Impact of smes on economic development

CHAPTER 4

Small businesses contribute substantially to two fundamentals of poverty reduction – job creation and economic growth (The World Bank Group). In the previous chapter we examined a complete picture of M&A in the theory of banking and at offering economic evaluation and strategic analyses of the process, also high lighting the performance of commercial banks in post consolidation period in Nigeria. It then viewed the benefits, consequences and limitations of M&A and concluded with recent estimates of the effects of bank consolidation on Small Business Lending.

In this chapter we shall be looking at the roles of SMEs, its benefits and impacts on the economic development. We shall also be looking at how SME get funded and the main sources of cash. Finally we will compare this credit availability to SMEs before consolidation and after consolidation in the Nigerian banking sector

4. 0 Introduction

Small enterprises are the seeds of the private sector, and also the source of innovation and diversification. They supply larger companies and develop their own activities and product lines. When they grow, they provide employment and tax revenues. Small and medium-sized enterprises can be the motors of economic growth. In most African countries, however, the business environment is not conducive to enterprise development (Bercy, 2005).

Small and Medium scale Enterprises (SMEs) are important for successful economic growth and social development. SMEs, properly supported, foster

Entrepreneurship – a proven pre-requisite for national economic success. Public and private policy support of SMEs is most effective when SMEs are part of the formal sector. One key objective therefore is to encourage migration of SMEs from informal to formal sector (Oyekanmi, 2006)

Nigerian SMEs in informal sector are beyond the reach/help of public or private policy

Policies do not provide sufficient support

Difficult access to finance

To use SMEs to stimulate economic growth and encourage businesses requires SMEs to move from informal sector to formal sector.

4. 1 Definition of SMEs

SME is an acronym for small and medium enterprise. It is a term that is used in a different way in different country and used differently even within the same industries. In the United States for instant SMEs can be used to express firms from small office home office to even large company. In Europe SMEs is used to refer to a business firm or company that has fifty to two hundred and fifty employees with an annual turnover of seven to forty million euro. Yet these SMEs must have a total asset less than twenty-seven million euro. In Canada, the industry uses the term SMEs as a reference to any company that has less than five hundred employees while categorizing company with employees above this number as large business. The definition of SMEs is country specific which is measured on size and level of development.

In Nigeria SMEs are the moral fibres of the economy, a large percentage of businesses in Nigeria employ less than one hundred employees (Oyekunmi, 2006). This segment provides fifty percent of employment and fifty percent of the total industrial output. This can be said that most of the developing nations, its private economy comprises totally of SMEs and seen as the only reasonable employment opportunity for communities (Oyekunmi, 2006)

4. 2 Impact of SMEs on Economic Development

Nowadays, the importance of SMEs has been recognised worldwide and their immense involvement to economic growth, community organisation, employment, catalysts of growth, innovation and skills and development. SMEs account for over 95% of enterprise and 60%-70% of employment, and generate a large share of new jobs in Organisation for economic Co-operation and development economies. (OECD Africa). Since the dawn of industrial changes and globalisation the importance and contribution of small firms is enhance as the economies of scale reduces. Nevertheless a lot of the conventional problems SMEs faces have also become more acute in this global environment. Such problems as lack of funding or credit availability, problems in utilization of technology, constrained managerial capabilities, regulatory weight down and low yield. Since every economy stands to gain from SMEs precise strength and weakness, policy framework and the role of government must evolve for these enterprises to flourish, adapt to new demands and strains and to reap the benefit of globalisation. For this reason encouraging entrepreneurship is high on the agenda of governments in OECD member countries, developed and developing economies. The importance of entrepreneurship stands out in this time of innovative change, and fostering a climate to help the dynamism in firm creation is considered fundamental worldwide.(OECD African Economic Outlook , 2009)

4. 3 Role of SMEs to Economy

Small and Medium Enterprises (SMEs) occupy a place of pride in virtually every country or state. Because of their significant roles in the development and growth of various economies, they have been referred to as the engine of growth and the vehicle for socio- economic change of any country. SMEs are seen as an authentic medium for the realization of national economic objectives of poverty alleviation and employment generation at low investment cost. Another benefit of SMEs includes access to the infrastructural facilities made available by the very existence on these enterprises. Also the spur of economic activities through supplies of items produced, distribution process stemming from rural to urban centre, enhances the standard of living of the employees and their families as well as those who directly and indirectly related with them (Onuorah, 2010). The benefits of SMEs are innumerable and cannot be exaggerated. These benefits are summarized below.

Economy contribution in the provision of outputs in form of goods and services.

