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Abstracts - The paper compares the performance of loans granted to small and medium enterprises by banks with that of micro-credit institutions in Nigeria, using Ondo State as a case study. Descriptive statistics were used to analyse the data collected through primary source. The paper reveals that the average repayment rate of 92.93% for banks was higher than the 34.06% for the micro-credit schemes. That is, the banks performed at much higher levels than micro-credit schemes. Based on the findings, it was recommended that there should be stern efforts by the credit institutions in screening of loan applications, monitoring of approved loans and enforcing loan contract. Government should provide the basic infrastructural facilities, which unnecessarily increase the cost of doing business in the country.

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I. INTRODUCTION

Small and medium enterprises (SMEs) are always constrained in accessing capital, especially from the formal financial institutions. Although, banks in Nigeria are liquid, and would like to make loans available to SMEs, they are constrained by the unfavourable characteristics of the enterprises. The lack

of accessibility to finance the enterprises, therefore, is attributable to both the supply and demand factors in lending. On the supply side, banks are reluctant to grant loans to SMEs because of lack of reliable information on borrowers, low transparency of operations and poor accounting standards, lack of discipline in the use of credit facilities, the perception of the SME sector as risky, and difficulties in enforcing loan contracts. On the demand side, borrowers are constrained by the absence of collateral, improper bookkeeping, high rates of loan diversion and their inability to prepare feasibility studies. In less developed countries where there is a dearth of information on the operations of SMEs, there is always risk aversion by the financial institutions in funding the sector (Ogujiuba, et. al., 2004).

The SME sector in Nigeria comprises those enterprises with a total capital employed not less than ₦1.5 million, but not exceeding ₦200 million, including working capital, but excluding cost of land and/or with staff strength of not less than 10 and not more than 300 (see Table 1).

Table 1 : Categories of Enterprises

Categories of enterprises	Number of Employees	Capital Investment (₦)
Micro enterprises	1-10	Up to 1.5 million
Small enterprises	11-100	1.5 million- 50 million
Medium enterprises	101-300	50 million-200 million
Large enterprises	301 plus	Above 200 million

Source: National Council on Industries, 2001

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The enterprises are in the following sectors: Production (Agriculture, Forestry and Fishing, Manufacturing, Mining and Quarrying; and Real Estate and Construction); General Commerce (domestic trade, export and imports); Services (Public Utilities, Transportation and Communication); and others (Personal and Professional, and Miscellaneous).

Wynarczyk, *et.al.* (1993) identified the characteristics of the small firm other than size. They argued that there are three ways of differentiating between small and large firms. The small firm has to deal with:

- (i) Uncertainty associated with being a price taker;
- (ii) Limited customer and product base;
- (iii) Uncertainty associated with greater diversity of objectives as compared with large firms.

As Berger *et. al.* (1998) observe, there is a consensus view from theoretical investigation supported by numerous empirical studies that small businesses as opposed to larger firms face specific constraints in raising external finance. The obvious question is why banks despite better debt servicing, do not expand SME portfolio? Why is the performance of banks' loans, based on their standardized lending requirements? Are the performance rates similar in banks and micro-credit institutions? Answers to the questions above constitute the focus of the research work. The paper compares the performance of loans granted to small and medium enterprises by banks with that of micro-credit institutions in Nigeria, using Ondo State as a case study. The paper also examines the factors that contribute to loan performance in banks and credit schemes in Nigeria. The study further examines the implications of such performance factors on financial stability of the country. This research, therefore, intends to provoke a further research, especially in developing countries on the issue of loan performance among small and medium enterprises. This is important in order to guarantee the safety, stability and soundness of the financial system. The results of the study will be useful in SMEs policy formulation on firms' financing, in both Nigeria and other countries.

