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SUSTAINING ECONOMIC DEVELOPMENT

A Business Case For Development Bank Of Nigeria

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Abstract

This paper astutely argues the importance of Micro, Small and Medium Enterprises (MSMEs) in the growth of economies globally. Specifically, in the United States, according to the Small Business Administration (SBA), small businesses make around 53% of United States employer firms, 63% of net new private-sector jobs, 48.5% of private-sector employment.

In the African continent, SMEs in South Africa make up 91% of business activities and 60 % of the labor force. In Ghana, SMEs make up 90% of business activities and contribute 70% towards the Gross Domestic Product (GDP). While in Nigeria, the statistics is daunting. In fact, 98% of businesses are considered micro while 2% are categorized small and medium enterprises. However, this sector contributes a paltry 48% towards GDP. Some of the major constraints of MSMEs access to finance in Nigeria include collateral/cosigner unavailability, incomplete loan applications, poor credit history and insufficient profitability.

On the other hand, some of the recurring reasons MSMEs inability to apply for loans includes; unfavorable interest rates, high collateral requirements and the application procedures for credit lines are onerous. Consequently, it is apropos the emergence of the Development Bank of Nigeria (DBN) to fill the financing gap within the industry by on-lending to Micro-finance Banks and Deposit Money Banks at competitive interest rates with built in risk sharing mechanisms that will ultimately allow end users of the loans to have longer payback periods of up to 10 years. This will allow MSMEs the capacity to grow their businesses and respective sectors of the economy they operate.

Keywords: Economic Growth, Sustainable Development, Micro Small Medium Enterprises,

Introduction

In advanced economies, small businesses have been seen to be the driving force in achieving growth in all sectors of the economy they operate. Similarly, in developing and emerging economies the same proposition can be seen. Countries such as Kenya, Ghana, and South Africa continue to reap the benefits of small businesses. One may argue that the governments of those countries provide a fair playing ground for participants in these sub-sectors to operate and in many cases grow. In the case of Nigeria, the experience is rather daunting. For instance, a typical small business owner may not be creditworthy despite this individual has been operating for years without seeking a loan. Indeed antidotal, consider this illustration of a farmer who has been farming on his land for many years and realizes that to save time through this labor-intensive exercise, it may be prudent to secure a loan and have machines till the soil to enable him farm.

So far, nothing innovative about this strategy. However, because of the numerous challenges in securing a loan through the banking system in Nigeria, farmers who are unable to secure a loan continue to struggle to remain afloat and, in some cases, exit the market due to external competition. What about an entrepreneur who has this grand business idea, puts together a business plan, and goes to a bank to apply for a loan and the outcome is unfavorable. The bank often gives elaborate reasons why the loan cannot be awarded or in some instances the bank outright gives a rejection. In the scenarios above the question one should pose is; Are the banks aware that small businesses and entrepreneurs are the engine that drives economic growth? The role Micro, Small, and Medium Enterprises (MSME) play in any economy cannot be overemphasized. To ensure there is clarity in definition and understanding, it is important to note that (MSMEs) have been defined in several ways by several different organizations both locally such as the Small, and Medium Scale Enterprises Development Agency of Nigeria (SMEDAN), Enhancing Financial Innovation and Access (EFInA) and internationally such as, the International Labor Organization (ILO). To be sure, the ILO in 1999 defined micro enterprises as companies that employ 1-10 employees and small-scale enterprises as companies that employ 11-50 employees however, the ILO at the time of the publication didn't mention the market spread or capital base requirements. In order to expand on the definition of MSMEs, SMEDAN an agency charged with the promotion and development of MSMEs in Nigeria and EFInA an organization charged with ensuring financial inclusion eloquently defined micro, small, and medium enterprises as follows:

- Micro Enterprise: Can be categorized as any firm that employs between 1-10 employees and has a capital base of 5 million Naira and annual turnover ranging from 1-10 million Naira.
- Small Enterprise: Can be categorized as any firm that employs between 10-49 employees and has a capital base of 5 – 50 million Naira and annual turnover ranging from 10 – 100 million Naira.