Generation of employment involves creation of jobs at relatively low capital cost. And the employment opportunities provided reduces village to city (rural-urban) migration and allows for even development

Utilization of local resources: This promotes the use of local raw materials requiring simple technology

SMEs help to reduce income disparity by developing a group of both skilled and semi-skilled workers as a basis for expansion

Income generation: SMEs constitute major avenues for income generation and participation in economic activities in the lower income and rural brackets of developing societies especially in agriculture, trading and services.

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. This selection problem occurs when providers of funds cannot validate the firms' access to quality projects. While the hazard problems is related with the possibility of SMEs diverting funds to alternative projects or taking more risks than they can afford to. (Ogujiuba, Ohuche, & Adenuga, 2004).

Since SMEs ordinarily do not have access to public funds through the capital market, they obviously have to depend on banks for funding. The reliance on banks makes them even more vulnerable for the simple reason that crisis in the financial system can have a great impact to credit supply to SMEs, thus, SMEs are subject to funding problems in equilibrium and these problems are worsening 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. Government worldwide have realised the importance of SMEs and have encouraged them by originating and creating policies that are favourable to encourage, support and make funding accessible. To encourage the developments in small and medium enterprise are a plus as the role SMEs plays in economic development. (Oladele, 2009).

4. 4 SMEs Promotion in Nigerian

The Nigerian government has supported the SMEs development programs since its independence, yet very few of which have yielded impressive results. Now the challenge is to recognise the factors that influence their performance and development as well as the implications of these factors for policy. Ever 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. Unfortunately, records indicate that the performance of SMEs in Nigeria has not justified the establishment of this overabundance of micro-credit institutions. Odedokun (1981) notes that in spite of the quantum of credit made available to the SME manufacturing sector; the contribution of the index of manufacturing to GDP was only 7 percent between 1970 and 1979.

Source: CBN Annual Report, 2008

The major credit programs and specialized credit delivery institutions implemented to promote SMEs in Nigeria between the year 1971 to 1997 includes: The small scale industries 1971, agricultural credit guarantee scheme (ACGSF)of 1973, the Nigerian Agricultural and Co-operative Bank of 1973, the Nigerian bank for Commerce and Industry of 1973, the small and medium scale enterprises loan scheme 1 & 2 of 1992, National Economic

Reconstruction Fund of 1994 and The Family Economic Advancement Program of 1997.(Oyekunmi, 2006).

Others includes 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. (Ogujiuba, Ohuche, & Adenuga, 2004). In addition there has been an entrepreneurship development centres in three zones since 2008, which is has trained nine thousand people and is expected to create about five hundred and twenty-five thousand jobs in three to five years. Most of these programmes failed due to poor administration in loan processing and credit procedure, poor monitoring techniques and the abuse of the scheme attributed to corruption (Oyekunmi, 2006).

CBN initiated together with the Bankers Committee In 1999, 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. (Ogujiuba, 2004). SMIEIS requires all banks in Nigeria to set aside 10% of their PBT for equity investment in SMEs (revised to 5% from end 2006) (Oyekunmi, 2006)

According to Mambula (1997), since its independence, the small business development programs have generally yielded poor results, despite the immense amount of money invested by the Nigerian government. But this can be associated to the fact that these funds hardly reached the SMEs business because funds got lost to bureaucratic bottle neck and end up in accounts of public office holders. It has however been worrisome that despite the incentives, policies, programmes and support aimed at revamping the SMEs, they have performed rather below expectation in Nigeria.

4. 5 Funding opportunity for SMEs

To assist SME development, priority should be given to financial reforms and appropriate financing. Effective financing of SMEs should include regulatory reform the creation of a friendly business environment for doing business, the extension of guarantees to local banks to entice them to lend in local currency (e. g. USAID Development Credit Program), tax incentives for rewarding companies that agree to have their financial statements audited, the creation of equity funds suitable for SMEs, financial incentives for partnerships, etc. (Bercy, 2005).

SMEs being very unique and important and because of their relative small size can be negatively affected by changes in the financial institution especially banks during crisis period. The credit availability to SMEs is very important and significant not only from a theoretical point of view but also for policy purposes.

In many countries different innovation have enthused extensive restructuring in the financial sector. Commercial banks have engaged in mergers and acquisitions, which has lead to the vanishing of many small credit institutions and appearance of complex financial conglomerates. Merger has open previously isolated markets due to the lifting of geographical barriers hence reducing market segmentation. SMEs can be funded in two major ways; internal finance, concerned with getting money from personal savings and from friends and relatives and external finance when the company grows and begins to expand. External financing is sourced from most financial institutions. There are two notable variants of external finance and these include debt financing and equity financing.