II. LITERATURE REVIEW

The financing, growth and performance of small and medium enterprises (SMEs) are of interest for a number of reasons. The enterprises contribute significantly in employment generation, income generation and catalyzing development in urban and rural areas (Rogers, 1999, Hallberg, 2000, Olutunla, 2001, Kaibori, 2001, Cook, 2001, Davis and Gaburici, 2001, NRO, 2002, Berry, 2002, Beyene, 2002, Mahemba and De Bruijn, 2003, OECD, 2004, Fraser, 2004, Kimambo, 2005 and Williams, 2006). However, these enterprises are constrained by myriad of problems including finance, lack of managerial and technical

skills, high costs of doing business and inadequate availability of support infrastructure services.

The enterprises do not have access to public capital markets and hence depend on banks for funding. This means that distress in the banking system can have significant impact on the supply of credit to the SMEs (Ogujiuba, *et. al.*, 2004). As Ojo(1992) argues, these enterprises have also been unable to obtain needed finance from the financial institutions, either because of (i) an "information gap", which prevents them from knowing how and where to obtain this finance on acceptable terms, or (ii) a genuine "availability of funds gap", which is due to the failure of financial institutions to appreciate the economic prospect and developmental role of these enterprises. The report of the World Bank (2001) survey in Nigeria, cited in Ogujiuba *et. al.* (2004), shows that 52% of the micro firms have access to external finance, 82% of small and 89% of medium scale firms also have access, while large firms have almost 100% access to external finance. The World Bank report also indicated that almost 50% of the micro, 39% and 37% of the small and medium scale firms sampled respectively, report being credit constrained, as opposed to 25% of the very large firms. The implication is that small businesses face funding limit, and are discriminated against in credit market, which may lead to large firms crowding out smaller firms in the market (Ogujiuba *et. al.* 2004). The lack of adequate funding means that SMEs are entangled in a vicious cycle of low incomes, low profits and low capital formation.

Similarly, the imperfect credit market conditions and lenders inefficiency allows the powerful (politically or otherwise), dishonest or credit unworthy borrowers to have access to larger loans, who tend to get away with credit money or to become willful defaulters. This is not true for SMEs. Surprisingly, the banks regard the SMEs as a high-risk sector, with high rate of default in loan repayment, apart from the information asymmetry that often exists between SMEs and the lending institutions. High default rate, if it exists, should be of major concern to both the lenders and policy makers, because of its unintended negative impacts on SMEs financing. Von-Pischke (1980) states that some of the impacts associated with default include: the inability to recycle funds to other borrowers; restraint by other financial intermediaries from serving the needs of small borrowers; and the creation of distrust.

Therefore, the theoretical framework adopted for the paper involved models of lending behaviour based on an agency framework (Cook, 2001). Agency theory is concerned with how agency affect the form of the contract and how they can be minimised, particularly, when contracting parties are asymmetrically informed. Fundamentally, the problem arises because lenders are imperfectly informed about the characteristics of potential borrowers, and it may be impossible, as a result, for lenders to distinguish 'good'

borrowers from 'bad' ones (Fraser, 2004). As observed by Akerlof (1970), and cited by Kitchen (1972), a systematic bias may arise in SME financing, because of the theory of the market for "lemons". Because small businesses, especially in developing countries, are regarded as "high-risk", the level of risk associated with the riskiest small business tends to be applied to all small businesses. Consequently, bad businesses tend to drive the good out of the financial market. The good businesses have to raise equity or debt on terms that exaggerate their risk. The gap between the true risk and the perceived risk of the financial markets is termed the "lemon gap". The problem of information asymmetries highlights the importance of relationships between lenders and borrowers. As Fraser (2004) observes, longer and broader relationships increase the amount and flow of information to lenders, enabling good borrowers to obtain better access to finance over time. Therefore, information asymmetries lead to sub-optimal flows of finance available to smaller firms compared to larger firms (Cook, 2001).

