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Financial Sector Liberalization and Challenges of Real Sector Financing in Nigeria: The World Bank Perspective

Ismail Radwan[*]

Deepening Nigeria's financial markets is a key component of economic diversification and job creation. An efficient and functioning market for credit will stimulate business activity and support Nigeria's dynamic entrepreneurs. There is a prevalent feeling that following the banking sector crisis which erupted in August 2009, this process has stalled as commercial banks have curtailed their lending to the private sector causing a credit crunch or squeeze.

Our analysis indicates that such a credit crunch has not taken place. Instead banks have moved to clean up their loan portfolios, writing off bad loans that fueled speculation in the stock market and the energy sector. Under increased scrutiny from the CBN, commercial banks have tightened credit procedures and improved reporting standards to reduce irregular practices such as related-party and insider-lending. This process has been accompanied by a flight to quality as banks switched from speculative assets to secure government papers and also placed increasing liquidity in the interbank market – now guaranteed by the CBN. As interest rates on government debt fell – yields on one year treasury bills plummeted to 4 per cent - the pressure on the banks to seek more lucrative earning assets has increased. Many banks are starting to focus on the emerging SME loan market, where interest rates are a good deal higher. But most are reluctant to enter a traditionally risky and difficult market. **If government can improve the SME lending environment, activity in the sector will grow quickly**.

The key threat to increased SME lending is the burgeoning fiscal deficit. Government spending has climbed inexorably since 2006, while revenues have been volatile. The excess crude account has been depleted and government has borrowed increasing amounts (largely financed from domestic sources) to finance the shortfall. If these trends are not reversed the private sector will continue to be crowded out, interest rates will rise and banks will continue to be tempted to focus on buying government paper rather than starting to expand lending to the real sector.

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In addition to ensuring fiscal discipline **government can take steps to improve real sector in Nigeria;**

- Improving creditor rights, credit information, collateral registries and fast-tracking the completion of a national identity management system and introducing commercial courts.

- Building regulatory capacity so that the ongoing reform of the financial sector is effective in managing risk rather than just a symbolic exercise.

- Building capacity in the private sector through business development services, managerial training and financial literacy programs.

- Building capacity in the banking sector through downscaling programs to introduce new techniques and products e.g. reverse factoring, warehouse receipts and equipment leasing.

- Quickly resolving the uncertainties surrounding the rescued banks and AMCON.

- Developing long-term options for housing finance and infrastructure finance.

In doing so government must avoid the mistakes of the past; ending costly and poorly targeted interest rate subsidies, avoiding directed credit and above all ensuring sound supervision and regulation of the banking sector.

I. Introduction: Real Sector Financing a Key Component of Job Creation

Nigeria has made tremendous progress in economic development over the last ten years. Successive governments have achieved macroeconomic stability, tamed inflation, secured a stable exchange rate and established fiscal prudence. These achievements, along with the write-off of Nigeria's external debt, have produced a period of long and steady economic growth. However, this growth has not been met with a corresponding increase in the number of jobs especially for Nigeria's youth.

It is widely accepted that the private sector is the engine of growth. The creation of an enabling environment will make it achievable. Three major challenges have been identified as constraints to doing business in Nigeria; the lack of power, poor roads and lack of access to finance as well as the cost of finance.

Providing finance to Nigeria's real sector especially the small and medium enterprises (SMEs) will be a key component of future job creation. Nigeria's banks have never successfully lent to the nation's SMEs. This paper reviews banks efforts in providing financing to the real sector with a view to creating more jobs. It provides recommendations on pro-active policy measures that the public sector authorities can undertake to address the issue.

II. The "Credit Crunch": Real or Imagined?

There is a widespread view in Nigeria that the recent banking sector crisis has been followed by a credit crunch and that this has restricted access to finance in the real sector. This section reviews the evidence starting from the banking sector reforms that took place between 2004 and 2006.