- Medium Enterprise: Can be categorized as any firm that employs between 50 -199 employees and has a capital base of 50 – 500 million Naira and annual turnover ranging from 100- 500 million Naira.

Micro, Small and Medium enterprises have been the backbone of economic growth and transformation in developed economies like the United States, United Kingdom and the Scandinavian region to name a few. In developing and frontier economies like Nigeria, the role MSMEs play is progressively becoming significant. MSMEs if managed well have the potential to achieve key macro-economic objectives, which include but are not limited to full employment, higher wage growth, development of local technology, which Nigeria critically needs to ensure balanced growth throughout the country. Therefore, the importance of MSMEs cannot be over emphasized in the general economic development of any nation especially an emerging economy like Nigeria.

Indeed, MSMEs are seen as an indubitable driver of economic development and the growth of MSMEs in Nigeria has been sluggish in many sectors of the economy. Regrettably, the success of MSMEs in countries like the United States has not been replicated in Nigeria. Some of the underlying problems and challenges this sub-sector of the economy has witnessed include: unfavorable interest rates and tenor on loans, deplorable infrastructural facilities, high collateral requirements, problems with credit history, inadequate managerial and entrepreneurial skills; application procedures for loans/credit lines too onerous etc. To that end, the central thrust of this paper is to examine the role MSMEs play in the economic growth and development of Nigeria and to highlight the market and finance gaps that continue to persist in the sector. Other ancillary objective of this paper is to promulgate the importance of the Development Bank of Nigeria in filling the gaps.

Review of Literature

According to (Omotola, 2008), and (Ihua, 2010) the performance, management and effectiveness of MSMEs as an instrument of economic growth and development in Nigeria have long been under scrutiny (Ezema, 2014). Crucially, the number of MSMEs in relation to large firms has not reached the level of expectation in achieving sustainable development and economic growth like peer firms in developed economies. The underperformance of MSMEs in achieving economic growth within the sectors of the economies they reside has unfortunately generated serious concern and skepticism whether MSMEs can bring about economic growth and sustainable development in Nigeria.

Although MSMEs have historically been underserved (Omotola, 2008) asserts that the challenges of MSMEs are tied to key economic variables. In the magnum opus, the author suggests some of the challenges that plague this sub-sector include high level of unemployment, high poverty incidence, and low industrialization capacity. Other metrics in the study stressed on the inconsistency in government policies, inadequate infrastructure and insecurity of the business climate among others. Furthermore, lack of financing to firms in this sector continues to inhibit their growth and as a result, fail to reach their full potential.

Overview of the Nigerian Banking Industry: Some Stylized Facts

According to the Central Bank of Nigeria research series (1993) the Nigerian financial system refers to a set of rules and regulations and the aggregation of financial arrangements, institutions, agents, that interact with each other and the rest of the world to foster economic growth and development of a nation. In the case of the Nigerian financial system it is mainly dominated by banks. In fact, prior to the banking consolidation and subsequent rebasing of the Gross Domestic product (GDP), deposit money bank assets accounted for around 30 percent of the Nigerian GDP. The vast majority of banks dominated the financial system by the level of trading of stocks as well as lending to borrowers of large firms.

According to a World Bank report, banks are the main participants in the money markets and act as settlement agents in the capital markets. Bank shares represent more than one-third of the market value of listed firms and are among the most actively traded shares. Due to the underdeveloped corporate bond and equity markets, bank credit is the main source of formal financing for Nigerian corporations.

The recent global financial crisis of 2008-2009 impacted the Nigerian financial system; forced banks in Nigeria recapitalize in some cases by tenfold to ensure no going concern. The Central Bank of Nigeria (CBN) during this period of tumult, took decisive measures to instill confidence within the banking industry by establishing The Asset Management Company of Nigeria (AMCON) to absorb the nonperforming loans that peaked at around 35 percent on banks' balance sheets. Furthermore, the CBN took significant strides by strengthening its supervisory enforcement to ensure banks showing signs of fragility in their operations would be put on notice.

