Evaluation of SMIEIS for External Funding

Generating an entrepreneurial idea is one thing but accessing the necessary finance to translate such ideas into reality is another. Many novel entrepreneurial ideas have been known to die simply because their originators could not fund them, and banks could not be convinced that they were worth investing in.

To fund a business idea, you have two major sources to access; internal and external finance. Internal finance is concerned with sourcing funds through personal savings, and those of friends and relatives. However, as the firm grows its financing requirements may go beyond personal savings.

The next source is external finance. External funding is based on merit according to the evaluation of financial institutions. There are two notable variants of external finance: debt financing and equity financing. Debt financing involves the procurement of interest bearing instruments such as loans, overdrafts, letters of credit and accounts receivable etc. They are secured by asset-based collateral and have term structures, that is, either short or long term. The equity component of external finance gives the financier the right of ownership in the business and as such may not require collateral since the equity participant will be part of the management of the business.

The critical problem in sourcing external finance is not just how to convince financial institutions that the project is worth investing in, but rather, can the banks play the required role? There are a number of models for evaluating the robustness of business ideas by financiers. The banking sector in Nigeria lopsided with 10 banks accounting for about 50% of the industry's total assets and liabilities. The small size of the sector leads to heavy fixed costs and operating expenses. This has grave implications for intermediation with small enterprises being the hardest hit. One of the recent developments in the banking system, which is of great concern to the monetary authorities is the significant dependence of many banks on government deposits, with the three tiers of government and parastatals accounting for over 20% of total deposit liabilities of deposit money banks. The summary of the foregoing is that the Nigerian banking system faces enormous challenges which if not

addressed would distort credit availability to small and medium enterprises, and ultimately snowball into financial crises for the system later in the future.

2.2 Feasibility Appraisal Model

The feasibility appraisal model is a risk-based, predetermined criterion that the business idea must be subjected to warrant commitment of external funding by investors.

Risk in this context is defined as the classification of the probability of an error resulting in a loss of the investment. The feasibility appraisal model provides both quantitative and qualitative methods of assessment. A quantitative technique deals with projections and other financial information while qualitative techniques consider other factors relevant to the success of the business that are not reflected in financial numbers.

The business environment and other socio-political considerations are critical to the success of the business.

An important role of banks is to design ways of providing loans to informationally opaque small business (Berger, Klapper, Udell 2001). However, a number of factors may affect the banking system's ability to provide credit to small borrowers in the future. There is evidence of bank consolidation across many countries of the world through mergers and acquisitions. These mega banks may be oriented towards transaction lending and providing capital markets services to large corporate clients. These institutions are also often head quartered at great distances from small business customers and may have difficulty processing locally based, and often less quantitative relationship information on small business.

Again bank financial distresses may also be an important determinant of credit availability during periods of 'credit crunch' and accompanying financial crises. However, there are very few small firms that will satisfy the rigorous condition set by the traditional feasibility appraisal model, which is often designed for both small and big firms. While some aspects of the criteria of the feasibility model are met by some small firms, others are not met at all, therefore for banks to lend to information opaque small firms, they need to develop lending rules that accommodate the peculiar characteristics both for the SMEs and their owners. Small scale lending rules of financial intermediaries can be categorized into four main distinct lending technologies. These are the Financial Statement Rule, the Asset-Based Rule, Credit Scoring, and Relationship Lending.[6] The adverse selection problems occur when

[6]The most notable cause of developing unique lending rules for SMEs is because of the problem posed by adverse selection and moral hazard.

banks cannot readily verify whether SMEs have access to qualitative projects, while moral hazards occur when SMEs divert funds for alternative projects (Stiglitz and Weiss 1981). Either of these problems can lead to either credit rationing or over lending (see de Meza and Webb 1987).

2.2.1 Financial Statement Rule

This lending rule places emphasis on evaluating information from the firm's financial statements. The decision to lend and terms of the contract are principally based on the strengths of the firm's balances sheet. Financial statement lending is best suited for relatively transparent firms with certified audited financial statements. Thus, it is likely to be the rule of choice for lending to large firms. But when adapting this rule for small firms, the firms must be ones with long histories, relatively transparent transactions and strong audited financial statements (Berger and Udell, 2001). Unfortunately, many small firms in Nigeria lack these qualities.