Explosive credit growth 2006-2008

As a result of the consolidation of the banking system completed in 2005, Nigeria witnessed increased growth in the banking sector. Banks expanded very rapidly, raising large amounts of new capital and attracting large volumes of new deposits. These were in turn deployed to fund enormous growth in the banks' loan portfolios. By 2008, analysts of the Nigerian financial sector were becoming increasingly concerned by the pace of credit growth given the weak governance of Nigerian banks, outdated legal and regulatory frameworks, and weakness of supervisory institutions.

During this review period, it was now recognize that much of the lending which was then taking place was either:

(a) margin loans; financing speculation in the stock market (often in the form of investments in bank shares);

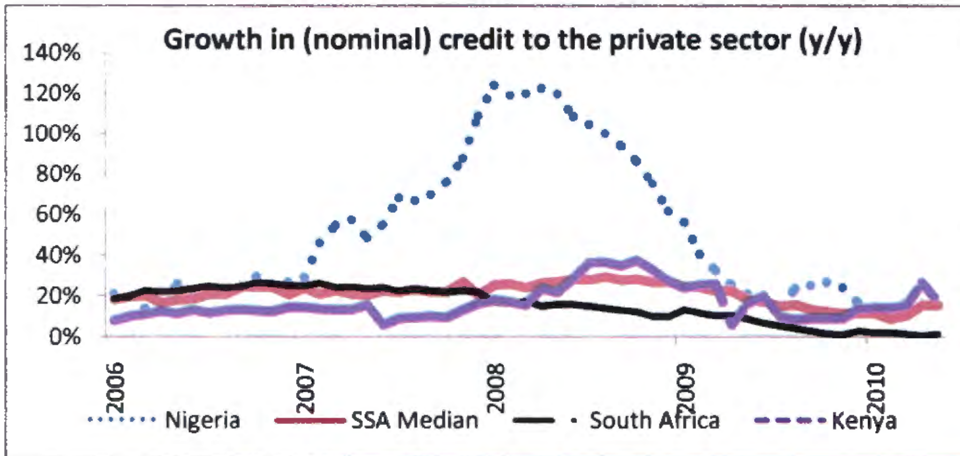
(b) concentrated in the oil and gas sector without adequate credit assessments or collateral;

(c) fraudulent behavior such as related-party lending, insider-trading and inaccurate reporting.

None of this lending was actually being channeled to productive uses in the real sector or value-adding businesses; and it became apparent that a credit and stock market bubble had formed by early 2008. In January 2008, the World Bank undertook an analysis that indicated that the Nigerian stock market had the

second highest price-earnings ratio of any stock market in the world. The report also underscored the weaknesses in the banks portfolios exacerbated by poor supervisory practices and weak accounting systems. During the review period, the global financial crisis, the stock market meltdown and the collapse in oil prices resulted in huge default rates in Nigeria's banks.

Figure 1: A Credit Bubble Develops 2006 – 2009



Source: Central Bank of Nigeria 2010.

The CBN reins in the banking sector's excesses

As a result of the special inspections carried out by the Central Bank of Nigeria (CBN) in mid-2009, the extent of the build-up of risk – and the inaccuracy of financial reporting – in the banking system became apparent. Eight banks were intervened in and "rescued" with convertible loans from the CBN, which simultaneously took measures to guarantee all interbank transactions, and replaced senior management and executive directors. These eight banks have not only depleted their capital but together accounted for further losses estimated to be in the order of ₦1.4 trillion (US$9.3 billion). In addition, even the stronger banks that passed the CBN's stress testing have also had to write-down bad loans and dramatically increase provisioning.

Since mid-2009 the CBN has implemented or announced a suite of measures designed to improve regulation, governance, and transparency in the banking sector, such as a common year-end for financial reporting, implementation of International Financial Reporting Standards (IFRS), abandonment of the universal banking model and introduction of financial holding companies, and restrictions on the terms of executive and non-executive directors. In parallel, the Securities

and Exchange Commission has moved to clean up the securities industry by suspending and prosecuting firms and individuals and by restructuring the management and governance of the Nigerian Stock Exchange (NSE).