Additionally, by the end of fiscal year 2012 all banks adopted the International Financial Reporting Standards (IFRS), which aided in the steady decline in the level of banks' nonperforming loans (NPLs). As of fiscal year end-2013, NPL ratio was 3.2 percent a significant decline from 35 percent in fiscal year end 2009. Also by fiscal year end-2013, return on assets (ROA) for the banking industry witnessed a modest increase to 2.1 percent, while return on equity (ROE) rose to 20.1 percent. It is important to note that the restructuring and bank consolidation process resulted in the decrease in the number of banks from 24 to 20. This coupled with the relief provided by AMCON in the absorption of the aforementioned nonperforming loans gave rise to a more resilient banking system.

It is now common knowledge that a well-functioning financial sector is of paramount importance in achieving shared private sector led growth in any economy (Levine, 2005). However, in the Nigerian experience its contribution to the financial sector remains relatively low. In contrast, peer countries like Kenya and South Africa have 40 -65 percent private sector credit to GDP. In the case of Nigeria, the data revealed a paltry 22 percent private sector credit to GDP. According to (Levine, 2004) well-managed firms lack access to finance for expansion, and as a direct result prohibit sustained employment growth in the formal sector. Additionally, individuals in the rural areas with limited access to finance greatly increases income volatility thereby reducing their ability to extenuate exogenous shocks, which as a direct consequence permits these individuals to remain in a vicious poverty trap. Given the forgoing, financial systems that are inclusive as well as effective in nature are an essential catalyst in promoting and ensuring equitable growth and poverty reduction in all sectors of the economy. Empirical analysis conducted by numerous scholars (Levine, 2005, Demigurc & Levine, 2004, Omotola, 2008) all revealed a strong positive relationship between a sound financial system and economic growth. Additionally, the researchers postulate that a sound financial system with available credit to on-lend to firms with viable projects in strategic sectors of the economy promotes inclusive growth and shared prosperity.

Market Gaps

Regrettably, the limited access to financing to MSMEs severely constrains opportunities for economic diversification. Typically, Nigerian banks observe a value chain business model that deals with already established firms with a track record of success. Consequently, these banks tend to ignore MSMEs because of poor or no credit history, insufficient collateral etc. To that effect, Nigerian banks resort back to what "they" understand to be a safe bet which is competing for larger firms and accepting lower margins only to exploit the higher yields earned from credit and perhaps other fees earned through product offerings as part of the loan agreements.

Conversely, MSMEs fortunate enough to get loan approval through deposit money banks often get those monies at their detriment because of the unfavorable loan terms. Consider this scenario, a study conducted by the organization Enhancing Financial Innovation and Access (EFInA) noted that the average MSME loan size disbursed by deposit money banks was 6 million Naira. The average interest rate offered to the lowest risk MSME was 20 percent, while the average loan maturity was 12 months cumulating with average nonperforming loan of 16 percent with large variations across industries. The aforementioned statistics give deposit money banks greater impetus not to lend to MSMEs because of the high risk of default.

Although MSMEs face insurmountable obstacles to access financing, female entrepreneurs in Nigeria face daunting challenges in accessing credit from formal institutions. A survey conducted in 2012 noted that only 2 percent of women gain access to financing, and 5 percent use bank accounts for the purpose of conducting business. Furthermore, Nigeria trails peer countries in female participation in firm ownership. For instance, according to the SME Survey of 2014, in South Africa, 78 percent of women owned businesses are profitable compared to 70 percent of their male counterparts. Consequently, the government of South African continue to aid women entrepreneurship. Closer home (Villars, 2004) opined women owned 38 percent of SMEs. Specifically, women owned 38.7 percent of small, and 38 percent of medium enterprises with these figures continuing to increase. Furthermore, in the Ghana women also represent a greater percentage in top management especially in exporting related enterprises. Perhaps the lack of female ownership of firms in rural parts Nigeria may have some cultural linkages nevertheless; female participation is estimated to be 20 percent compared to 36 percent in other regional economies in Africa. Alas, some of the factors that hinder female entrepreneurs in Nigeria are arguably knowledge gaps, in some regions ownership rights to property, and finally limited access to harnessing existing supply chains within the sectors they operate.