2.2.2 Asset-Based Lending Rule

The most apparently guaranteed form of lending to SMEs is asset-based lending. This lending technology bases its decision to lend on the quality of the available collateral. This type of lending requires constant monitoring of the business and this can prove to be expensive. The collateral in this case may be accounts receivable and inventory; this is why the bank has to intensively monitor the turnover of these assets. This is the most common lending rule for SMEs in Nigeria.

2.2.3 Credit-Scoring Rule[7]

This lending technology uses a summary statistic about the borrowers expected future loan performance (Feldman 1997, and Mester, 1997). In fact credit scoring assumes that credit analysis ultimately determines that the personal credit history of small business owners is highly predictive of the loan repayment prospects of the business (Berger, Frame and Miller, 2002). Rutherford (1994, 1995) observes that although credit scores have been used for sometime now in the U.S in underwriting consumers' loans, this lending approach has only been recently applied to small commercial credits which have been thought to have non-

[7]The personal information needed or used in credit scoring might include the owners' monthly income, outstanding debt, financial assets, employment tenure, home ownership and premium loan defaults or delinquencies (Mester 1997).

standardized documentation and to be too heterogeneous. The method for the use of credit scoring involves attaching heavy statistical weights to the financial conditions and history of the principal owner given that the credit worthiness of the owner and that of the firm are closely related for most small businesses (Feldman 1997, Mester 1997)

2.2.4 Relationship Lending Rule

In relationship lending, the lender bases its decision to lend in substantial part on propriety information about the firm and its owner through a variety of contacts over time. This information is obtained through the provision of loans (e.g. Peterson and Rajah 1994, Berger and Udell, 1995) and deposits and other financial products (e.g. Nakamura 1993, Cole 1998, Mester, Nakamura and Renault, 1998).

Additional information may also be gathered through other members of the local community, such as suppliers and customers, who may give specific information about the firm owner or general information about the business environment in which they operate. Importantly, the information gathered over time has significant value beyond the firms' financial statements, collateral and credit scores. This information helps the relationship lender deal with information opacity better than potential transaction based lenders. Empirical studies have proved that relationship lending affects the pricing and availability of credit (Cole 1998, Elsas and Krannen, 1998; di Salvo and Ferri, 1998). A stronger relationship measured in various ways is empirically associated with lower interest rates for the firms (Berger and Udell 1995, Harkoff and Koiting 1998). Berlin and Mester (1998) also report that relationship lending provides greater protection against the interest rate cycle.

However, relationship lending involves the role of agents in gathering information and this could add extra costs to the banks. There is still a gap in the empirical literature as to how to determine how relationship lending works and how the organizational structure of the banks aids their ability to deliver. It is also necessary to determine how recent changes in the economic environment are likely to affect the availability of credit to small businesses.

3. Nigerian Banks and the Problem of Financing SMEs

Countries all over the world, no matter the stage of their development recognize the importance of promoting small and medium scale firms as the engine of growth and industrialization. Past studies of SME development and their problems have concluded that

they suffer from identical weaknesses in developing countries. There are three major problems affecting the growth of SMEs: namely: inadequate access to finance; unfavourable macroeconomic environment and poor infrastructure facilities:

Banks in Nigeria are known to be highly liquid and report that they would like to make loans available to SMEs but they are put off by the very risky nature of SMEs in Nigeria. Because banks do not provide the required credit to SMEs, they rely on personal assets for working capital thus making it difficult to operate at full capacity and increase output and sales. The shortage of finance also limits investment to improve technology and to expand operations. The source of major risk according to banks in Nigeria are lack of information on the SMES true financial conditions and performance, the Judicial system is reportedly inefficient, banks cannot easily enforce contracts, the business environment is generally risk prone and uncertain and firms are not able to service debts. As a result of the foregoing banks resort to heavily asset- based lending rules.

3.1 Asset-Based Lending Rule: An Assessment

The predominant facility available to small and medium scale businesses in Nigeria is bank overdrafts, and short-term loans (asset-based loans).

Banks prefer overdrafts and short term loans for the simple reason that.

(i) They are easily rolled over

(ii) They attract almost market interest rates

(iii) They are fully collaterized

These points are clearly brought out by a summary of a survey of Nigerian firms' access to finance conducted by World Bank in 2001.