Lastly, the National Assembly recently approved the establishment of the Asset Management Corporation of Nigeria (AMCON), which will purchase toxic assets from banks and/or recapitalize distressed banks where this is required to support their sale to new investors. By relieving banks of the management burden of dealing with distressed assets, and by cleaning up their balance sheets sufficiently to allow them to raise new capital, AMCON has the potential to encourage renewed credit growth. The possible entry of strong strategic partners through acquisition of the distressed banks also offers an important opportunity to inject the skills and technology required to prudently expand lending.

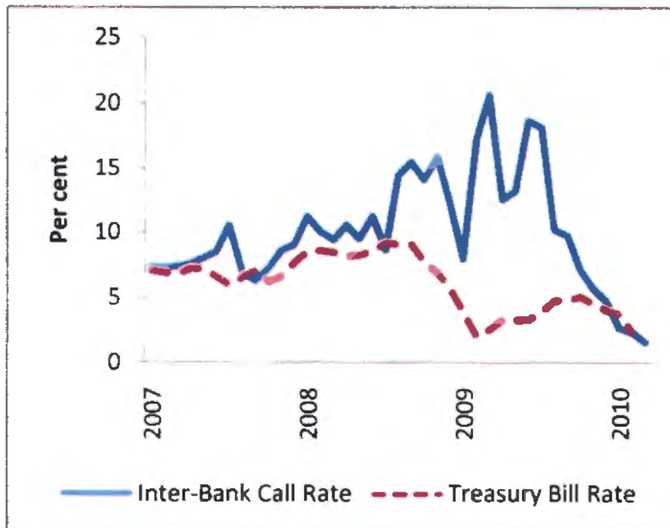
However, several key aspects of AMCON's operations remain to be defined:

- The formula determining the price at which AMCON will purchase assets from banks must be set in a way which carefully balances providing a fair value for assets against a too-generous formula which allows banks to "dump" assets on the taxpayer, potentially transferring value from the taxpayer to shareholders. A correctly set price should, thus, inflict some pain on banks selling assets to AMCON, but not so much that banks do not use the facility. A price which gives AMCON some reasonable probability of recovering the amount paid to a bank for assets – but not of making a significant profit – would be the optimum.

- The CBN is concerned about the problem of how to deal with small shareholders of the banks – whom it can be argued were simply victims of widespread fraud which the authorities failed to prevent. Dealing with such an issue is extremely difficult. Considerable public resentment can be expected if the banks' shareholders are "bailed out" by AMCON. It is vital that shareholders do not receive compensation – if they do, serious moral hazard would be created and a large measure of the beneficial effects of the shock recently delivered to bank management and shareholder (improving governance) would be lost. In this context, it is important that the CBN focuses on improving the regulation and supervision of banks to ensure that shareholders and depositors are well protected in the future.

