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Are Deposit Money Banks' Credit to SMEs Enough to Stimulate Economic Growth in Nigeria? Issues for Legislative Consideration.

Augustine Osigwe, Phd
Chukwuemeka Onyimadu

Executive Summary

Small and Medium Enterprises (SMEs) contribute positively to economic growth through their positive effects on most socio-economic indices. Against this backdrop, this sector analysis examines whether Deposit Money Banks credit to the SMEs is enough to stimulate economic growth in Nigeria. Analysis of data shows that although loans to the private sector consistently increased from 2010 to 2016, the fraction of these loans that went to SMEs declined drastically, standing at 0.07% as at 2016. Also, with correlation statistics of – 0.13, we found that higher interest rates are associated with lower growth rates of loans to SMEs. This finding corroborate the huge problem of access to finance by SMEs. A review of cross country experience towards promoting SMEs access to finance presents credit models that Nigeria can tap into. In India, we learned that credit ratings for SMEs subsidized by the Government boost their access to funding whereas in Indonesia we discovered that in 2012, a legislation was passed requiring banks to increase the proportion of their loans advanced to SMEs to 20% by 2018. On the basis of our findings, a number of punchy recommendations that will aid the National Assembly consider how to boost credit to the SMEs so as to stimulate economic growth in Nigeria are presented.

I. Overview

1. It has been widely argued that Small and Medium Enterprises (SMEs) contribute positively to economic growth of most countries through their positive effects on socio-economic indices. In resolving the problems of poverty and unemployment in most developing countries Small and medium scale enterprises (SMEs) have proved to be a major intervention (Aremu and Adeyemi, 2011). Regrettably, in Nigeria, unemployment and poverty have remained high, despite efforts by the relevant institutions to boost credit availability to the SMEs. Despite recent improvement in the ease of doing business, financing constraints is still a major problem facing most SMEs in

Nigeria. Over time government and other bodies have taken the challenge to support SMEs through various interventions, bilateral arrangements and establishment of various institutions and programmes. These includes the Nigerian Industrial Development Bank (1962), small scale Industries credit scheme (1971), the Nigerian Bank for Commerce and Industry (1973), Small and Medium Enterprises Equity Investment Scheme (1999) and the Bank of Industry (2001). From 2002, the Central Bank of Nigeria intervened by establishing several schemes including the Refinancing and Rediscounting facility, 200 Billion Naira Restructuring/Refinancing Scheme, 200 Billion Naira commercial Agriculture credit scheme (2009), Nigerian incentive based Risk sharing system for Agriculture lending (2011), Micro, Small and Medium Enterprises Development Fund (2013), Anchor Borrowers' Programme (2015), Youth Entrepreneurship Development Programme (2016), among others.

II. Analysis of relevant data

2. The shortage of finance occupies a very central position regarding the underperformance of SMEs. Globally, commercial banks which remain the biggest source of funds to SMEs have in most cases, shielded away because of the perceived risks and uncertainties. In Nigeria, the fragile economic environment and absence of requisite infrastructure has rendered SME practice costly and inefficient, thereby worsening their credit competitiveness.

Table 1: Loans to SMEs, Total Loans by DMBs and Selected Macroeconomic Variables.