3.2 Summary and Analysis of A Survey of Nigerian Firms

The result of this survey confirms most a priori intuitions about the problems of sourcing external finance by Nigerian firms including small and medium scale firms and others. Our interest is on small and medium scale firms.

We shall discuss this survey in the light of the objectives of our study and see whether it throws light on the earlier stated hypothesis.

Table 4.1

Percentage of Firms Having Access To External Credit. Group Percentage Constrained

Full sample	Micro	Small	Medium	Large	Very large	Foreign owned	Indigenous
80.3	51.7	81.8	89.8	100.0	93.1	93.6	70.1

Source: World Bank Report 2001

Table 4.1 presents the percentage of firms that ordinarily have access to external funding. About 52% of the micro firms have access to external finance, while 82% of small and 89% of medium scale firms also have access. It is interesting to note that large firms have almost 100 percent access to external finance. We must note that having access to external finance does not translate into procuring the loan and the important point to note is that large firms that require large amounts of capital may crowd out smaller firms in the credit market.

Table 4.2

Percentage Of Firms Reporting Being Credit Constrained. Group Percentage Constrained

Full sample	Micro	Small	Medium	Large	Very large	Foreign owned	Indigenous
38.5	48.2	38.6	36.7	36.1	25.0	33.3	42.5

Source: World Bank Report 2001

In table 4.2 almost 50% of the micro, 39% and 37% of the small and medium scale firms sampled respectively, report being credit constrained, as opposed to 25% of the very large firms. This suggests that small and medium scale firms are discriminated against in the credit market. Another implication of this result is that the stringent conditions attached to loan availability may scare small firms away from applying for such facilities. Since most SMEs rely heavily on bank loans, this can frustrate their growth.

Table 4.3

Interest Rates on Over Drafts: Group Percentage Constrained

Full sample	Micro	Small	Medium	Large	Very large	Foreign owned	Indigenous
23.5	25.1	25.2	23.2	23.2	20.8	21.8	25.4

Source: World Bank Report 2001

Table 4.3 presents the percentage of firms that are constrained because of the interest rates charged on both overdrafts and short-term loans. 25.2% of the small business and 23.2% of medium scale businesses sampled complained of high interest charges and claimed that because of this they could not secure loans. This is against 20.8% of very large firms. This suggests that high interest charges do not constrain big businesses in Nigeria. Because short-term loans are usually rolled over, there is effectively little difference between them and overdrafts in terms of interest charges.

Another interesting point highlighted by the survey is that the average level of collateral for the firms in the sample was in excess of 151% of the value of the loan. This has serious implications for accessing external finance especially for the majority of Nigerian SMEs because of their weak asset base.

Table 4.4

Firms Receiving Long Term Loans Group Percentage Constrained

Full sample	Micro	Small	Medium	Large	Very large	Foreign owned	Indigenous
15.6	12.1	11.4	20.4	20.5	10.3	21.3	11.3

Source: World Bank, Report 2001(Nigeria) Business Day 05/09/2001

The above confirms that Nigerian Banks do not provide long-term loans to SMEs. Banks prefer to give short terms loans in the form of overdrafts where they charge market interest rates on the amount they borrow.

For instance, 20.4% of medium scale firms sampled reported being constrained in receiving long-term loans as against 10.3% of very large firms.
Short-term facilities accompanied by high interest rates and high collateral can hardly aid the growth of small and medium enterprises. They cannot make long term plans because of the shortness of the facilities available to them.

The lack of long-term credit facilities forces small and medium scale businesses to finance investment with internal finance, which is highly unsustainable. SME's are often forced to delay investment until they have built up the necessary capital. Some managers of SMEs reported that since they had to rely on short-term funds, they were hesitant to under take major investments because they could not be certain that they would have the funds to complete them. This might engender cost overruns and the eventual collapse of the projects.

4. A Review of the CBN Interim Report on the Small and Medium Scale Industries Equity Investment Scheme (SMIEIS)

The SMIEIS programme is a voluntary initiative of the bankers committee aimed at mitigating the problems of the risk-averse behaviour of banks in funding SMEs in Nigeria (Guardian, Mon., Nov. 26, 2001). The principal objectives of the programme are to jump-start the economy and to create more employment opportunities for the unemployed. It is designed to bridge the funding gap created by the failure of micro credit institutions and conventional banks to adequately fund SMEs. The bankers committee approved the proposal that 10% of banks' before tax profit be channeled into equity investments in small-scale industries (SMIEIS). The CBN established the Small and Medium Scale Industries Office in its development finance department to handle the implementation of the scheme.