Figure 2 : A Flight to Quality Takes Place

Treasury bill and interbank call rates plummet



Source: CBN 2010

A flight to quality by lenders and borrowers

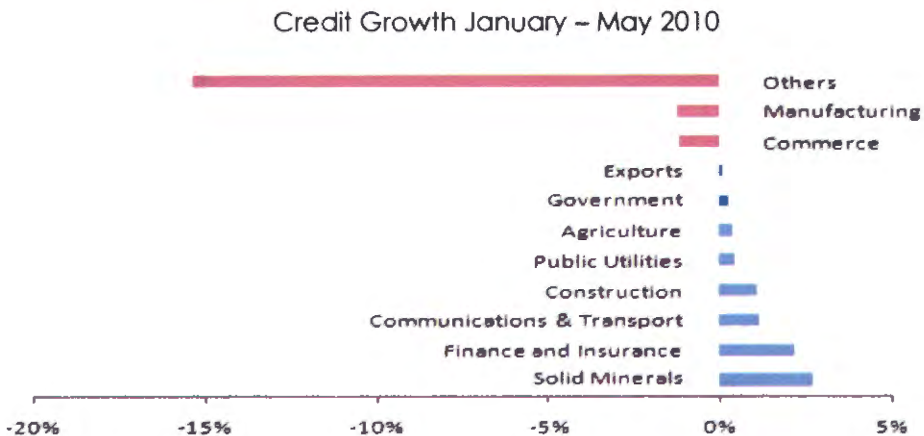
Following the CBN's special inspections, the banking sector "went into shock" and a general flight to quality took place: on the part of depositors to the largest and best managed banks which had survived the mid-2009 inspections, and on the part of banks to cease lending and redeploy their funds into government securities and the inter-bank market. As a result, by early 2010, banks began to rapidly accumulate liquidity, and treasury bills rates plummeted, with the interbank call rate falling to 1.1 per cent and 1 year Treasury bill to 4.2 per cent by mid-August 2010, from 4.5 per cent and 20.4 per cent, respectively, a year earlier.

Has credit been squeezed?

Within such an environment one might expect to see a tremendous contraction in credit to the private sector. Indeed, there have been complaints in the Nigerian media that the real sector faces an unprecedented credit squeeze as a result of banks' withdrawal from lending, with attendant negative consequences for growth and employment. However, these complaints need to be assessed with caution. Analysis indicates that while total credit did contract in the first five months of 2010, this contraction (overall 9.5 per cent) was highly concentrated in a single category "Others" which contracted by more than 15.0 per cent. At the height of the boom, this category accounted for more than 30.0 per cent of bank

lending and is believed to be primarily share-purchase margin loans. The contraction in this category is, therefore, predominantly the result of banks taking provisions and write-offs against margin loans in recognition of the diminished value of the underlying share collateral.

Figure 3 : Credit is still growing in most sectors

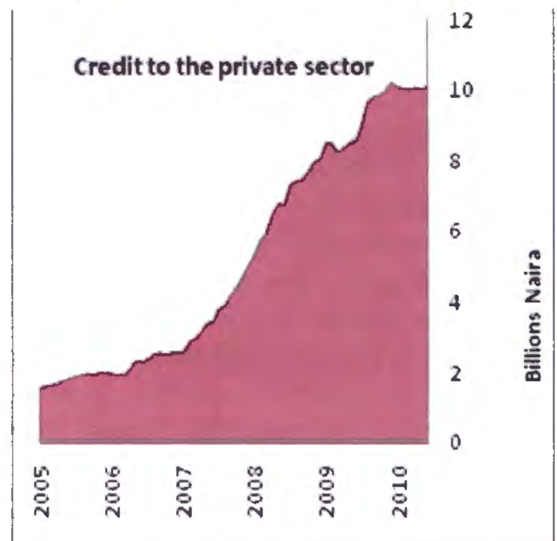


Source: Central Bank of Nigeria 2010

The real sector appears to be unaffected

While total credit to the private sector (Figure 4) flattened in nominal terms in the early months of 2010, lending to the real sector[1] continued to increase in nominal terms – indicating that it remained flat in real terms – and over the longer period of January 2009 through May 2010 has in fact increased in both real and nominal terms. Credit to the financial sector also increased reflecting banks' deployment of increased liquidity into the interbank market and more recently in solid minerals sub-sector.