III. COMMERCIAL BANKS AND MICRO-CREDIT'S PROGRAMMES FOR SMES

In Nigeria, the financial system is dualistic and consists of formal and informal systems. The Informal Financial System (IFS) comprises the institutions that

are virtually outside the control of the established legal framework. The Formal Financial System (FFS) refers to an organized, registered and regulated sector of the financial system. Thus, banks and credit schemes are components of the formal and informal financial systems. Commercial banks in Nigeria, although mainly cater for large borrowers, have developed an innovative interventionist lending strategy known as Small and Medium Industries Equity Investment Scheme (SMIEIS), from 1st August, 2001, to address the credit needs of small borrowers. The scheme requires all commercial banks in Nigeria to invest 10 per cent of their profit before tax in small and medium scale enterprises of their choice in equity participation. This is aimed at improving the flow of funds to re-vitalize the real sector of the economy. A cumulative sum of ₦38.2 billion was set aside by the existing 25 banks under the SMIEIS as at the end of the first quarter of 2007, out of which ₦18.1 billion or 47.3 % was invested in 258 projects (CBN, 2007). Commercial banking credit to the small and medium enterprises in Nigeria has continued to dwindle over the years. Figure 1 shows commercial banks' loans to small-scale enterprises as percentage of total credit to the economy.

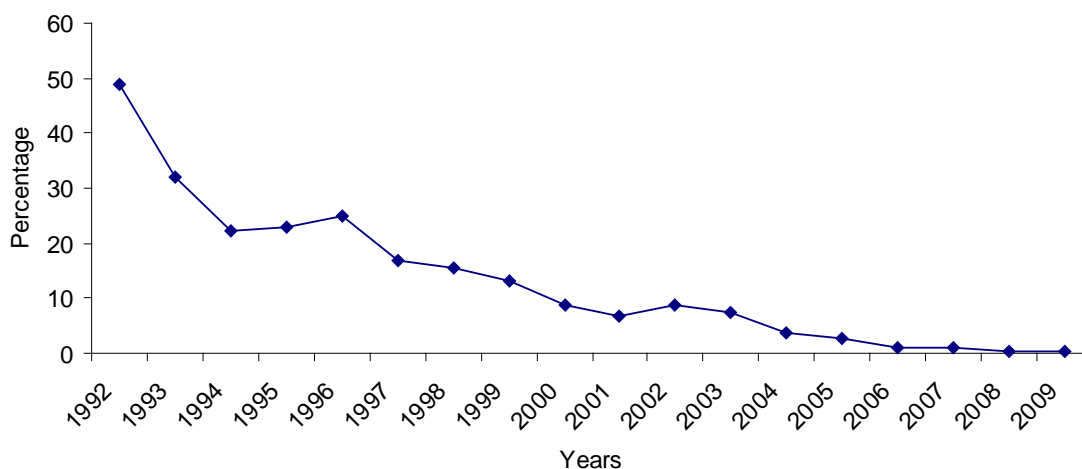


Fig. 1: Commercial Banks Loans to Small Scale Enterprises as Percentage of Total Credit in Nigeria

In assessing the creditworthiness of borrowers, banks applied standard and stringent requirements, to determine the viability of the business and the ability to repay the loans. Banks prefer borrowers who have record of accomplishment of profitability and assets that can be used as collateral. The range of factors usually considered include financial strength, profitability, net worth, track record, management quality, relations and

payment records with other banks, business prospects, business risks, opinions from trade counterparties and collateral. In most cases, banks request for personal guarantee for SMEs loans. The banks requested for collateral as an additional requirement, apart from requiring personal guarantees for SME loans, because the financial and operational transparencies of SMEs were relatively low and their accounting standards were