4.1 Modalities of the SMIEIS Programme

Funds invested by participating banks are to be in the form of equity investments in eligible industries under the scheme. Equity investment should be in the form of cash injections and/or the conversion of existing debts owed to a participating bank. A participating industry may obtain more loans from banks in addition to equity investment under the scheme.

4.2 SMIEIS: So Far, So What?

An interim report released by the CBN contains the following facts: a total of N12.37b have so far been set aside by 79 banks since the inception of the programme in 2001. Only N0.73b has been invested in 36 projects by 36 banks representing a paltry 14% of the total available sum. The spread of the projects is lopsided in favour of Lagos, with over 90% of the total projects so far executed in Lagos alone. One each, in Cross-River, Anambra, Delta and Oyo States. 75% of the projects executed are in the service sector alone.

4.3 Evaluation

In as much as the programme is designed to encourage SMEs to bridge the funding gap that has been established previously, the SMIEIS programme report shows that both banks and owners of SMEs are still not taking full advantage of the programme. Utilization of only 14% of the total sum set aside is on the low side. Secondly, concentrating the programme in Lagos indicates that the programme is facing the lack of the basic infrastructure necessary to spread to other States. Recall that the working document provides that 60% should go to the core real sector manufacturing firms, 30% to services and 10% to micro enterprises such as NGOs. 75% of the executed projects so far are in the service sector alone and this implies that banks are still averse to funding projects in the real sector. An important question to ask is why in spite of all the incentives and a much more open system of banks funding of SMEs, the programme is still not enthusiastically welcomed, both by the banks and the owners of SMEs. The answers may not be far from the causes of the risk-averse attitudes of banks to finance SMEs in Nigeria that still persists.

5. Causes of Banks' Risk-Averse Behaviour to Financing SMIEs in Nigeria

The World Bank survey on access to finance of Nigerian firms has demonstrated that most banks are reluctant to provide long term credit to small and medium scale industries in Nigeria. It is also obvious from the survey that even when banks extend short-term credit to small and medium scale firms it is often based on high collateral requirements and the facilities do not go beyond a one-year term.

This behaviour is akin to risk aversion. A bank is risk-averse when it considers the expected value of returns on an investment as being less than the expected utility of the investment outlay. In other words, it is better not to invest and keep the money to earn interest since the

interest payment on the asset is more certain than the expected return from investing in small and medium scale industries. This is encouraged by the high inter-bank rates and other high premium existing in the Nigerian financial sector. The obvious consequences of this risk-averse behaviour is that SMEs which rely on bank loans cannot plan on a long term basis thereby constraining growth plans and long term investment decisions. A number of reasons have been advanced to explain this risk-averse behaviour by banks. For the purposes of this discussion; we shall categorise these causes under three broad headings:

(i) A poor macroeconomic environment

(ii) Lack of basic infrastructure facilities.

(iii) Internal management problems of SMEs

The Nigerian macroeconomic environment is known to be unstable. The most notable shocks are that of high interest rates, exchange rate disparity, unavailability, and dominance of the government sector in the economy. E.g. deficit financing and budgetary distortions etc