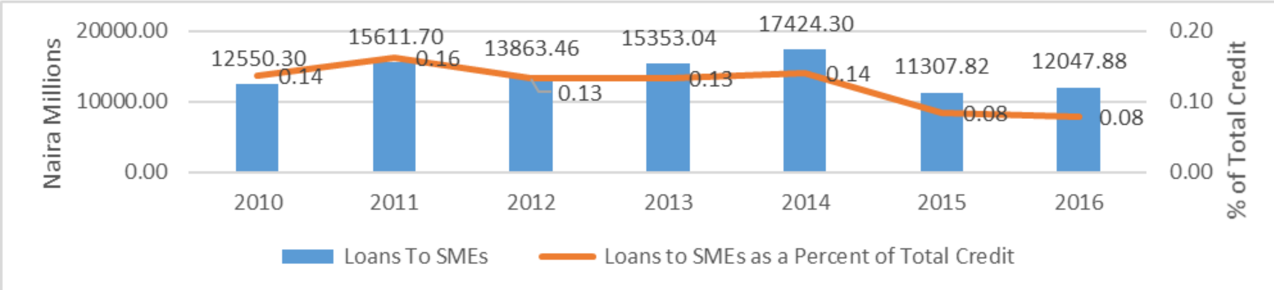
Period	Loan To SMEs	Credit to Private Sector	% Growth Rate of Loans to SMEs	Loans to SME as a Percent of Total Credit	interest rates	Unemployment Rate	% GDP growth
2010	12550.3	9198173	-23.31	0.13	22.50	5.1	7.8
2011	15611.7	9614446	24.39	0.16	22.41	6	4.9
2012	13863.46	10440956	-11.19	0.13	23.78	10.6	4.3
2013	15353.04	11543650	10.74	0.13	24.69	10	5.4
2014	17424.3	12511672	13.49	0.14	25.74	7.8	6.3
2015	11307.82	13568878	-35.10	0.08	26.70	9	2.7
2016	12047.88	15628551	6.54	0.07	27.29	13.4	-1.5

Source: CBN Statistical Bulletin 2016.

3. Available information showed that credit delivery to SMEs from 2010 to 2016 has been marginal at best. This can be clearly seen when considering the fraction of SMEs loans to total credit to the private sector and the growth rate of loans to SMEs. Though loans to the private sector consistently increased from 2010 to 2016, the fraction of these loans that went to SMEs declined drastically, standing at 0.07% as at 2016 (Figure 1). This lends credence to the conclusion that there still exists structural limitations on the

ability of SMEs to access loans and credit[1].

Figure 1: Loans to SMEs as a Percentage of Total Credits by Deposit Money Banks



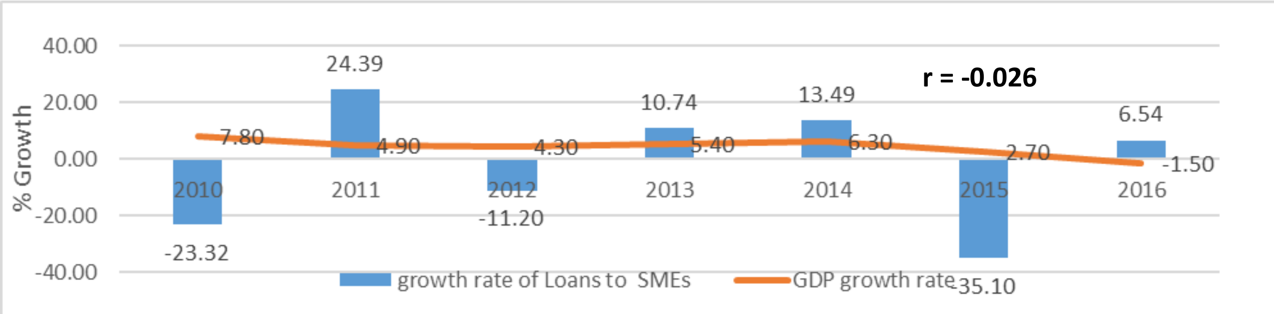
Source: CBN Statistical Bulletin, 2016

4. To further buttress the inadequacy of the current levels of loans to SMEs, we compared the trends in growth rates of loans to SMEs with some macroeconomic indices – Interest rates, unemployment and GDP. In performing the comparative trend analysis, a simple liner correlation statistic ***(r)*** is used. The correlation statistic if positive, shows that increases (decreases) in one variable is associated with increases (decreases) in another variable and negative if, increases (decreases) in one variable is associated with decreases (increases) in another variable.