Dept financing engages interest bearing instruments and are secured by asset collateral and have term structured into it. This can be long termed or short termed. Examples of dept finance include loans, overdrafts, leasing and hire purchase arrangement and letters of credit. Equity financing allows the banker or investor the right of ownership in the business. This as such may not require collateral since the equity participant will be part of the management of the business. (Ogujiuba et all, 2004).

We have seen the two approaches to overcome financial gap to SMEs. This approach has been further encouraged by two approaches. The first has been to broaden the collateral based approach by encouraging bank lenders to finance SMEs with insufficient collateral. The second approach is to broaden the viability based approach since its concerned with the business itself and the aim has been to provide an increase return in the general business, create a favourable environment and reduce risk. Viability based financing is especially associated with venture capital. This often entails a detailed review and assistance with the business plan. A common aim or feature of the viability based approach is the provision of appropriate finance that is tailored to the cash flows of the SME. (Berger and Udell, 2005). Levy in 1993 reported that smaller enterprises have limited access to financial resources compare to larger organisations and he discussed the impact of his findings in economic growth.

SMEs funding is supplied through the business financial market in the following

Retained Profit

The Financial Market

The use of banks.

Government monetary policy

4. 5. 1 Retained Profit

In the course of running a business profits are made, when these profits are kept for future use to expand the business it is referred to as retained profit. This profit is there for use to help buy new machinery, vehicle, computer etc to improve the business and keeps it going. On the other hand the retain earnings can be used to expand the business by diversification. And it can also be kept for a rainy day.

4. 5. 2 Financial Market

The financial Market is a system that allows buying and selling of financial securities and instruments. It is a centre where bonds and stock are traded, and allows people to buy or sell commodities such as precious metals or agricultural good and other items of value at low transaction costs. Both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded) exist. In finance, financial markets facilitate:

The raising of capital (in the capital markets)

The transfer of risk (in the derivatives markets)

International trade (in the currency markets)

The financial market matches those who want to buy with those who want to see. Money market is one component of the financial market for asset involved in short term borrowing and lending usually not exceeding one year. Trades in the money market involve T-bills, Commercial Papers (CP), bankers' acceptance, Certificate of Deposits (CD) and both mortgage and asset backed securities.

4. 5. 3 Banks

The systems of banking in Africa are not properly adapted to lending to SMEs with some exceptions. This makes financing a more difficult approach, hence making financing more flexible would be a welcoming help (Bercy, 2005). All over the world the importance of promoting SMEs as a channel of growth and industrialization has been recognized. One of the vital roles of the banks is to devise a way to creating loan package and providing loans to small business that are otherwise not properly informed. (Berger, Klapper and Udell 2001). Conversely credit provision to small borrowers may be affected by a number of factors. Bank consolidation is one of the major factor affecting credit to small borrowers. The creation of mega bank suggests that large institution devote less of their asset proportion to lending to small business than smaller less complex institution. (Emeni and Okafor, 2008) . These mega banks may be oriented towards transaction lending and providing capital markets services to large corporate clients. These institutions often have their headquarters in business metropolis far away city centre that are a great distant from small borrower. Ogujiuba, Ohuche and Adenuga, 2004)

Banks in Nigeria although reported to being highly liquid and wanting to make loans available, they are usually put off by the uncertain nature of SMEs. And since these banks do not provide the necessary funds required to start a business, run the business and keeps it going, SMEs tend to rely on personal assets for their working capital. This reliance on personal funds makes it very difficult to operate at optimum capacity, increase output and make sales. It also limits investment to develop, expand operation or even improve technology. This risk on bank not lending is attributed to lack of information on SMEs true situation in terms of finance and their performance ability to repay loans both principal and interest. And since the judicial system is not reliable, banks cannot enforce contracts, hence making business environment generally risk prone and uncertain.(Ogujiuba, Ohuche and Adenuga, 2004)

The table below show the proportion of loans given to SMEs by commercial banks. It gives a brief summary for six years from 2000- 2005 of the ratio of loans given to SMEs to the total credit available to commercial banks in Nigeria. From this table it can be deduce that percentage of loans made available to SMEs is very low and over the years it reduces even more to a more trivial proportion.

