

# **Nigeria Financial System Strategy 2020**

## **Credit Markets and SMEs**

### ***Lessons Learned and Reform Opportunities***

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World Bank Financial and Private Sector Development

# ISSUES FOR DISCUSSION

- **MSME lending – Recent History**
- **Closing the Asymmetry Gap**
  - Systemic and Institutional solutions
  - Reform Opportunities
  - Nigeria Context
- **Current World Bank Group Involvement**
  - The MSME project

# MSME Financial Service Needs

- **Traditional Approaches** highlighted: shortage of funds and solutions focused on increased liquidity provided at subsidized rates to end users via intermediaries for which this activity was not a core business interest.
- **Results** have in general been disappointing:
  - Credit being captured by non-target groups
  - High rates of arrears and outright default
  - Lack of interest towards the MSME as a profitable market by commercial banks
- The more fundamental constraint is seen to be a particular type of market failure – **information asymmetries** between demanders of financial services (MSMEs) and suppliers (financial intermediaries) that increase the risk facing the provider which results reduced volume and higher price of credit that is available
- **Nigeria is not short of liquidity** and Enterprise and other financial intermediary studies done in Nigeria (RPED 2002) over recent years confirm the primacy of the information asymmetry of the liquidity constraint to increased and lower priced credit to MSME

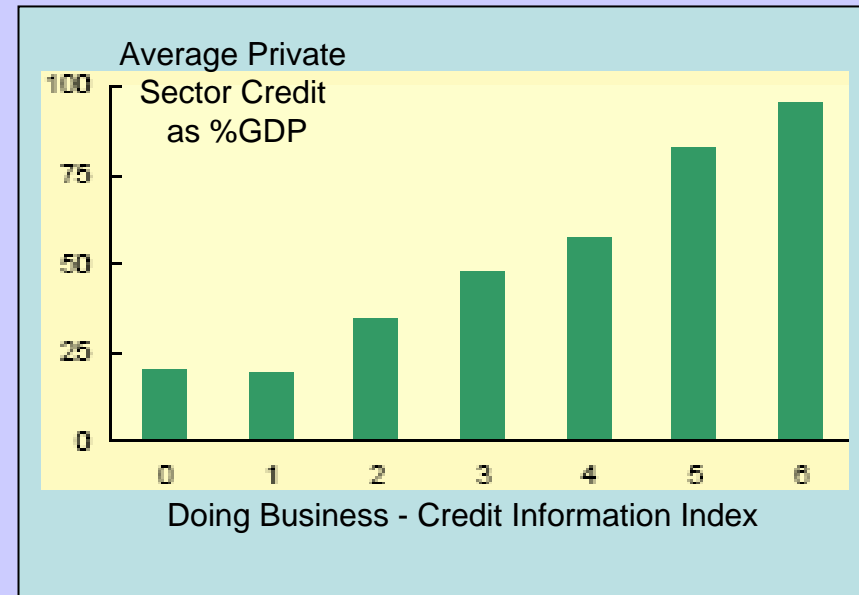
# Closing the Asymmetry Gap

Three key areas for improved risk management:

- 1. Financial Information - Credit Bureaus:**  
Generating and Increasing Access to credit performance information
- 2. Secured Lending:** Broadening collateral base and security of claims
- 3. Institutional Strengthening and internal operational reforms:** Building cash-flow assessment in financial institutions through IT and Skill Development

# Financial information infrastructure facilitates lending

- Access to Finance constrained by absence of credit reference and other financial information infrastructure:
  - Bad borrowers can recycle loans and over-borrow
  - Good borrowers lack opportunity to demonstrate payment discipline
- In the short-run: Higher return on information than on legal and judicial reform



# Financial Information Infrastructure: Think beyond credit reference bureaus

- Enhance reliability, quality and availability of corporate information: Accounting, Corporate Registries etc.
- Personal IDs
- The more information, the better: include microfinance, retailers' credit, utilities
- Unexpected sources provide great information: prepaid cell phone credit indicates cash-flow
- Regional approaches to facilitate cross-order access and exchange of information
- Value-added services: risk scoring, ratings, screening