Existing Development Finance Institutions

There are several development finance institutions (DFI) in Nigeria with their separate mandates to intervene in a broad spectrum of the economy ranging from agriculture and oil and gas, to the manufacturing and housing sectors. However, these DFIs have had minimal success in their ability to address the market as well as finance gaps to enable firms operating in their various sectors to achieve economies of scale. Indeed, the DFIs made salient attempts to intervene directly in the market place however, the approach in which they took by assuming credit risks failed to achieve their intended goals. To that effect, these DFIs inevitably where confronted with high nonperforming loans which could be traced back to the methodology in lending practice and their capital base to militate high risk firms. Other factors that can be linked to the inefficiencies of existing DFIs include a lack of incentive mechanism in place to maintain performing loans and perhaps to buffer against nonperforming loans. Lastly, the governance structures of the existing DFIs are typically politically influenced and in some cases these DFIs do not have the independence to make lending decisions. Perhaps the lack of independence plays into the elevated nonperforming loans figures.

"According to the government's Ad Hoc Sub-Committee on Development Finance which recently reviewed DFIs' performance in Nigeria, the cumulative losses of the three main DFIs in the past five years have reached approximately NGN43 billion, eroding their capital to a net negative position despite combined capital injections of approximately NGN25 billion".(World Bank report). As a direct result of the past performance, existing DFIs were not able to attain operational and financial effectiveness and more importantly they were unable to achieve their respective mandate in financing MSMEs, which would have provided a much-needed boost in spurring aggregate demand.

Federal Government Intervention Programs

The Central Bank of Nigeria serves as the banker to the government. In line with its mandate, their core function is to regulate and supervise the financial institutions, manage the exchange rate and maintain price stability. Indeed, their mandate is derived in the revised Central Bank of Nigeria (CBN) ACT of 2007, as the country developed. In line with their core mandate CBN has over the years performed some major developmental functions, focused on all the key sectors of the Nigerian economy (financial, agricultural and industrial sectors). Overall, these mandates are carried out by the Bank through its various departments (CBN, 2007).

One of the major intervention schemes that have made some headway in the economy is the Agricultural Intervention Fund Anchor Borrowers Program, which provides concessionary loans to the agricultural sector. As a direct result of this quasi experiment, for the first time in recent years, Nigeria is on pace for self-sufficiency in rice production. More importantly, the intervention scheme with price tag of 750 billion naira has received immense patronage by the general population. An economy that primarily relies on oil and gas production to achieve economic growth is gradually pivoting away towards diversification.

Another intervention scheme initiated by the apex bank directly supporting Small and Medium Enterprises is the Small and Medium Enterprise Credit Guarantee Scheme (SMECGS). In May 2010 in light of the global financial crisis, the apex bank observed that the fragile economic environment and absence of requisite infrastructure rendered MSMES practice costly and inefficient, thereby worsening their credit competitiveness (FSS 2020 SME Sector Report, 2007). To improve access to finance by SMEs, the apex bank approved the investment of 500 billion Naira debenture stock to be issued by the Bank of Industry (BOI). In order to ensure market penetration, the apex bank split the total endowment in two tranches. The first was earmarked to power projects throughout the country to the tune of 300billion Naira. While the second was earmarked for the refinancing/restructuring of banks existing loan portfolios as well as Nigerian SME/manufacturing sector totaling 200billion Naira. To be sure, the funding to the SME/manufacturing sector are two folds; a) Fast-track the development of the SMEs and manufacturing sector of the Nigerian economy and b) To improve the financial position of the deposit money banks.

