

Smes benefits and  
impacts on the  
economic  
development  
economics essay



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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 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 stands for Small to Medium Enterprise. It is a business term used differently in different countries and sometimes differently in different industries in the same country. In the US, any firm from a small-office home-office (SOHO) to a large corporation may be called a SME. In European Union, a firm with 50 to 250 employees, annual turnover of Euro 7 to 40 million, total assets less than Euro 27 million, and not more than 25 percent ownership by a large corporation, may be classified as a SME. The International Chamber Of Commerce (ICC) defines a SME as having 100 to 2000 employees. However, what exactly an SME or Small to Medium Enterprise is depends on who's doing the defining. Industry Canada uses the term SME to refer to businesses with fewer than 500 employees, while classifying firms with 500 or more employees as " large" businesses. SMEs definition is individual country specific and is based on the size and level of development of each respective economy. In Nigeria SMEs are the backbones to the economy, 97% of all businesses in Nigeria employ less than 100 employees.( Oyekunmi, 2006). Looking at our earlier definition of SMEs, it means that 97% of all businesses in Nigeria are " small businesses". The SME sector provides, on average, 50% of Nigeria's employment, and 50% of its industrial output. In much of the developing world, the private economy almost entirely comprises SMEs. In many cases, they are the only realistic employment opportunity for communities (Oyekanmi, 2006)

## **4. 2 Impact of SMES on Economic Development**

Many economies, developed and developing have come to appreciate the value of small businesses. This is because small businesses are characterised by dynamism, innovations, efficiency, and their small size allows for faster decision-making process. The benefits of SME's to any economy are easily apparent, they include: contribution to the economy in terms of output of goods and services; creation of jobs at relatively low capital cost, especially in the fast growing service sector; provide a vehicle for reducing income disparities; develop a pool of skilled and semi-skilled workers as a basis for the future industrial expansion; improve forward and backward linkages between economically, socially and geographically diverse sectors of the economy; provide opportunities for developing and adapting appropriate technological approaches; offer an excellent breeding ground for entrepreneurial and managerial talent, the critical shortage of which is often a great handicap to economic development, among others. ( Aina O, 2007)

SMEs are believed to be the engine room for the development of any economy because they form the bulk of business activities in a growing economy like that of Nigeria.

## **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 (SMEs) significant roles in the development and growth of various economies, they (SMEs) have aptly been referred to as “ the engine of growth” and “ catalysts for socio-economic transformation of any country.” SMEs represent a veritable vehicle for the <https://assignbuster.com/smes-benefits-and-impacts-on-the-economic-development-economics-essay/>

achievement of national economic objectives of employment generation and poverty reduction at low investment cost as well as the development of entrepreneurial capabilities including indigenous technology. Other intrinsic benefits of vibrant SMEs include access to the infrastructural facilities occasioned by the existence of such SMEs in their surroundings, the stimulation of economic activities such as suppliers of various items and distributive trades for items produced and or needed by the SMEs, stemming from rural urban migration, enhancement of standard of living of the employees of the SMEs and their dependents as well as those who are directly or indirectly associated with them.( Onuorah, 2010).

Generation of Employment, Studies show that SMEs account for a large proportion of employment in many countries. In Nigeria, SMEs contribution is about 30% to global GDP. SMEs play a critical role of principal safety net for the bulk of the population in developing economies. Their labour intensity structure accounts for their recognition as a job creating avenue. The employment opportunities provided reduces rural-urban migration and allows for even development.

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

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.

The benefits of SMEs cannot be overemphasized they include; contributions to the economy in terms of output of goods and services, creation of jobs at relatively low capital cost, especially in the fast growing service sector; It's a vehicle for the reduction of income inequality thus developing a pool of skilled or semi-skilled workers as a basis for the future industrial expansion; improve forward and backward linkages between economically, Socially and geographically diverse sectors of the economy provide opportunities for developing and adapting appropriate technological approaches; offer an excellent breeding ground for entrepreneurial and managerial talent, the critical shortage of which is often a great handicap to economic development among others.

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. (Ogujiuba, Ohuche, & Adenuga, 2004)

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. <https://assignbuster.com/smes-benefits-and-impacts-on-the-economic-development-economics-essay/>

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.

Governments all over the world have realised the importance of this category of companies and have formulated comprehensive public policies to encourage, support and fund the establishment of SME's. Developments in small and medium enterprise are a plus for employment generation, solid entrepreneurial base and encouragement for the use of local raw materials and technology. (Oladele, 2009).

Since its independence, the Nigerian government has supported many entrepreneurial and small business development programs, few of which have yielded impressive results. The challenge is to identify the factors that influence the development and performance of small and medium-sized enterprises (SMEs) in Nigeria, as well as the implications of these factors for policy.