Table 4. 1 Ratio of Loans to SMEs to Commercial Banks' Total Credit

YEAR

Loan to SMEs (= N=’M)

Commercial Bank Total Credit (= N=’M)

Ratio of Loan to Total Credit (%)

2000

44, 542. 3

508, 302. 2

9. 7

2001

52, 428. 4

796, 164. 8

6. 6

2002

82, 368. 4

954, 628. 8

8. 6

2003

90, 176. 5

1, 210, 033. 1

7. 5

2004

54, 981. 2

1, 519, 242. 7

3. 6

2005

50, 672. 6

1, 899, 346. 4

2. 7

Source: Central Bank of Nigeria Statistical Bulletin Volume 16, 2005

4. 5. 4 Government policy (New Monetary Policy)

The Nigeria Government in a bid to encourage small and medium scale enterprises has introduced several monetary policies. This has been mentioned in the previous chapters. The success of this strategy is based on its proper implementation, co-ordination and supervision. These monetary policies includes: The Small and Medium Enterprise Equity Investment

Scheme (SMEEIS), the Small and Medium Enterprises Credit Guarantee Scheme (SMECGS) and the Microfinance Banks and Micro Credit Fund.

4. 5. 4. 1 Small and Medium Enterprises Equity Investment Scheme (SMEEIS)

The Small and Medium Enterprises Equity Investment Scheme is a voluntary initiative of the Bankers' Committee in agreement with CBN, approved IN 1999. It was aimed at mitigating the risk-averse behaviour of banks. The scheme was a responds by the federal government to the promotion of small and medium enterprises as a tool of industrialization, poverty alleviation and job creation or employments. This scheme required all commercial banks in Nigeria to set aside annually ten percent of their profit before tax (PBT) for promotion of small and medium enterprises and equity investments. This was the banks' own contribution in responds to the federal government's efforts in economic growth. This takes care of the burden of all financial charges such interest under normal bank lending. In addition the scheme provides financial, advisory, technical and managerial support from the banking industry. (Soludo, 2005). Activities approved for funding under the scheme includes manufacturing, construction, Information technology, education, tourism and services.

The funds set aside by banks under the scheme increased from N13. 1 billion in 2002 to N41. 4 billion in 2005. However, actual investments grew much slower from N2. 2 billion in 2002 to N12. 1 billion in 2005, representing only 29. 1 per cent of the funds set aside. This further increased to N21billion in 2007 representing a further 21. 5 per cent of funds set aside. (CBN Statistical Bulletin, 2008)

Figure 4. 2 Banks Investment in SMEs through SMEEIS

Source: CBN Statistical Bulletin, 2008

Table 4. 1 SME Reserve for Small and Medium Scale Industry of Top Five Commercial Banks in Nigeria. (N'M)

Zenith

First Bank

UBA

Union Bank

Intercontinental

2009

3, 729, 204

11, 193, 000

2008

3, 729, 204

9, 439, 000

2, 635, 000

3, 868, 498

2007

3, 729, 204

7, 916, 000

2, 635, 000

5, 537, 000

3, 868, 498

2006

3, 729, 204

6, 998, 000

2, 635, 000

4, 931, 000

2, 387, 122

2005

2, 580, 324

1, 379, 000

2, 050, 000

4, 429, 000

1, 527, 532

2004

1, 224, 242

1, 379, 000

1, 426, 000

3, 491, 000

856, 935

2003

1, 224, 242

1, 379, 000

865, 000

2, 280, 000

856, 935

Source: Annual Reports of the Various Banks

Various studies have pointed out that inadequate data on SMEs business activities and the vague scope of economic activities are some of the major issues constraining disbursement of funds under the scheme. Two very important policy actions were than taken by the Bankers' Committee in 2005, to restructure the scheme so it could take proper effect. The first policy action was to implement the funding of all business activities with the exception of general commerce and financial services under this scheme. It was restructured to contain and provide for non-industrial enterprises so that other sectors of the economy such as agriculture, housing, transport and utilities can be funded under this scheme. The name of the scheme was, therefore, changed to Small and Medium Enterprises Equity Investment Scheme (SMEEIS), to reflect the expanded focus. The Bankers' Committee also embarked setting the guidelines for the management of withdrawn un-invested funds during the year. The second policy action was to set the limit of banks' equity investment in a single enterprise. This was increased from N200 million to N500 million, thus accommodating the real medium sized industries that constitute the missing middle in Nigeria's industrial structure.

These two policies had an instantaneous impact on the scheme as investment rose by 29. 4 per cent in 2005 to N12. 1 billion. The cumulative amount set aside by the banks at end- December 2005 stood at N41. 4 billion, compared with N28. 8 billion at the end of the preceding year 2004. The final benefit of this policy is expected to manifest fully from 2006, following the success on bank consolidation exercise in 2005. (CBN Annual Report, 2005).