poor. The enterprises are also perceived as risky because, in most cases, the death of the owner leads to the death of the business, diversion of funds, high cost of monitoring loans and the fact that most of the loans may not be collateralised. The enterprises are also accorded very low priority rating in credit institutions' lending, because they are perceived to be associated with high degree of loan diversion to unscheduled activities and high rate of default in loan repayment (Inang and Ukpong, 1992). Loan default can be defined as the inability of a borrower to fulfill his or her loan obligation as and when due (Balogun and Alimi, 1990). Many factors have been identified as major determinants of loan defaults. A large number of studies has claimed that the disparity in problem loans and losses among commercial banks depend largely on bank internal factors such as management quality, bank size, portfolio composition, cost control, credit policy, capital adequacy and credit risk (Huh and Kim, 1994; lyoha and Udegbumam, 1998; and Udegbumam, 2000, 2001). However, the lending activities of government credit institutions are different from that of the commercial banks. This is because the cost of administering small business loans is higher for the banks. As Hill and Martin (2000) observe, if default rates and loans administration costs differ between two groups, lenders have an economic motive for applying different lending criteria to different groups. Most micro-credit institutions in Nigeria are public owned. Some of the past and present government credit schemes in Nigeria are Small Scale Industries Credit Guarantee Scheme (1971), Agricultural Credit Guarantee Scheme (1973), National Economic Reconstruction Fund (1992), Small and Medium Scale Enterprises Loan Scheme (1992), Family Economic Advancement Programme (1997), and Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) in 2004.

The government of Ondo State put forth comprehensive credit schemes to minimise the adverse economic impacts on the economically active entrepreneurs. The schemes are meant to provide credit for the small and medium businesses in the State. The loans attract low interest rates and maximum of three-year repayment period. The main intentions of the credit schemes are to create self-employment and target poverty reduction. Thus, there is improper screening of loan application, improper monitoring of loans after approval and lack of political will to enforce loan contract. There is a tendency for most of the loans from micro-credit institutions to be involved in defaults. Moreover, the fact that most of the loans may not be collateralised means that the micro-Credit institutions are likely to be involved in problem loans and losses. Okorie (1986) shows that the nature, time of disbursement,

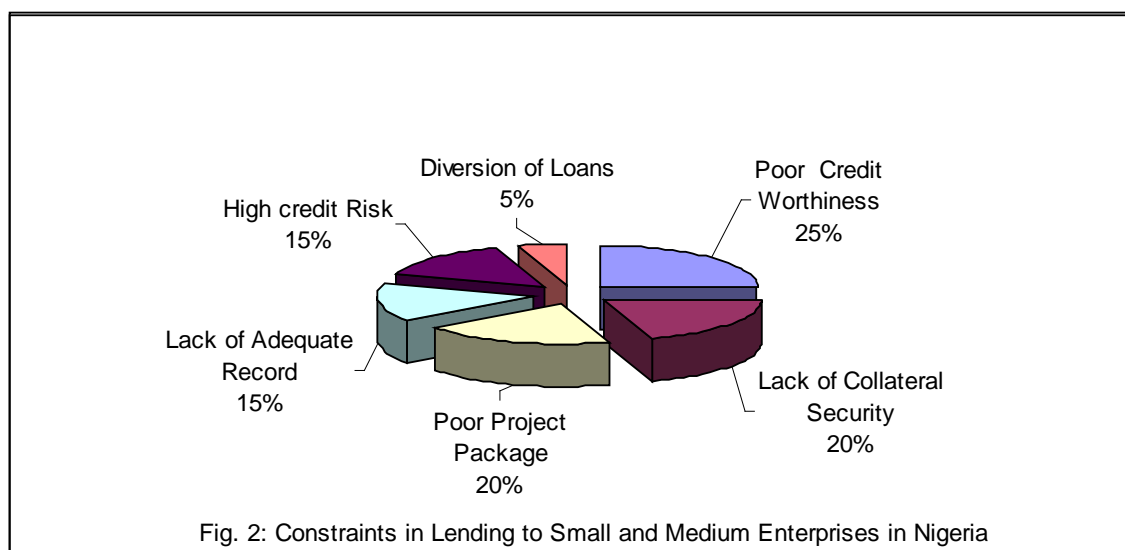
supervision and profitability of enterprises which benefited from small holder loan scheme in Ondo State, contributed to the repayment ability and consequently high default rates.