Overall, the objectives of the Small and Medium Enterprise Credit Guarantee Scheme (SMECGS) are as follows;

- Provide guarantee for credit from banks to SMEs and manufacturers.
- Increase the access of promoters of SMEs and manufacturers to credit.
- Set the pace for industrialization of the Nigerian economy.

Finally, the overall goal of these two initiatives are to increase output, generate employment, diversify the revenue base, increase foreign exchange earnings and provide inputs for the industrial sector on a sustainable basis (FSS, 2020 report).

Why Development Bank of Nigeria (DBN) Matters

Based on the limitations as well as market penetration of the existing DFIs in Nigeria the Federal Government along with international partners like the World Bank and KFW Development Bank established a new development finance framework that is better governed with defined development priorities. Consequently, since its official kickoff in March 2017, DBN will be operationally and financially sustainable. Additionally, the various product offerings will be delivered wholesale (second-tier) which ensures that the participating financial institutions (PFI) meet specific eligibility requirements (see website for more information). Further, the DBN is designed to effectively address market gaps in the economy and also to complement and leverage private sector funding, and ensures that the pricing of loans fully reflect the costs as well as credit risk. To provide clarity on the methodology of DBNs lending practices, the first round of on lending was disbursed to three national micro finance banks to the tune of 5billion Naira earmarked for on lending to MSMEs around the country. Furthermore, DBN provides competitive interest rate that DMBs typically cannot afford to on-lend to MSMEs because of the risk with the sector. Nevertheless, DBN ensures the recipients of the loans are given a longer tenor period of ten years with a two moratorium. The general intuition supporting this strategy is that historically, MSMEs that are fortunate to access credit financing typically get a shorter loan tenor of twelve months and a much higher interest rate of 20 percent setting the recipients up to fail and as a result negatively impacting the balance sheet of the DFIs and deposit money banks.

Apropos of the forgoing initiatives, DBN will be subject to rigid corporate governance standards, and the implementation of those standards will be supported by equity stakes of international and institutional investors. As an added measure best practice, DBN like other DFIs and deposit money banks will be subject to prudential regulation and continuous monitoring and supervision by the apex bank and by Security and Exchange Commission as a PLC. Furthermore, the Federal Ministry of Finance will serve as an additional check to ensure the mandate is achieved and no financial impropriety occurs. Finally, within the DBN the Monitoring and Evaluation department will be charged with ensuring continued performance of the loans disbursed and achievement of the developmental impacts expected. In the end, it is envisaged that only the participating financial institutions that continue to live up to the full set of eligibility requirements, including the apex banks prudential requirements will be eligible to receive financing through the DBN.

Concluding Remarks

To recapitulate, this paper set out to examine the state of MSMEs in the economy as well as the role MSMEs plays in the economic development of Nigeria. Additionally, significant strides were made in highlighting the market and financing gaps that continue to plague this sub-sector. Further, we stressed on the challenges of MSMEs in accessing credit. This paper also emphasized that the financial market which is dominated by deposit money banks offer unfavorable loan terms that regrettably, sets potential borrowers up to fail which as a result, increases the nonperforming loans on banks' balance sheet. To that end, the banks in most cases refuse to lend to MSMEs, which unfortunately creates a vicious cycle within the sub-sector. Additionally, we enumerated the various intervention schemes championed by the apex bank to bolster the balance sheets of existing DFIs and in the process, spur aggregate demand within the agricultural sector i.e. Agricultural Intervention Scheme and in the manufacturing sectors through the Small and Medium Enterprise Credit Guarantee Scheme (SMECGS). Finally, it is considering the forgoing that the importance of the Development Bank of Nigeria in filling the financing gap is ripe and the technical know-how and framework are in place to ensure MSMEs have their rightful place in sustaining economic development throughout Nigeria.

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