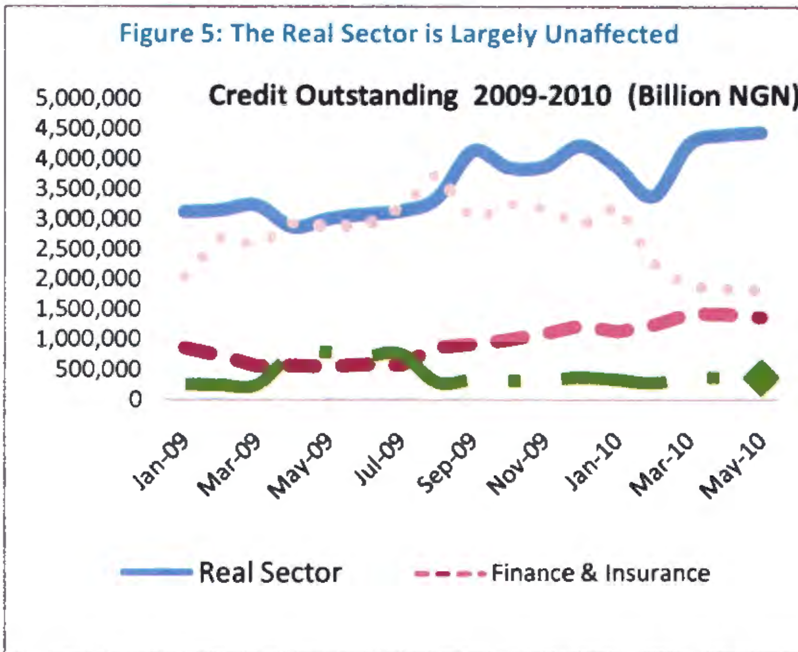
Figure 4 : Credit has not been squeezed



The data indicates that the real sector in

[1] The CBN's credit categories of: Agriculture, Exports, Manufacturing, Public Utilities, Solid Minerals, General Commerce, and Real Estate & Construction.

the aggregate has not experienced a credit crunch of any magnitude, although lending to manufacturing and commerce, both important areas for job creation has contracted. The CBN has taken steps to cushion the potential fallout from this development.



Discussions with bankers reinforce the conclusion that real sector credit has always been highly concentrated in approximately 60 large, "blue chip", Nigerian and multinational firms and the post-crisis banking system has returned to its traditional focus on these firms. To the degree that credit standards have tightened, the "losers" have been small and medium enterprise (SMEs) "entrepreneurs" in commerce and manufacturing, who were able to secure credit during the boom years from banks. Following the special audits, as the banks reigned in their excessive lending, they also withdrew credit lines to these SMEs in the process. Indeed, were the provisions taken against loans to such borrowers from August 2009 to May 2010 period, which was excluded from the analysis, the expansion of credit to blue chip firms would likely be shown to have continued at its usual annual rate.

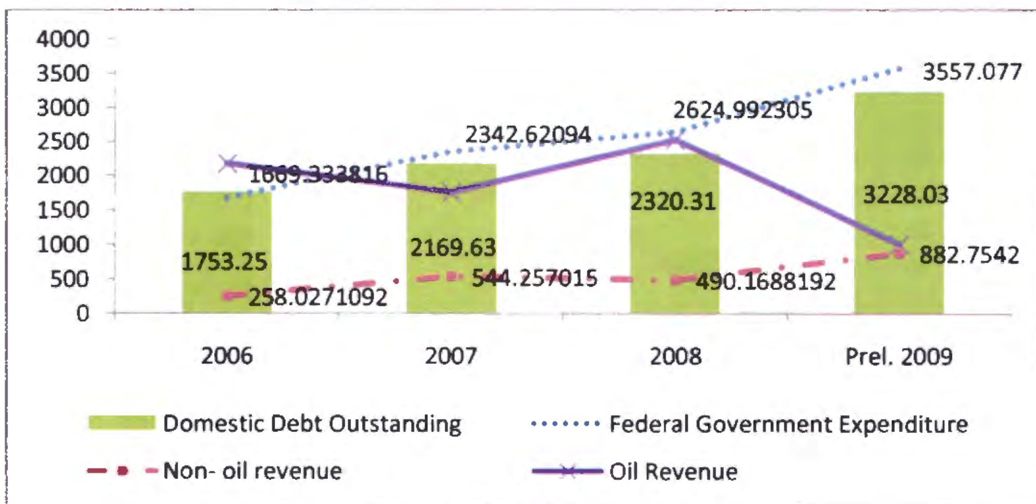
Is real sector lending being "crowded out"?