5. First, GDP growth rates and Growth rates of loans to SMEs are compared. The correlation statistics of – 0.026 indicates that higher GDP growth rates are associated with lower growth rates of loans to SMEs (Figure 2). This is counter intuitive, as it is expected that higher growth rates should encourage commercial banks to lend more to the SMEs Subsector. However, the data shows this is not so. This is a clear indication that Nigeria has not begun to take advantage of its SMEs in boosting economic growth. This trend has to be reversed for Nigeria to be placed on a better growth trajectory.

[1] http://eprints.covenantuniversity.edu.ng/6928/1/SMEs_financing_and_its_effects_on_Nigerian_economic_grow.pdf

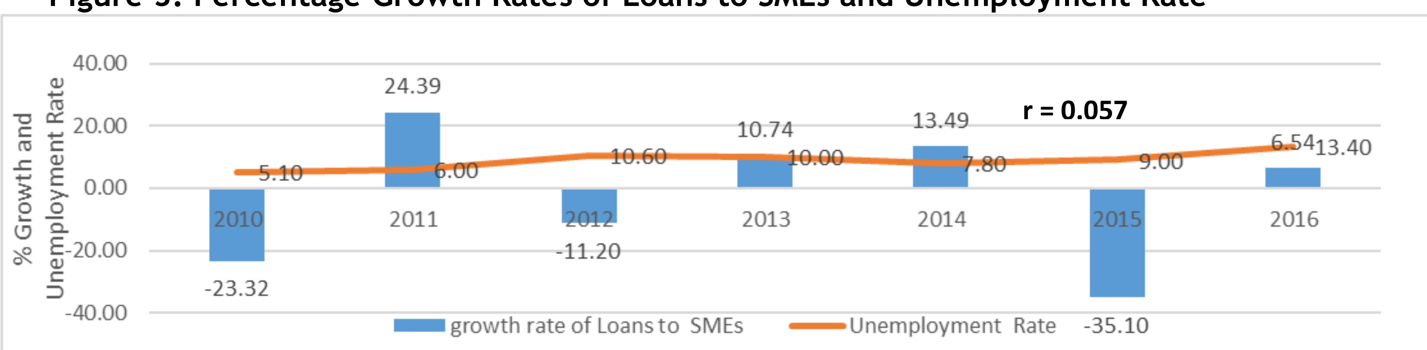
Figure 2: Percentage Growth Rates of Loans to SMEs and GDP Growth



Source: CBN Statistical Bulletin, 2016

6. Second, we compared the trend of unemployment rates with growth rates of loans to SMEs. The correlation statistics of 0.057 indicates that higher unemployment rates are associated with higher growth rates of loans to SMEs (Figure 3). This trend association is also counter intuitive. As already stated, the role of SMEs, especially for a developing economy like Nigeria, involves creating employment. Thus, if SMEs have access to finance, these SMEs will naturally expand their production and output, which will reduce unemployment. However, from the data, it is clear SMEs in Nigeria have not been able to live up to the role of job creation. The positive correlation results indicate that, when loans to SMEs increase, unemployment increases too. A possible explanation for this counter intuitive scenario, is that loans to SMEs may have been round tripped for other purposes or even when they eventually get to SMEs they may not be effectively utilized in expanding production capacity.