4. 5. 4. 2 Small and Medium Enterprises Credit Guarantee Scheme (SMECGS)

CBN established the Small and Medium Enterprises Credit Guarantee Scheme (SMECGS).

This scheme was set up in a bid to ease the rigid nature of the credit market in Nigeria, to also augment credit to the real sector and complement its 500 billion Naira Power/Manufacturing facility; the Management of the Central Bank of Nigeria (CBN) approved the establishment of a N200 billion Small and Medium Enterprises Credit Guarantee Scheme (SMECGS), to promoting access to credit to manufacturers and SMEs in Nigeria. It is funded one percent and managed by CBN. The aim ideas behind this scheme is to fast track the development of SMEs and the manufacturing sectors in Nigeria as a whole by providing guarantees, creating an atmosphere favourable for industrialization, increasing the accessibility of credit and generate employment. (Soludo, 2006)

4. 5. 4. 3 Microfinance Banks and Micro Credit Fund

The Microfinance Policy Regulatory and Supervisory framework was a major policy initiative of the Bank in 2005 after consolidation of banks. Microfinance Banks and Micro Credit Fund was a replacement to community banks with a deadline to microfinance bank latest December 2007. The policy, among others, addresses the problem of lack of access to credit by entrepreneurs who do not have access to regular banks; strengthens the weak capacity of such entrepreneurs, and raises the capital base of microfinance institutions. The key elements of this framework was to set aside not less than one percent of the annual budget by state governments and local government for on lending through the microfinance banks, in addition to endorse and authorise the management of microfinance banks, establishment of the micro credit funds and introduce deposit insurance for micro finance banks to protect depositors funds.

Problems associated with Credit availability for SMEs

According to Cork and Nisxon, (2000) poor management and accounting practices have hampered the ability of smaller enterprises to raise finance. Owning to the nature of small business and the personal lifestyle of individual owners, goes a long way to affect operations and sustainability of the business. As a consequence of the ownership structure, some of these businesses are unstable and may not guarantee returns in the long run. However, there is reason to hope because according to Liedholm et al. (1994), a large number of small enterprises fail because of non-financial reasons. Remmers et al. (1974) reported the debt/total assets ratio to be independent of firm size while Peterson and Schulman (1987) reported that debt/total assets ratio to first rise and then fall with size of firm. Whatever sides you choose to take, the granting of loans to SMEs depends solely on the decision of the loan granting institution. And this choice is also depended on size of the balance sheet of the SMEs. The general problems associated with credit availability for SMEs everywhere is summarized below.

Bad Credit History

An adverse borrowing history of SMEs particularly if it is involving a sister organization will discourage the lender. The logical presumption is that if you do not have a good credit history then that is indicative of a personality pattern which means that in the future you will face the same problems as you are trying to clear you refinancing initiative. The bank is then well advised to stay away from you or at the very most offer you some very stringent terms for borrowing.

Poor business plans

Most SMEs applying for loans do not present convincing feasibility studies or attractive business plans. They are therefore regarded as high-risk ventures.

Lack of Collateral

Thirdly, even those SMEs with business plans not backed by adequate collateral. The lack of adequate collateral would be unacceptable risk for the lender. As banks cannot afford to take any chances of non-repayment of loans, they insist on these collateral requirements being met. In as much as they have nothing to fall back on should you default on your loan repayment obligations? Good financial management requires that they do not accept a refinancing initiative until they are sure that you are more than capable of covering the full loan if circumstances demand it. Collateral is the final reserve to meet this criteria and if it is missing, then the decision is likely to be negative.

The impact of regulatory and monetary factors on bank loan

The result is that monetary policy effects on bank lending depend on the capital adequacy of the banking sector; lending by banks with low capital has a delayed and then amplified reaction to interest rate shocks, relative to well-capitalized banks. Other implications are that bank capital affects lending even when the regulatory constraint is not momentarily binding, and that shocks to bank profits, such as loan defaults, can have a persistent impact on lending.

Financial crisis

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 , they need to develop lending rules that accommodate the peculiar characteristics both for the SMEs and their owners.

Other reasons

In addition, many SMEs do not hold deposit accounts in the formal banking sector, which the banks require from loan applicants. Another reason SMEs were not given any concessions in terms of loan conditions was that in Nigeria no law exists to protect bankers against default. Yet another reason banks resist loans to SMEs is the unwillingness of owner/managers to acquire formal training. Such training is useful in providing added expertise and competence in a chosen field of business and in improving chances of obtaining loans.(Mambula, 2002)

THE END …….