The incentive for banks to expand their lending to the real sector is driven by the current pressure on their earning capacity, particularly the recent quite dramatic

drop in money market and government security interest rates – i.e. the interest earned on alternative 'safer' assets (Figure 2). Experience suggests that Nigerian banks are keener to invest in safer assets and avoid the risks associated with expanding their loan books. This behavior is likely accentuated both due to current political uncertainties and the recent write-offs they have experienced, even though the latter were not a result of real sector loans going into default.

Unfortunately, the process of crowding out is already very much in evidence. Maintaining the balance of incentives to the advantage of encouraging banks to increase their lending to the real sector will be a major challenge in the coming months. As shown in Figure 6, Government oil revenues declined considerably in 2009 while government expenditure has continued to climb inexorably higher. Government filled its financing gap through the increased issuance of treasury securities. This has led to a situation where total debt outstanding has gradually risen. As most of this debt is financed domestically, it has started to crowd out the private sector.

Figure 5 : Trends in Federal Govt. Expenditure, Revenue and Government Debt Stock (N'Billion)



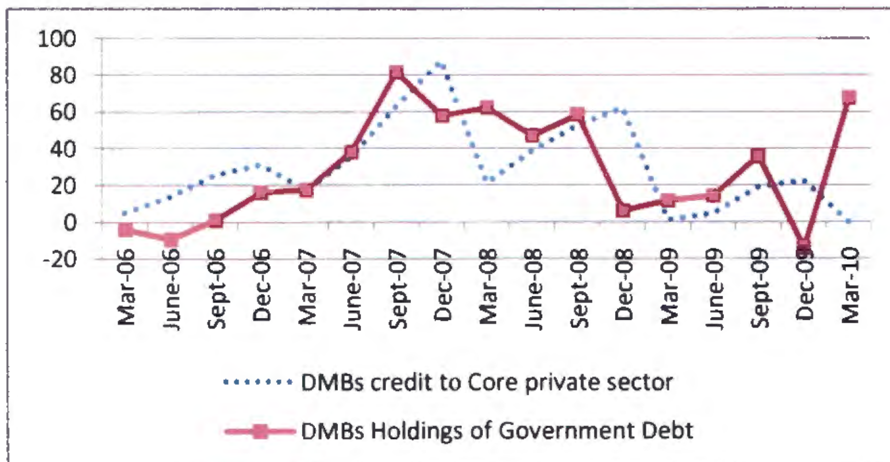
Source: DMO, FMF, IMF

Following the bank consolidation process, banks rapidly expanded both their lending to the private sector and their holdings of Government securities in 2007 and through most of 2008. Subsequently, loan growth has flattened, but of more concern is that banks are already rapidly accumulating Government securities (Figure 6). Unless the Government can rein in its deficit and, thereby, contain its

reliance on treasury securities as a source of funding, there is every reason to expect that the Government will be obliged to pay higher interest rates on treasury securities and the banks will once again prefer the secure returns on such securities rather than develop skills to enable them to expand responsible lending to the real sector.

Based on the above analysis we come to the conclusion that there has not been a sizeable reduction in credit to the private sector. Commercial banks have reacted predictably to changing market conditions and increased scrutiny on the part of the regulator. Non-performing loans are being purged from the system and banks are replacing some of their disastrous margin loans with sounder support for communications, construction and solid minerals. Nigerian banks are also placing excess liquidity with the central bank as well as the interbank market (which remains guaranteed by the central bank). However, as rates on these assets have plummeted dramatically over the last year, this strategy is unsustainable, if banks are to maintain positive returns for the shareholders. Thus, going forward banks will be forced to build their loan books in order to remain viable and profitable.

Figure 6 : Growth in DMBs core private sector credit and holdings of Domestic Debt [2/] (per cent)



Source: DMO, CBN

Of overriding importance is that the Government maintains a very close watch on its fiscal deficit. Should the deficit continue to grow, the Government will be obliged to revert to increased borrowing leading to increased issuance of

[2/] Growth is measured over preceding December stock levels.