Figure 3: Percentage Growth Rates of Loans to SMEs and Unemployment Rate

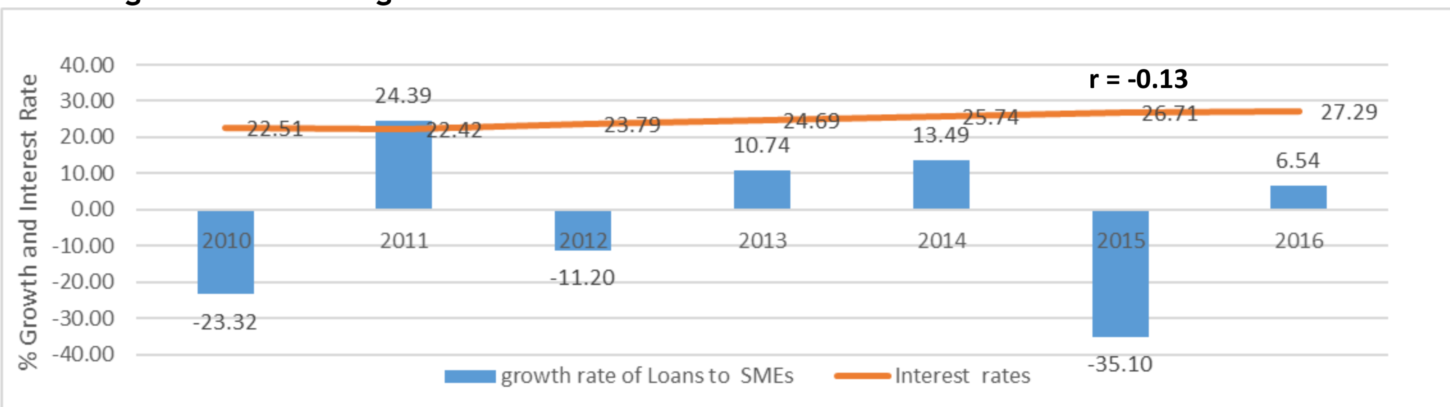


Source: CBN Statistical Bulletin, 2016

7. Third, we compared the trends of growth rates of loans to SMEs and the maximum interest rates by Deposit Money Banks (DMBs). The correlation statistics of – 0.13 indicates that higher interest rates are associated with

lower growth rates of loans to SMEs (Figure 4). This finding from the data, buttresses the problem of access to finance by SMEs. The data shows that, as long as interest rates remain very high, it will increase the cost of loans to SMEs, thereby reducing the incentive for further borrowing. As long as this high cost of borrowing persist, DMBs are faced with the incentive to borrow available funds to other sectors where they can make huge profits at less risk of default. Thus, DMBs would rather pay a fine (payment of fine arises when DMBs do not meet the CBN specified loan amount for SMEs) than to give loans to SMEs at a low profit level and high risk of default.

Figure 4: Percentage Growth Rates of Loans to SMEs and interest rate



Source: CBN Statistical Bulletin, 2016

III. Issues

8. Although banks recognize small businesses as an important revenue source through credit facilities, they remain wary of this business group due to the difficulty of assessing and managing the risks associated with credit. This has translated to very stringent screening measures and requirements by the banks when considering credit/loans for such businesses. This act does not only scare young entrepreneurs/investors away, but also reduces the capacity of the government to generate huge revenue needed to transform Nigeria.
9. The World Bank Enterprise Surveys in 2013 discovered that financial institutions often demand for immovable assets like land/buildings from small businesses as collaterals 73 percent of the time, whereas, 78 percent of the capital assets owned by these businesses are vehicles, machinery, equipment and account receivables, which can also be used as movable collaterals.

IV. Cross country experience towards promoting SMEs access to finance

This section highlights SMEs development policies/strategies that have been implemented in Indonesia and India. These countries are among the best experience regards SMEs funding.

Indonesia

10. In Indonesia, micro enterprises are largely rampant in the agriculture sector while the small firms are found in the trade and agriculture sector. The Manufacturing companies account for a significant share of the medium enterprises. The Ministry of Cooperatives & SMEs is empowered with the responsibility of formulating policies and ensuring coordination among SMEs and Cooperatives. The Ministry also oversees the implementation of SMEs policies, along with monitoring and evaluating their performances.

11. ***Access to Funding***
Government (through the Bank Indonesia) is focused on implementing legislation aimed at improving SMEs accessibility to funding. In 2001, Indonesian banks were allowed to set self-determined targets for SME financing and report same to the apex bank. However, in 2012, this was amended following the issuance of Regulation No.14/22/PBI by the Bank Indonesia. The regulation requires banks to increase the proportion of their loans advanced to SMEs to 20% by 2018. This increase is phased as; 5% in 2015, 10% in 2016; 15% in 2017 and 20% in 2018.