In less developed countries where there is a deficiency 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. (Ogujiuba, Ohuche, & Adenuga, 2004)

#### **4. 4 SMEs Promotion in Nigerian**

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. (Ogujiuba, Ohuche, & Adenuga, 2004).

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 manufacturing sector; the contribution of the index of manufacturing to GDP was only 7 percent between 1970 and 1979.

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 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 of 1992, National Economic Reconstruction Fund of 1994 and The Family Economic Advancement Program of 1997.( Oyekunmi, 2006)



All these programmes have been associated with high rates of default attributed to Poor loan processing and credit administration procedures, Lack of adequate project monitoring techniques , Abuse of programs in which clearly unviable projects were financed attributed to lack of ownership, corruption, etc. (Oyekunmi, 2006).

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. (Ogujiuba, Ohuche, & Adenuga, 2004). SMIEIS requires all banks in Nigeria to set aside 10% of their PAT for equity investment in SMEs (revised to 5% from end 2006) ( Oyekunmi, 2006)

Source: CBN Annual Report

2007

According to Mambula (1997), since its independence, the Nigerian government has been spending an immense amount of money obtained from external funding institutions for entrepreneurial and small business development programs, which have generally yielded poor results.

Unfortunately these funds hardly reach the desired business because they may be lost to bureaucratic bottle necks 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**

Because of their special nature, small obscure firms may be adversely affected by changes in the structure of the banking industry. The issue of availability of credit to these borrowers is relevant not only from a theoretical point of view but also for policy purposes. In many countries deregulation and financial and technological innovation have stimulated extensive restructuring in the financial sector. Commercial banks have engaged in mergers and acquisitions, leading to the disappearance of many small credit institutions and the emergence of complex financial conglomerates. The lifting of barriers to geographic expansion has allowed entry in previously isolated local markets, reducing segmentation. 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. ( Ogujiuba et al, 2004)

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).

#### **4. 5. 0 Where do SME get their capital?**

“ Most small firms will never be able to put together all the funding they would like from banks and other institutions. In this crude sense there will always be a deficiency in the funding of the sector equal to the difference between the total demand for funding and that part of this demand which qualifies for funding support” (Hamilton and Mark, 1998). As a result, a clear and present challenge for operating and intending small business is sourcing of funds.

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. According to Cork and Nisxon, (2000) poor management and accounting practices have hampered the ability of smaller enterprises to raise finance. This is coupled with the fact that small businesses are mostly owned by individuals whose personal lifestyle may have far reaching effects on the operations and sustainability of such businesses. 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 <https://assignbuster.com/smes-benefits-and-impacts-on-the-economic-development-economics-essay/>

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. Irrespective of which side of the divide one is, the behaviour of loan granting institutions can be obviously predicted when they have a choice of granting loan facilities to either a big business with a good balance sheet or a small business with an equally good balance sheet. Funds can be sourced by the following methods

Retained Profit

The Financial Market

The use of banks.

New Government monetary policy

#### **4. 5. 1 Retained Profit**

When a business makes a profit and it does not spend it, it keeps it. The retained profit is then available to use within the business to help with buying new machinery, vehicles, computers and so on or developing the business in any other way. Retained profits are also kept if the owners think that they may have difficulties in the future so they save them for a rainy day!

Small business may start up from personal savings, gifts from friends and relatives and sometimes loans. In Nigeria, banks particularly the Agriculture Development banks are mandated to give loans to small business but the

inability of most small business owners and intending entrepreneurs to present the required collateral remains a major setback.

## **4. 5. 2 Financial Market**

A financial market is a mechanism that allows people to buy and sell (trade) financial

securities (such as stocks and bonds), commodities (such as precious metals or agricultural goods), and other fungible items of value at low transaction costs and at prices that reflect the efficient-market hypothesis. Both general markets (where many commodities are traded) and specialized markets (where only one commodity is traded) exist. Markets work by placing many interested buyers and sellers in one “ place”, thus making it easier for them to find each other. An economy which relies primarily on interactions between buyers and sellers to allocate resources is known as a market economy in contrast either to a command economy or to a non-market economy such as a gift economy. 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)

And they are used to match those who want capital to those who have it. The money market is a component of the financial markets for assets involved in short-term borrowing and lending with original maturities of one year or shorter time frames. Trading in the money markets involves Treasury bills,

commercial paper, bankers' acceptances, certificates of deposit, federal funds, and short-lived mortgage-backed and asset-backed securities.[1] It provides liquidity funding for the global financial system. Companies such as SMEs borrow money to aid short term or long term cash flows. They also borrow to fund modernization or future business expansion.

### **4. 5. 3 Banks**

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. 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. 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 <https://assignbuster.com/smes-benefits-and-impacts-on-the-economic-development-economics-essay/>

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.

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

##### **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 approved at its 246th Meeting held on 21st December, 1999. The initiative was in response to the Federal Government's concerns and policy measures for the promotion of Small and Medium Enterprises (SMEs) as vehicles for rapid industrialisation, sustainable economic development, poverty alleviation and employment generation.