# Going Forward: Who needs to do what?

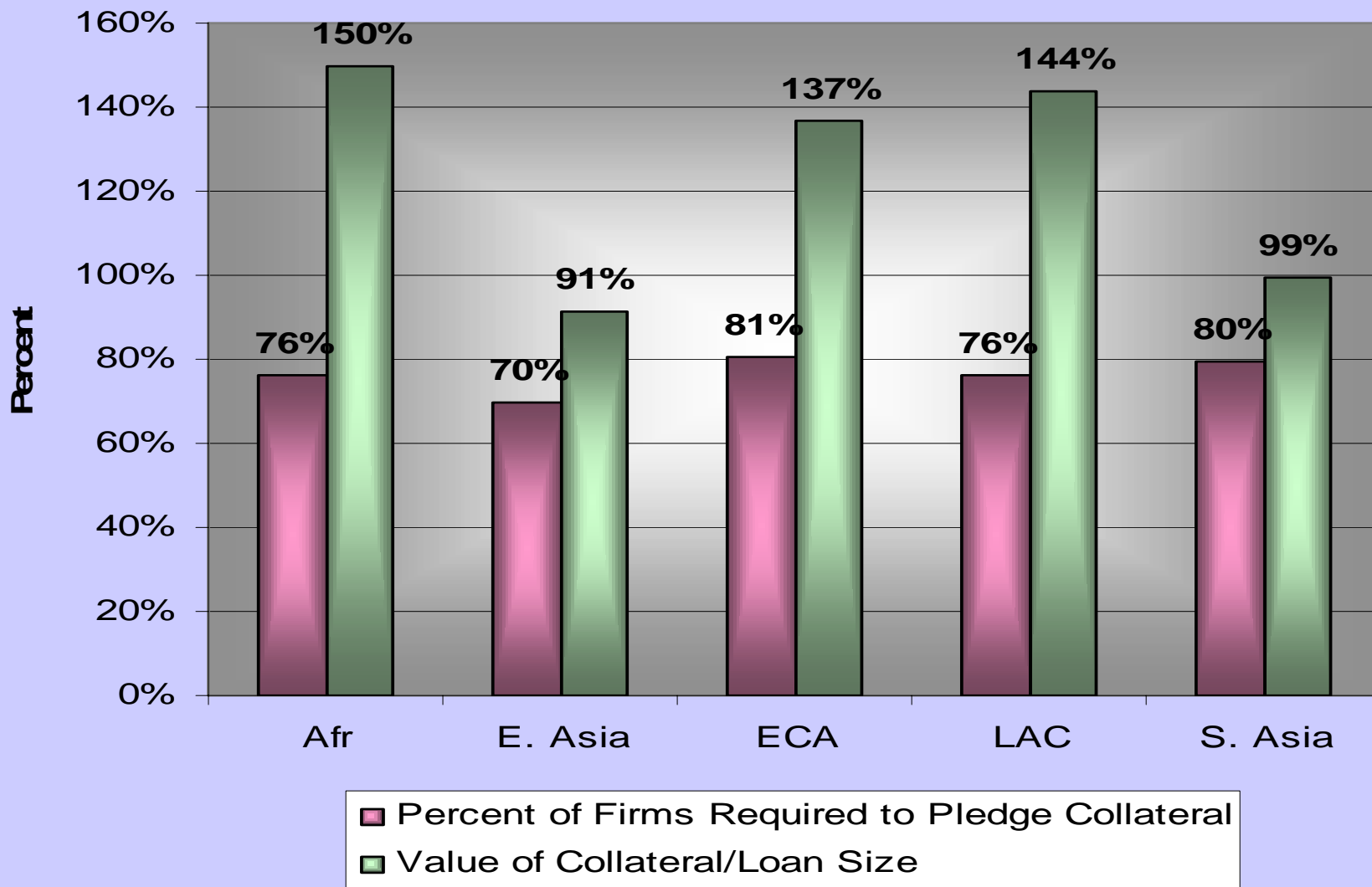
- Commercial Banks:
  - ‘The wave raises all boats’: Achieve economies of scale through cooperation, coordination and sharing of information
  - Build capacity to benefit from information: Develop adequate business models and invest in skills and technology
  - Promote awareness and financial literacy of new customer groups
- Government:
  - Use convening power to facilitate private initiative and coordination
  - Act as broker between different interest
  - Provide adequate legal and regulatory framework, Don't over regulate
  - Set incentives for information sharing and reporting
  - Ensure protection of consumer rights and broaden financial literacy

# On Collateral

- What is the role of collateral in financial contracts?
- What is the impact on different constituencies (SMEs, informal, gender)?
- What are the opportunity costs of inefficient secured transactions systems?
- Implementing the reform