IV. METHODOLOGY

The study was conducted in Ondo State, Nigeria, because the State has abundant human and natural resources for the growth of Small and medium enterprises. Data were collected from the records of commercial banks in the State. The list of all commercial banks and their addresses were obtained from the Central Bank of Nigeria, Akure Branch. From the 28 commercial banks existing as at the time of the study, 15 banks were selected through a stratified random sampling technique, out of which 9 banks provided complete data for the study. In each bank, data was collected, dealing with the number of SMEs financed, amount of loans granted, amount of loans repaid, amount of loans defaulted and the perception of the banks about SMEs, among others. This information was used to assess the level of loan defaults by small and medium enterprises. For comparative purpose, the study also made use of data collected from the records of 9 micro-credit schemes, out of the 13 credit schemes based on their involvement in SMEs loans. The author also administered questionnaire to 166 SMEs, which were randomly selected from a list of active (operating) enterprises provided at the Ondo State Board of Internal Revenue and Ondo State Ministry of Commerce and Industry, Akure.

V. DATA ANALYSIS AND RESULTS

The fear of loan performance has been pronounced in many public lectures as one of the reasons why commercial banks have not shown much interest in SMEs financing. This perception, notwithstanding, the commercial banks interviewed indicated that their unwillingness to lend to SMEs was due to a number of unfavourable factors associated with the enterprises. As shown in Figure 2, some of the constraints militating against commercial banks granting loans to SMEs include, although not limited to, poor credit worthiness (41.7%), lack of collateral security (33.3%), poor project-package (33.3%), lack of adequate record (25.0%) and high risk (25.0%).



All these problems have combined in several ways to make lending to the SMEs sector very difficult by the commercial banks. The full implications of the various constraints to lending have been that commercial banks lending to the SMEs sector has been mainly on short-term basis, which hardly improve firm performance. Jaramillo and Schiantarelli (1996) gave two main reasons why long-term loans may improve productivity of firms. First, it may allow firms to better

and more productive technologies, which the firm may be reluctant in financing with short-term debt because of fear of liquidation. Second, lack of availability of long-term finance may put a squeeze on working capital and this may have adverse consequences on productivity.

Table 2 shows a comparative loan performance of banks and micro-credit schemes among the small and medium enterprises.

Table 2: Summary Comparison of Loan Performance of Banks and Credit Schemes in Ondo State, Nigeria

Institution		Credit Scheme			Bank		
Code	Amount Due (N' million)	Amount Recovered (N'million)	Repayment Rate (%)	Amount Due (N'million)	Cum. Rec. (N'million)	Repayment (%)	
01	180	76.84	42.69	25.3	22.66	89.57	
02	7.2	4.5	62.50	1740	1640	94.25	
03	5.435	1.606	29.55	55.3	49.20	88.97	
04	115.54	10.167	8.80	34.0	29.80	87.65	
05	14.0	2.2	15.71	20.0	18.00	90.00	
06	9.0	7.5	83.33	11.2	9.90	88.39	
07	2.0	1.5	75.00	500.0	446.0	89.20	
08	15.68	0.199	1.27	149.5	145.5	97.32	
09	30.5	24.7	81.00	29.42	22.31	75.83	
Total	379.36	129.212	34.06	2564.72	2383.37	92.93	