- **Interest Rates:** High interest rates are not favourable to investors in the sense that the cost of funds could undermine profits, and cause a loss of the investment. Interest rates in Nigeria officially are as high as 23.6 % and this has a negative impact on the ability of small and medium scale industries to obtain credit from the banks. The situation is even more disturbing when considering the situation in the manufacturing sub-sector. The banks consider lending to the manufacturing sector as high risk, therefore the banks lend to firms in the manufacturing sub-sector on differential rates. At times, the interest rate goes as high as 36% or more. Evidence abounds to prove that big firms are given even lower interest rates (see the World Bank Survey; 2001). It has also been noticed that most of the big manufacturing firms are subsidiaries of the multinational companies, while the SMEs are mainly owned by Nigerians. In spite of the fact that the SMEs in the manufacturing sub-sector are greater in number and provide over 50% of the employment, the big firms, aided by banks, crowd them out of the credit market.
- **Exchange Rates:** Managing exchange rates in Nigeria has proved a very challenging task to many regimes. Before 1995, the Exchange Control Act of 1962, which essentially prohibited the sale and purchase of foreign currency, mainly featured a fixed exchange rate regime. The policy was aimed at controlling imports and the incidence of high tariffs (Sogunle, 2002). A partial liberalization of the exchange rate commenced in 1986, with the addition of SFEM. While exchange rate management under the Exchange Control Act of 1962 was reserved for official government business, the Second-tier Foreign Exchange Market was used for other commercial transactions. The disparities in the management of FOREX introduced distortions in its role in sustaining the business environment. While the FOREX (IFEM) market went as high as N126, per dollar, the government official rate was still N22 to the dollar this situation made it difficult for businesses to secure FOREX because of round tripping and instability in the price of foreign exchange. The excessive monetization of the petro-dollar has also

led to surplus money supply. This affected the ability of small and medium scale industries to procure raw materials from abroad and equally constrains the availability of trade credits for SMEs by banks.

- **Inconsistency in Government Industrial Policies:** Njoku (2002) identifies inconsistencies in government policies as a major problem affecting the growth of small and medium scale industries. The inability of the government to execute budgets on time is a major restriction on the ability of manufacturing firms to factor tariff measures into their trade decisions. The second policy inconsistency is the sudden reversal of the backward interaction policy that required firms to source their raw materials locally. Now, all the raw materials such as cotton and malt are allowed into projects.
- **Lack of Infrastructural facilities:** Many banks blame their inability to fund SMEs on the poor economic climate prevalent in the country, citing for instance the low performance of public utilities as one of the factors threatening fund managers (Olanrewaju, 2001). However, Chris Onalo of the CMC international bank rejects the banks' complaint over poor infrastructure pointing out that the huge profit being declared in recent times by banks were clear indications that the operating environment was not as bad as they claim. But Anyaoku (2002) wonders why small and medium scale firms have to provide water, electricity, roads and even security required for them to operate. In no other countries do SMEs provide such services and still grow, he contends. The point is that the state of infrastructure in Nigeria is unacceptable. Electricity generation is unstable and inadequate; new roads are neither constructed nor old roads maintained; water supply is not sustainable etc. For banks to extend credit to SMEs, all these factors must be considered. At the end, it is realized that the cost of doing business is so high that the ability of the banks to recoup their investment is uncertain.
- **Internal Problems of SMEs:** Apart from the external problems that hamper the growth of SME's, there is an also serious internal problem that greatly constrains their growth and serves as a deterrent for banks to lend. These problems include:
- **Poor Management Practices:** Most SMEs do not have good management structures. Often the firms are owned by a family and this engenders poor internal control systems. Also because of poor management of the firms there is an obvious lack of a proper keeping of financial records. There is also a lack of technical and economic counseling since such businesses rarely engage the service of qualified consultants
- **High Rate of Business Failure:** Because most small and medium businesses do not have access to the amount of external finance they require for their business, their capital base is often weak. A weak capital base cannot absorb a major shock to the business and this could lead to the failure of the business. Information about their businesses is kept as business secrets. They are reluctant to divulge these secrets for fear of being competed out of the market. The failure of SMEs can also derive from susceptibility to sudden policy changes. When a particular government policy is suddenly changed, the effect on SMEs could be devastating
- **Poor Accounting Standards:** There is an incidence of poor accounting standards within the SMEs. Simple records of financial transactions are not kept and this creates loopholes for fraud. Improper records of business transactions certainly limit accessibility to institutional credit.

- **Shortage of Skilled Manpower:** The inadequacy of financial resources to recruit skilled manpower naturally restrains expansion and limits productivity and growth. Many SME's employ semi skilled or unskilled labour. This is of course hinders competitiveness.
- **Financial Indiscipline:** The problem of financial indiscipline has been highlighted as the major cause of the inability of the SMEs to access funds from the banks. Firms are most likely to divert funds meant for the business in funding other projects. This naturally will impact on the survivability of the business and equally compromise the ability of the firm to pay back a loan.