Government securities and upward pressure on domestic interest rates (Figure 6). Rather than lending to private sector clients, whom they perceive as risky, banks will prefer to purchase Government securities and lending to SMEs will diminish.

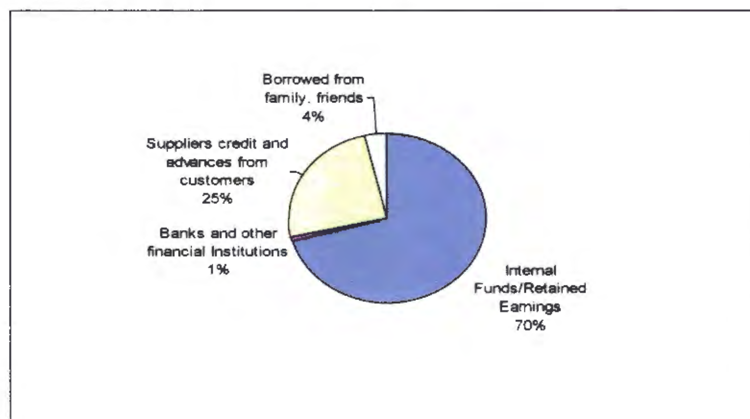
Within this context, it is important that the future expansion of the asset side of the banks' balance sheets in the future takes place in a prudent manner in order to sustain the long run expansion of the real sector of the economy. The following section presents a framework on the strategy and some suggestions that policymakers can consider for implementation to improve the situation.

III. Sustainable and productive expansion of real sector financing

Capital is a vital input to any business. However, for most of the years analysed the real sector is starved of formal sector credit. Of the more than 80.0 per cent of businesses that wants to access a bank loan, only 1.0 per cent is successful (see Figure 7). These figures are in stark contrast to more dynamic economies such as China, India and Indonesia where more than a fifth of businesses are able to secure bank loans and India and South Africa where more than one-third can. The situation is especially dire for Nigeria's SMEs and informal businesses (Figure 8).

Figure 7 : Nigerian businesses do not have access to formal sector credit

Sources of short term finance for Nigerian formal sector businesses



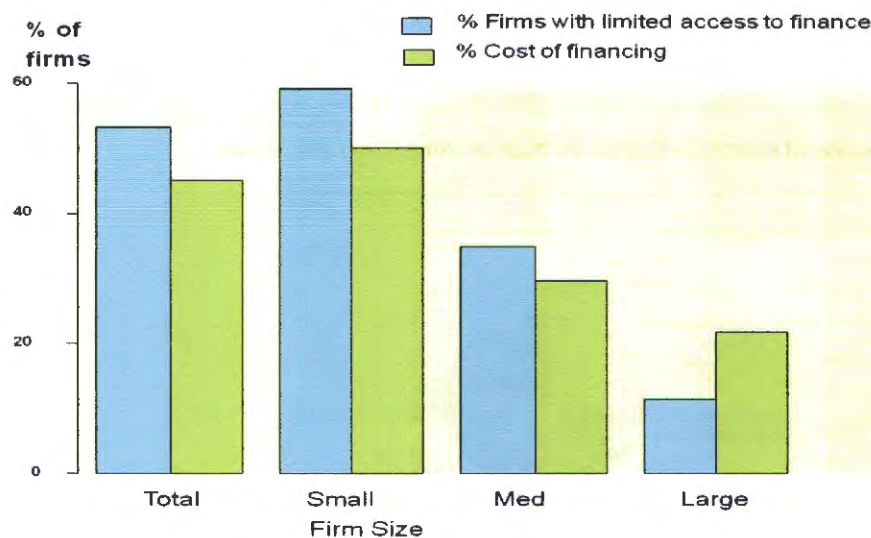
Even Nigeria's large formal sector businesses find it difficult to access finance and the cost of finance. Those that can access loans are limited to loans of 21 months average duration while many competitor countries can access loans of two or three times the duration (Table 1).