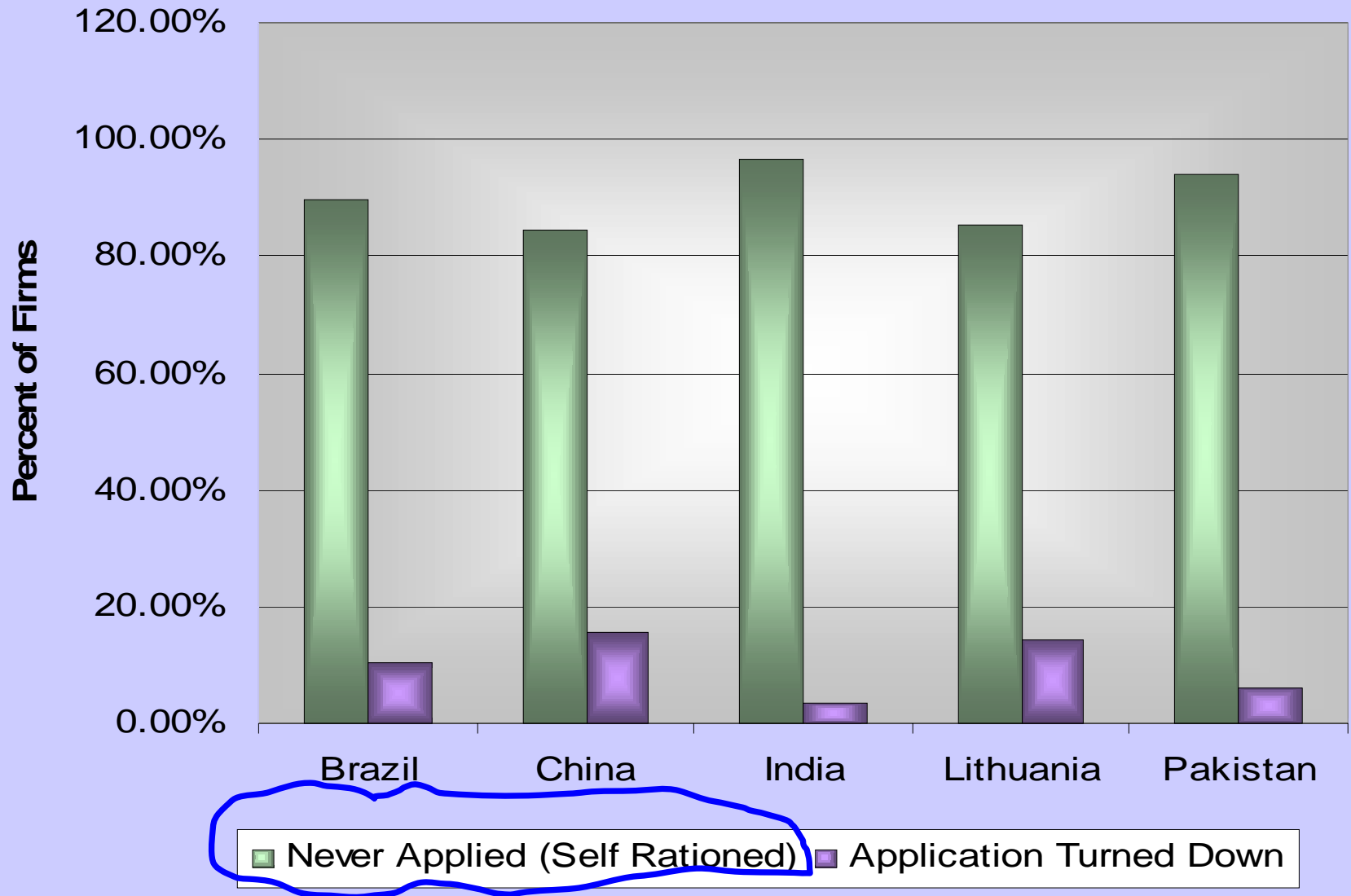
# Role of collateral in financial contracts