6. Banks Risk- averse Behaviour to Financing SMEs : Implications for Financial Stability

Our analysis of the access to credit market for small and medium scale businesses in Nigeria has established two important facts: (i) macroeconomic instability and uncertainty in the business environment has forced banks to lend short to SMEs; (ii) such overdrafts and short term loans are made available at high interest rates of over 26% and they are also heavily collaterised. In a situation in which SMEs are mainly dependent on bank loans, this situation could be dangerous. The implication is that many SMEs do not have access to bank loans with grave implications for their growth and development.

Crocket (1997) defines a situation of financial instability as one in which the failure of one institution causes wide spread damage to the entire economy. Evidence abounds that the Nigerian financial system has undergone crises that have produced distress in the banking sector. One major potential implication for bank distress is a contagious loss of confidence in the banking system and the impact on the economy of contractions in the money supply and credit (See Raufman 1985, Benson et al 1986).

An important economic theory of bank distress is the inferior management theory, which explains that banks fail due to incompetence in management. Incompetence refers to the inability of the management to accurately assess the expected return and risk of bank assets. In general, incompetent managers select inefficient portfolios for the bank with dire consequences for the survival of such financial institutions. Over concentration on funding big businesses without diversification in banks' portfolios could lead to distress.

The second theory for bank problems is the moral hazard theory, which explains that bank failures occur because competent managers respond to financial incentives by taking excessive risks. This hypothesis blames structural imbalances, inappropriate economic policies, and regulatory and supervisory policies for creating some perverse incentives for

banks to undertake excessive risks. In the past five years or so, a number of factors have combined to force banks to develop some risk-aversive behaviour as a means of hedging against failure. These factors induced increased surveillance by the regulatory institutions (CBN and NDIC), an unstable macroeconomic environment and stringent safety nets to avoid mismanagement and subsequent distress.
Unfortunately, the cautious behaviour of banks especially in extending loans to needy and important sectors like SMEs is impacting not only on the growth of output and GDP, but also on the effectiveness of monetary policy.

A combination of capital requirement constraints and bank reserve constraints which is often the case in Nigeria may impact on the extent that monetary policy is transmitted through the credit channel (Peek and Rosengren 1995). Berger and Udell (2001) observe that under the credit channel of monetary policy transmission, a monetary tightening reduces bank reserves which force banks to contract their lending. This contraction may have particularly strong effects on small businesses that rely on relationship lending and do not have access to public capital markets or other sources of external finance. Kashyap and Stein (1997) report that tight monetary policy reduces bank lending and lowers the growth and investment of small businesses (also see Gertler and Gilchrist 1994). Under the second credit channel – the balance sheet channel- a monetary tightening raises interest rates, depressing the financial rates on the balance sheets of potential borrowers, reducing the value of their collateral and/or reducing their credit scores. In turn this deterioration in credit worthiness may make it more difficult for small business borrowers who rely on transaction-based lending such as Nigerian SMEs to access credit. Empirical evidence also supports the balance sheet channel as affecting the condition of small businesses (see Bernenke, Gertler and Gilchrist, 1996).

Since 1986, when the Nigerian financial system was deregulated, and the monetary policy approach changed from an indirect to a direct or market-based approach, which relies on the monetary authorities to influence the credit operations of banks through the control of bank reserves, has not yielded any meaningful progress either in reducing inter-bank rates or ensuring a more stable foreign exchange market. It has been noticed that the spate of distresses that rocked the Nigerian financial system in the mid 1990s were preceded by spiraling inter-bank rates and uncontrolled liquidity surges in the financial sub-sector (Ezema, 1998)

Our argument therefore is that if a monetary policy stance that induces the reduction of bank credit, distorts the credit channel of monetary policy transmission and eventually does not achieve a reduction in interest rates, in an unstable macroeconomic environment could send wrong signals to financial institutions. This could induce a credit crunch and stifle the growth of SMEs, which would reduce output growth and ultimately return the entire economy to a regime of instability, including the financial system.

7. Models of Funding SMEs from other Countries

- **INDIAN MODEL***:* The basic principle guiding the funding of SMEs in India is that the government regards small business as the 'eggs' that hatch big businesses. Apart from adequate incentives, the government supports SMEs by bulk purchasing their products and retailing them both for the domestic market and for exports. To facilitate their access to bank credits, the government issues SMES LPOS. Banks accept such contract papers as collateral. When small business bid for Government contracts with small ones, big businesses must bid 15% less than small businesses for them to supply government needs. Payments are promptly made to the SMEs and this encourages their growth.