12. The regulation encourages banks to direct an increasing share of funds to the SMEs and increase the number of training extended to SMEs. Under regulation, banks can either disburse loans directly to SMEs or through clusters. Failure to meet specified target would imply that the banks will have to allocate funds in providing relevant training for SMEs. Bank Indonesia also provides technical assistance to SMEs to increase capacity such as training, research and provision of information. Bank Indonesia segregated SMEs into four major groups to properly determine the appropriate type of financial assistance to offer to them (Table 2).

Group	Financing type
SMEs that are not feasible and not bankable	Soft loans as part of corporate social responsibility
SMEs that are not feasible but bankable	Subsidised interest rate credit program
SMEs that are feasible but not bankable	The Indonesian Government offers guaranteed credit program of 80% while the remaining 20% will be borne by the banks
SMEs that are bankable and feasible	Commercial loans

Table 2: MSME grouping and type of financing model
Source: Bank Indonesia

13. **Lessons from Indonesia**
    - Through regulation, banks are encouraged to offer trainings to SMEs.
    - In 2012 Indonesia legislated that banks should increase the proportion of their loans advanced to SMEs to 20% by 2018.
    - Soft loans are given as part of corporate social responsibility.
    - Subsidised interest rate credit program.

14. **India**
    The Indian Government has sought to drive the development of MSMEs through infrastructure development, relevant training programs, among others. MSME development policies have been driven by both municipals and federal governments. For instance, in the state of Andra Pradesh, a policy that stipulates that new MSMEs would be given a 100% exemption on VAT, Central Sales Tax (CST), Goods and Services Tax (SGST) for five years from the date of commercial production was implemented. This policy is also inclusive of uninterrupted power supply. However, in the event that MSMEs incur power generating expenses, the charge is reimbursable at Rs 1 per unit for 5 years from beginning of commercial production. In addition, the new policy also allows for a 15% investment subsidy on fixed capital investment up to Rs. 20 lakhs for MSMEs and interest subsidy for fixed capital investment by new MSMEs on term loans.

15. Further, the Government of India has taken active policy steps to develop selected sectors. This includes the removal of production quota in the textile sector and the deregulation of the financial sector. Indian banks have been allowed to set the targets for funding SMEs and are required to achieve a 20% year-on-year growth in credit to micro and small enterprises and a 10% annual growth in the number of micro enterprise accounts which has improved the ability of SMEs to access much needed funds. The India Government, has adopted a number of policies to support the development of SMEs. Among these policies is the credit ratings initiative.

16. Implementation of Credit Ratings for SMEs in India
    Government of India has supported the funding of SMEs through the implementation of credit ratings. Credit rating for SMEs was adopted in India as a means of addressing several challenges confronting SMEs and financial Institutions with regards to access to funding. These challenges include the absence of effective management tools in most SMEs, lack of knowledge of banking guidelines for accessing commercial loans, ineffective mechanisms to measure credit worthiness of SMEs, among others.

17. Prior to the adoption of credit ratings for SMEs in 2004, SMEs could rarely access funds from formal sources. Access to funding from formal sources stood as low as 11%, but has increased to about 34%. Credit rating simplifies decision making for lenders by

providing information on the creditworthiness of SMEs. The Government has also incentivised SMEs by restricting certain contracts for firms that have undertaken credit ratings. In addition, the Government would require SMEs to undertake credit ratings before the loan is disbursed to them as it serves as a credible measure for evaluating internal risks.

18. Credit rating services for SMEs are conducted by SME Rating Agency (SMERA) and selected rating agencies in India. SMERA is a public-private partnership between government/private/multinational corporations/lenders and banks committed to the SME sector such as the Small Industries Development Bank of India. SMERA has entered into MOUs with 29 banks and financial institutions to incentivise SMEs by providing commercial benefits to highly rated SMERA units. SMERA commenced rating SMEs in 2004 and had completed about 40,000 SME ratings as at the end of Q3 2014.