The Scheme requires all banks in Nigeria to set aside ten (10) percent of their Profit After Tax (PAT) for equity investment and promotion of small and medium enterprises. The 10% of the Profit After Tax (PAT) to be set aside annually shall be invested in small and medium enterprises as the banking industry's contribution to the Federal Government's efforts towards stimulating economic growth, developing local technology and generating employment. The funding to be provided under the scheme shall be in the form of equity investment in eligible enterprises and or loans at single digit interest rate in order to reduce the burden of interest and other financial charges under normal bank lending, as well as provide financial, advisory, <https://assignbuster.com/smes-benefits-and-impacts-on-the-economic-development-economics-essay/>

technical and managerial support from the banking industry. Every legal business activity is covered under the Scheme with the exception of trading/merchandising and financial services. Ten percent (10%) of the funds set aside has been earmarked for lending to microfinance enterprises.

#### **4. 5. 4. 2 Microfinance Banks**

The Microfinance Policy Regulatory and Supervisory framework was a major policy initiative of the Bank in 2005 after consolidation of banks. The President and Commander-in-Chief of the Armed Forces of the Federal Republic of Nigeria launched the Micro finance Policy on December 15, 2005. 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 the new policy framework include the following:

Setting aside an amount of not less than 1. 0 per cent of the annual budgets by State/and Local Governments for on lending activities through microfinance banks;

Constitution of the National Microfinance Policy Consultative Committee (NMFPC);

An accreditation process for the management of micro-finance Banks (MFBs);

Listing of all the micro-finance Institutions (MFIs) in Nigeria for CBN's microfinance database;



Establishment of a Microfinance Development Fund;

Introduction of deposit insurance for microfinance banks to protect depositors; and

The formation of an apex body for microfinance banks (MFBs)

## **4. 6 Problems associated with Credit availability for SMEs**

### **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 your 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.

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## 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)

## **4. 7 The Nigerian loan Scheme to SMEs**

The Small and Medium Industries Equity Investment Scheme (SMIEIS) was introduced by the CBN and the Bankers' Committee in 2001, with the objective of providing both finance and managerial expertise to the small and medium industries (SMIs) in the Nigerian economy. The guidelines for the scheme require all deposit money banks in Nigeria to set aside 10 per cent of their pre-tax profit for equity investment in the SMIs. They also provide, among others, that funds set aside be invested within 18 months in the first instance and 12 months thereafter. After the grace period, the CBN is required to debit the banks that fail to invest the set aside funds and invest same in treasury bills for 6 months. Thereafter, the un-invested fund would be bided for by successful investors under the scheme. Activities approved for funding under the scheme range from manufacturing and solid minerals extraction to 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, <https://assignbuster.com/smes-benefits-and-impacts-on-the-economic-development-economics-essay/>

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.

In February 2005, two major policy actions were taken by the Bankers' Committee to restructure the scheme. First, with the exception of general commerce and financial services, all business activities can now be funded under the scheme. The scheme was restructured to accommodate non-industrial enterprises. Thus, other major sectors of the economy, such as agriculture, housing, transport and utilities can be funded. The name of the scheme was, therefore, changed to Small and Medium Enterprises Equity Investment Scheme (SMEEIS), to reflect the expanded focus. Second, the limit of banks' equity investment in a single enterprise 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 measures had an immediate impact on the scheme, as investment rose by 29. 4 per cent in 2005 to N12. 1 billion. The full impact of the liberalization is expected from 2006, following the successful completion of the bank consolidation exercise in 2005. (CBN Annual Report , 2005)

The SMEEIS recorded improved performance in 2005. 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. (CBN Annual Report, 2005)

Similarly, cumulative investment by banks increased by 41. 3 per cent to N12. 1 billion. Analysis of the investments showed that the real sector received N6. 9 billion in 136 projects, compared with N5. 6 billion in 115

projects in 2004. Investments in the real sector represented 57.5 per cent of total sum invested by banks. The service sector received N5.1 billion in 76 projects. Various studies indicated that inadequate data on SME potentials and the narrow scope of economic activities funded were some of the major problems constraining the disbursement of funds under the scheme. In response to the data problem, the CBN contracted Nigerian universities to conduct a baseline economic survey of SMI in Nigeria in 2003. In order to increase accessibility to the Fund, the Scheme was restructured to accommodate non-industrial enterprises (excluding trading). The name of the scheme was, therefore, changed from SMIEIS to Small and Medium Enterprises Equity Investment Scheme (SMEEIS) in February 2005 to reflect the new focus. Also, the Bankers' Committee approved the guidelines for the management of the withdrawn un-invested SMEEIS fund during the year.

Source: CBN Statistical Bulletin, 2008

Source: CBN Statistical Bulletin, 2008