## Collateral - Necessity and Value



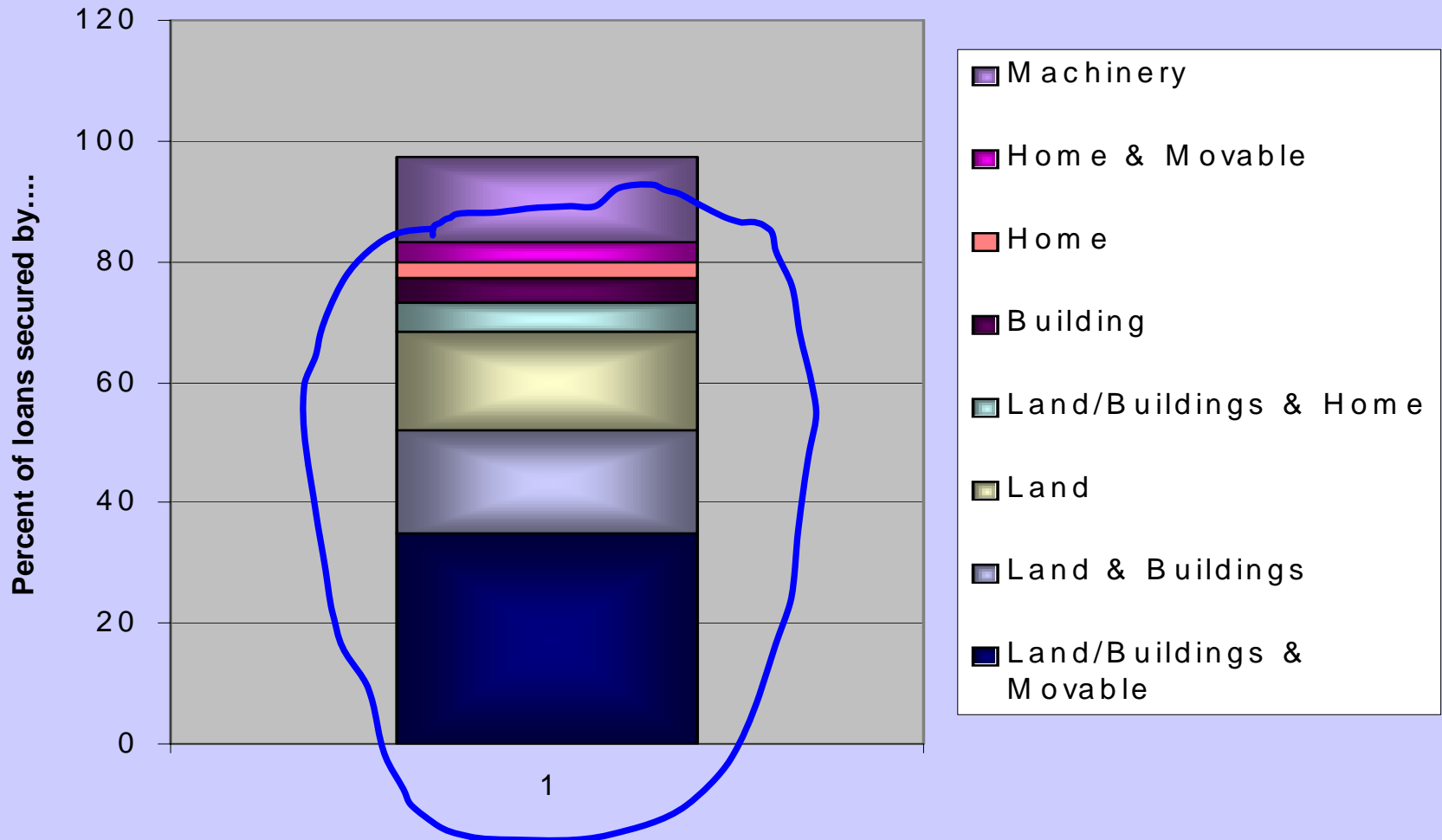
# *Role of collateral in financial contracts*