19. Credit ratings for SMEs are subsidized by the Government. The Ministry of Finance allocates funds to the National Small Industry Corporation which in turn disburses the fee to SMEs. Under the current framework, the SMEs pay 25% of the rating fee and the National Small Industry Corporation pay the rest (75%) to the credit rating agency. In addition the Indian Banking Association has also assisted SMERA with connecting to potential clients and giving a 1%-2% interest rate subsidy for highly rated SMEs.

20. **Lesson for Nigeria**

- Credit ratings boost access to SMEs funding. Although, there exists credit bureaus in the Country, the level of information offered by these services are not commensurate to risks borne by lending institutions upon loan disbursal.

- Indian banks have been allowed to set the targets for funding SMEs and are required to achieve a 20% year-on-year growth in credit to micro and small enterprises and a 10% annual growth in the number of micro enterprise accounts.

V. Conclusion/Issues to Note for Legislative Action

21. This sector analysis examined whether DMBs credit to the SMEs is enough to stimulate economic growth in Nigeria. Analysis of data shows that although loans to the private sector consistently increased from 2010 to 2016, the fraction of these loans that went to SMEs declined drastically, standing at 0.07% as at 2016. Also, with correlation statistics of – 0.13 we found that higher interest rates are associated with lower growth rates of loans to SMEs. This finding corroborate the huge problem of access to finance by SMEs. A review of cross country experience towards promoting SMEs access to finance presented credit models that Nigeria can tap into. On the basis of our findings, the following actionable recommendations that will aid the National Assembly consider how to boost credit to the SMEs so as to

stimulate economic growth in Nigeria are presented.

22. The National Assembly should encourage the Ministry of Finance to adopt credit ratings for SMEs as it is the case in India. This initiative will help in addressing several challenges confronting SME with regards to access to funding from financial institutions. The credit rating would enable financial institutions to readily assess the financial capacity of the SMEs and by extension boost their confidence for them.

23. The relevant NASS committees should cause the CBN to come up with legislation that encourages banks to direct an increasing share of funds to the SMEs and increase the number of training extended to SMEs. Failure to meet specified target would imply that the banks will have to allocate funds in providing relevant training for SMEs. Bank Indonesia provides technical assistance to SMEs to increase capacity such as training, research and provision of information. We there add that the training should incorporate business plan writing since it forms one of the essential requirements in obtaining loans from banks – BOI inclusive.

24. To address the negative impact of high interest rate on SMEs, we recommend a single digit interest rate for the SMEs or a subsidised interest rate credit program (experience to be borrowed from Indonesia)

25. In pursuance of Section 8 of the principal Act that established SMEDAN, the relevant National Assembly Committees should carry out their oversight function to ensure that SMEDAN presents before them the related information, data and reports on activities relating to the promotion and development of small and medium scale industries from banks, research and development institutions and other support organisation. In specific, the committees should demand for verifiable records regarding the disbursement of federal government funded loans to small businesses and the beneficiaries. This recommendation comes at the heels of the 2010 survey report on MSMEs in Nigeria which revealed that only 45.5% of the Small and Medium enterprises are also aware of SMEDAN.

26. The relevant National Assembly Committees should as well demand that the CBN furnish them with information relating to all federal government loans targeted at promoting small businesses in Nigeria, at least in the last five years.

References

Aremu, M.A. and Adeyemi, S.L. (2011), “Small and medium scale enterprises as a survival strategy for employment generation in Nigeria”, Journal of Sustainable Development, Vol. 4 No. 1, pp. 200–206.

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Contact
National Institute for Legislative and Democratic Studies (National Assembly)
14/18 Danube Street, Off IBB Way, Maitama
Abuja, Nigeria.
Email: info@nils.gov.ng
Website: **http://nils.gov.ng/**
Tweeter: **@nilsnigeria**

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