- **BANGLADESH-THE GRAMEN MODEL**: Prof Yunus Mohammed developed the GRAMEN MODEL. In this model, banks target potential borrowers for its core operations and form them into groups. Then soft loans are made available to these SMES, repayable within a specific period before others in that strategic group can benefit from the scheme. With this system there is a subtle pressure from other SMES that are members of this strategic core on the benefiting group to repay so that others can benefit from the scheme. This has introduced healthy capitalization among SMES in Bangladesh through factoring the credibility of the borrowers.

- **THE BRAZILIAN MODEL**:The main thrust of the Brazilian model is that apart from heavy funding and subsidies, the Government provides infrastructure in an area and encourages the cluster of industries in such areas. The SINOS VALLEY shoe cluster industries in Brazil have revolutionized the Brazilian shoe industry. For the past 30 years, over 500 SMEs that produce shoes are located there. Today Brazil is the worlds third largest shoe exporter.

8. Summary and Recommendations

This work sheds light on the causes of banks risk- averse behaviour in lending to SMEs in Nigeria. We reviewed a survey by the World Bank on access to credit from Nigerian banks. The results of the survey confirmed that small and medium scale firms are discriminated against in the provision of medium to long-term loan facilities.

The Bankers Committee introduced the small and medium scale industries equity participation programme (SMIEIS) designed to solve the problem of funding SMEs in Nigeria. We reviewed the interim report on this programme by CBN. Based on the analysis of the two reports, we identified a number of causes of banks' risk-averse behaviour to lending to SMES. Apart from external factors hinging around inadequate capital base of banks, there are the internal problems of the SMEs responsible for banks attitude towards funding them. We analyzed the monetary policy implications of these problems and concluded that it has a potential to induce economic and financial instability. There is no way Nigeria can achieve sustainable funding of SMEs unless both the external and internal problems of SMEs are solved. Banks react to the stimulus of the macroeconomic environment, and as long as the environment remains unconducive, banks will continue to exhibit risk-averse behaviour irrespective of the programmes put in place to address this problem, including the SMIEIs Programme. Also, strengthening the legal and institutional framework for the operation of microfinance institutions that includes, streamlining of the operational guidelines and tax incentives for SME's would be of benefit. This will include explicit recognition of the informal sector and the resolution of the constraints to implementation of the SMIEIs and design of special incentives targeted at investors who would wholly specialize in exporting to foreign markets.

Bank capitalization may also influence the way lending supply reacts to output shocks. Bank capitalization, that is bank wealth, is linked to risk taking behavior and then to banks' portfolio choices; this means that lending of banks with different degrees of capitalization (or risk aversion) may react differently to economic downturns. While a wide stream of literature on financial intermediation has analyzed the relation between bank capitalization and risk taking behavior, the nature of this link is still quite controversial. Capitalization also influences the way banks react to GDP shocks. Again, the credit supply of well-capitalized banks is less pro-cyclical. This indicates that well capitalized banks are not risk-averse and, as their borrowers are less risky, suffer less from economic downturns via loan losses. Moreover, well-capitalized banks can better absorb temporarily financial difficulties on the part of their borrowers and preserve long term lending relationships.

The government needs to urgently address the problem of infrastructural development as a national priority. In order to turn-around the dwindling fortunes of the manufacturing (SMEs in particular) sector, government's focus in this sector would be the removal of infrastructural

constraints on SMEs and expedite action on establishment of the clusters and industrial parks. These critical ingredients to increasing the participation of the private sector will be targeted at "growth poles", with banks taking the center stage. Mega banks adequate – *'capital base'* should play a more active role in actualizing the objectives of SMIEIs by setting up separate desks to manage the fund and vigorously pursuing the idea as with any other bank product and undertaking studies aimed at attracting foreign investors, scanning, overseas markets and monitoring developments that have implications for the sector. The banks should adopt relationship lending as a dominant bank rule in funding SMEs. This will mitigate the problem of weak asset-based collateral. The macroeconomic environment should be stabilized through proper fiscal and monetary policy coordination to reduce interest rates, stabilize prices and reduce rent seeking behaviour among economic agents especially among banks.

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