## **Firms Rationed Out of Credit Market**



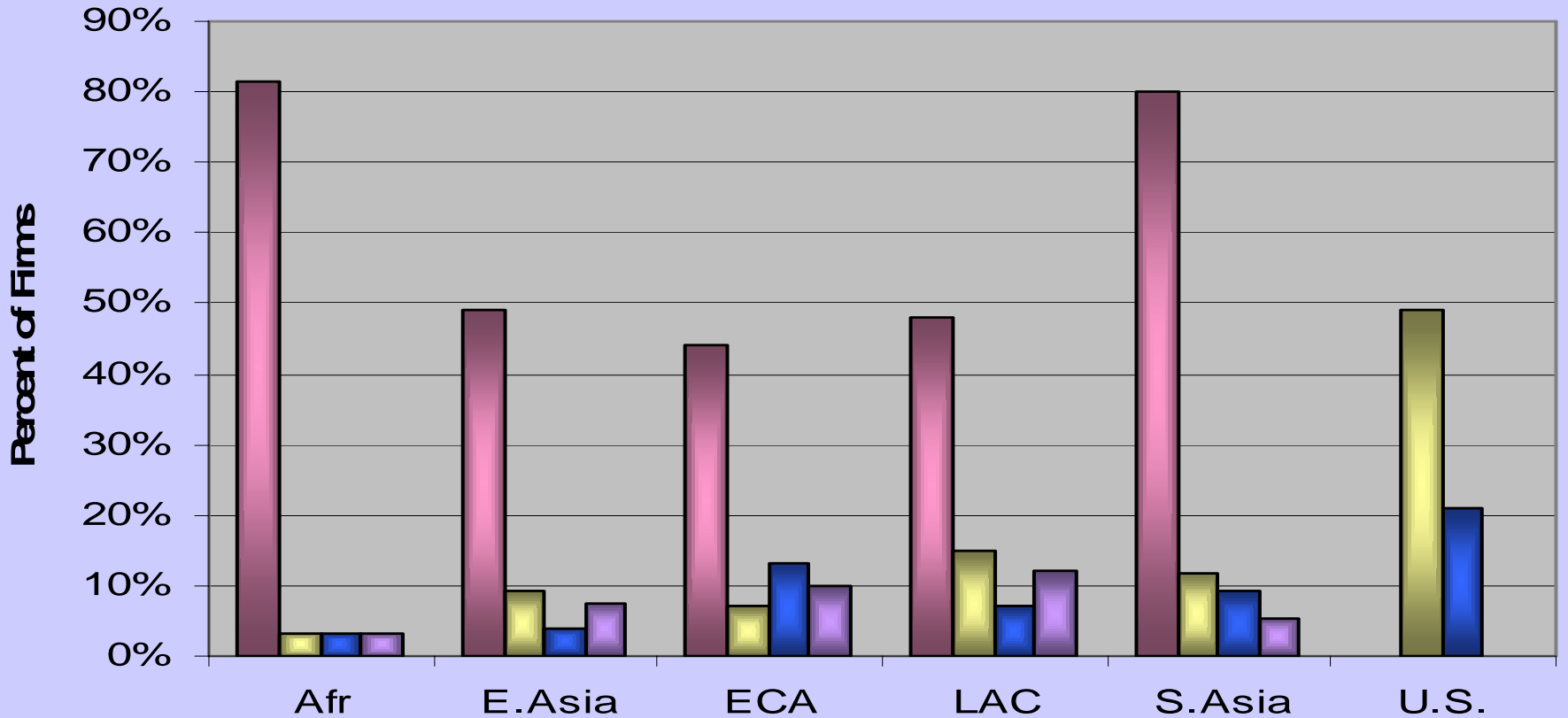
# *Role of collateral in financial contracts*