Source: Computed from field data

From Table 2, the average repayment rate of 92.93% for banks was higher than the 34.06% for the micro-credit schemes. Thus, the banks have generated self-employment opportunities for people who were either unemployed or underemployed earlier, increasing economic activities in the State. Anderson (1982), for example, spoke of default rates varying from 10 per cent to 60 per cent or more in most developing countries. Little (1987), quoting Levitsky (1983) and Rangarajan (1980) and cited in Balogun and Alimi(1988), concluded that "when loans have been made to very small and new enterprises by development banks, the default rate has been high, often catastrophically high". The explanation for the observed high repayments of debt by the SMEs operators could be that the SMEs are utilizing the loans for productive purposes. The entrepreneurs may wish to preserve their reputations as good borrowers and to avoid the threat of direct sanctions. As warned by Albee(1996) and cited in Snow and Buss (2001), this development presumes that there is no potential 'debt trap' for the borrowers by using new loans to pay off old loans, creating the illusion of high repayment rates. However, part of the result is likely to be due to the bias that for those small and medium enterprises that the lenders believe they have high probabilities of default, loan applications are not approved, as well as the problems of self-rationing of small and medium enterprises. However, the performance rate of banks can be compared to that of credit schemes in the State. Based on the analysis in Table 2, it was found that the repayment rates in most of the government credit schemes fluctuated from a low level of 1.27% to 81.0% for some of the government credit schemes. Specifically, the low performance rate in the credit schemes could be attributed to the following reasons: First, there was no credit culture in lending for the schemes, which among others involves proper screening of loan applications, and monitoring of the loans after approval. Second, the design of the schemes made it entirely state-owned and state-managed schemes. Thus, the wrong perception of Nigerians and the entrepreneurs about State-owned and State-managed schemes has reflected in their unwillingness to repay loans, as they considered the loans as their shares of government funds. Although, the funds obtained were used by the entrepreneurs to either start or expand their businesses, most times, they are unwilling to repay based on the mentality of using government funds. Third, the politically active entrepreneurs are always favoured in lending for start-up or expansion, but may not be sufficiently committed to the businesses for which the loans were granted. Thus, it becomes difficult for the government, to exercise necessary political will to force repayment, if the business failed or could not pay back the loans. It is common for most of such businesses failing after 6 - 10

months of establishment. Fourth, the low repayment could have also arisen from the long period over which loans were granted (between 12- 48 months), especially in the absence of good lending principles. The results of low loan performance for government credit schemes in this study confirm the study in Indonesia (USAID, 2005), where public ownership models for microfinance for the past three decades have not performed well, due to misguided government policies which distort markets, through targeted subsidised credits, political interference or corruption. This explains why governments in some countries have taken new approaches to public ownership of Micro Finance Institutions, by encouraging public-private ownership, mechanisms to depoliticalise the institutions, and an increased adherence to market principles (USAID, 2005). The Grameen bank's extraordinarily high repayment from 98 to 100 per cent is largely due to the tight supervision and the participatory process at work in the groups of five and in the centre (Bahar, 2001). However, the study found that only few enterprises in Ondo State, Nigeria, have capital investment above the ₦1.5 million stipulated as minimum capital for SMEs. This is not surprising because the level of income is low in the country, and most enterprises derive their start-up capital from past savings and borrowing from friends/relatives. Thus, the government and the banks should review the operational definition of SMEs, especially for the purpose of SMEIS financing.

VI. CONCLUSIONS

The paper compared the performance of loans granted to small and medium enterprises by banks with that of micro-credit institutions in Nigeria, using Ondo State as a case study. The study also examined the implications of such loan performance on financial stability of the country. The research revealed that loan performance rate in bank was higher than that of government credit schemes for SMEs in Ondo State. Thus, the results implied that the banks have performed at much higher levels than government credit schemes. The results disagree with the common belief that small business lending is risky for banks relative to other types of lending. The paper recommended that there should be stern efforts by the credit institutions in screening of loan applications, monitoring of approved loans and enforcing loan contract. Policy makers should ensure conducive environment necessary for improved performance and growth of SMEs. This might involve providing the basic infrastructural facilities, which unnecessarily increase the cost of doing business in the country. The stakeholders in the financial system must always work together to reinforce the financial benefits arising from high loan performance because it has positive effects on the stability of the financial system.

More importantly, there is need for the private-public sector approaches in SMEs funding, which will change the mind-sets of the people towards handling loans from government credit schemes.

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