**Firms usually provide multiple assets to secure a loan in Bangladesh**



# *Role of collateral in financial contracts*

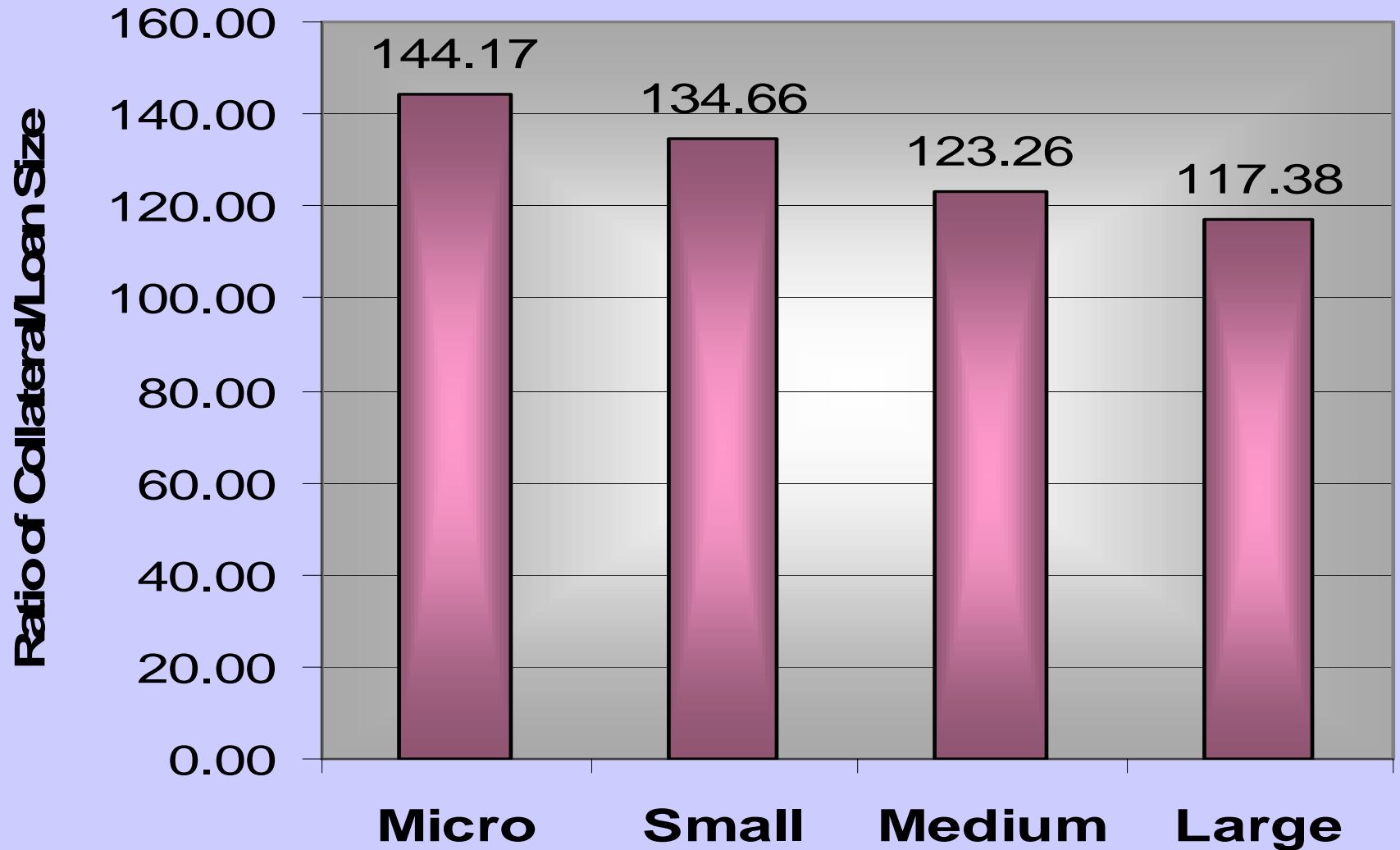
## **Accepted Sources of Collateral**



- Land and buildings
- Machinery
- Intangible assets (e.g. accounts receivable, inventory)
- Personal assets (e.g. house)

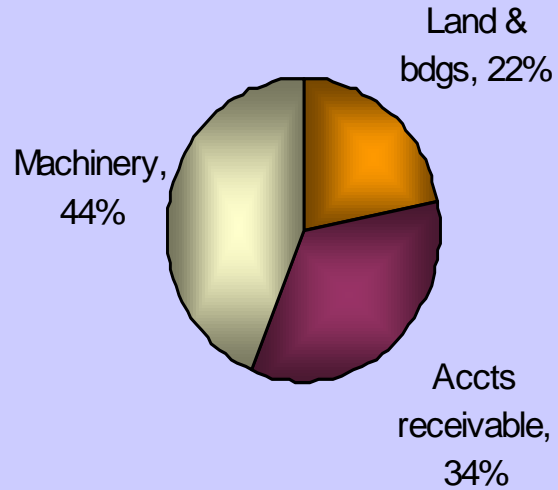
*Impact on different constituencies*

**Value of Collateral Relative to Loan Amount by Firm Size**

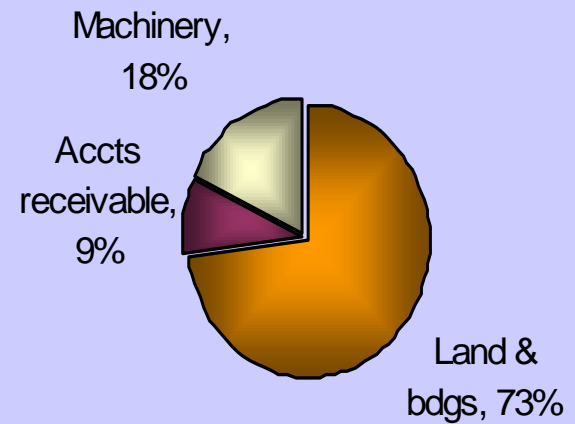


# Opportunity costs

Composition of assets held by firms

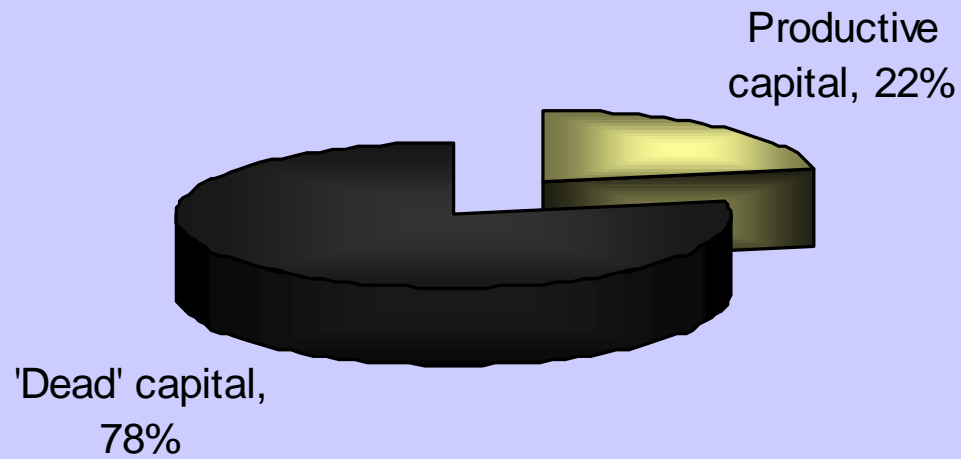


Composition of assets banks accept as collateral from firms



# *Opportunity costs*

**Most assets can not be used to secure a loan**



# Implementing the reform

Creation

Priority

Publicity

Enforcement

# Financial Institutions for MSME Lending

Institutional developments for MSME lending have come from three directions:

1. **Upscaling** from NGO operations (BancoSol)
2. **Downscaling** from Commercial Banks (Bank Rayat)
3. **De Novo institutions** (Bosnia Microfinance Bank)

# The DownScaling Option

- ***Favourable policy environment*** – particularly non caps on interest rates and avoidance of high reserve requirements
- ***Market Incentive:*** spare liquidity, margins being squeezed in existing profit areas, concentrated markets for volume business – can involve loans to MFIs who supply to the MSME
- ***Management Commitment*** – particularly in those institutions whose core business is not retail
- ***Administrative options*** – selecting between integrated, ring-fenced, special vehicles
- ***Human and IT Resources*** – incentives and staff values, specialised Financial IT systems now available

# The De Novo Option

This can often come in form of subsidiary of commercial bank. Start-Up requirements includes:

1. Favourable ***policy environment***
2. Upstream ***timebound performance-based subsidy*** to support institutions over initial period to develop expertise and operations and generate cost-covering revenue from portfolio
3. Concentrated ***market demand for services*** and scale up before extending to less dense markets

# Implementing the Reform

- Strong **commercially based business plans** against which the institution and portfolio can be measured
- Good understanding of the market demand – ***both volume and product requirements***
- Access to ***best practices and new technologies***

# Technical Assistance Options

Technical assistance, linked to portfolio performance covers the following range of activities:

- Streamlining loan policy and procedures
- Prepare SME credit manuals and loan application materials
- Training and mentoring of relationship managers and credit analysts
- Develop Staff incentive systems
- Organization and management of new SME credit departments
- Development of specialised credit scoring models
- Portfolio monitoring

# Institutions for MSME Lending - The Nigeria Context

- The launch of the ***new microfinance policy framework*** has created a framework for the growth of services to this under-served segment of the market. The liquidity in the country (eg: SMIEIS, independent investors) provides ready financing
- Current evidence is that the ***de novo option is moving the fastest***, although as the consolidation exercise settles expectation is that commercial banks will also start to enter the market more through new product (eg guarantees, loans to MFIs), institutional approaches to direct provision
- As secured lending and credit bureau services extend and skills and technology become more widespread and familiar in the industry, it can be anticipated that ***commercial banks will increasingly provide MSME services*** from integrated model