Table 1: Cost of Debt and Duration in International Comparison

	Nigeria 2008	Brazil 2003	China 2003	India 2005	Indonesia 2003	Kenya 2007	S. Africa 2003
Average annual interest rate	14	22	5	12	14	15	11
Real Interest Rate (Using GDP Deflator)	6	11	5	8	9	15	0
Duration (months)	21	42	49	49	23	38	68

Source: ICA Survey and World Development Indicators

Figure 8 : SMEs face the largest hurdles



Source: ICA Survey 2009

Nigeria's smaller businesses face particular hurdles to accessing finance. They are not able to access loans, they cannot easily raise a mortgage on their housing or land to finance their enterprises nor do they have access to reliable and adequate infrastructure to produce goods and get them to the market. These are the priority areas to address in order to expand real sector financing in Nigeria:

- Expanding access to credit for small and medium-sized enterprises (SMEs);

- Increasing the housing finance market; and
- Expanding the supply of medium- and long-term credit for both businesses and private participation in infrastructure investment.

For each of these issues, a summary of constraining factors is provided below along with an analysis of the measures that have already been undertaken by the government and recommendations for measures which would increase the supply of credit. In many of these areas, far more detailed analysis and recommendations have previously been prepared by the World Bank in the course of its support for FSS 2020, and are appropriately referred.

Access to credit for SMEs

Following years of losing international competitiveness, the Nigerian SME sector is fragile, operating in a business environment that presents considerable challenges (e.g. poor infrastructure, low skills and weak regulatory environment). This caused the overall share of SME contribution to GDP growth to halve (from 8.4 per cent to 4.6 per cent) between 1980 and 2005.[3] The SME sector in Nigeria is much smaller than in other developing countries, with MSMEs (including microenterprises) accounting for close to 50.0 per cent of GDP (compared to 80.0 per cent for many developing countries), (National Bureau of Statistics). Manufacturing as a whole is estimated to account for less than 5.0 per cent of GDP, with SMEs accounting for half of this.

Why Don't Banks Lend to SMEs?

There is a consensus within the banking sector regarding the constraints on SME access to credit. These constraints fall into three broad categories: (a) infrastructure constraints, (b) supply-side constraints, which relate to the incentives for banks to lend to SMEs; and (c) environmental constraints, which reflect the combination of institutional, legal, infrastructure, and capacity problems which make SME lending cumbersome and risky:

- **Infrastructure constraints**: Nigerian businesses claim that they are forced to produce their own power, water and sometimes roads as well as providing security for their businesses. This is confirmed by a recent World Bank survey that revealed that 99.0 per cent of Nigeria businesses owned their own generators. Given the enormous costs of providing such basic amenities, SMEs struggle to compete with cheap imports or finds it difficult to offer services at a cost that is affordable to the consumer. Bank

[3] Malik, A. and F. Teal, "Towards a More Competitive Manufacturing Sector", in Collier, et al, 2008.

managers support this analysis and are, therefore, reluctant to lend to SMEs or have trouble in finding viable SME investment opportunities. Although this is a key constraint, analysis of infrastructure weaknesses are beyond the scope of this paper.

- **Supply-side constraints**: Nigerian banks have historically enjoyed very high net interest margins as a result of four main factors. These are poor fiscal management resulting in high rates paid on government securities; high demand for credit for speculation in the years 2006 to 2008; high interbank rates as a result of liquidity pressures on poorly-managed banks with large volumes of non-performing assets; and, the shortage of competing non-bank savings products (such as money market funds) to put upward pressure on bank deposit rates. As a result, banks were able to charge high real rates of interest while paying most depositors negative real rates. Well-managed banks have thereby been able to earn high rates of return without actively seeking to downscale their lending activities: the risk-adjusted marginal profitability of SME lending has been negative relative to lending to other banks, lending to blue chip firms, or lending to the government and, accordingly, banks have not experienced any incentive to make the investments required to build capacity to lend to SMEs.

- **Environmental constraints**: The environmental constraints on lending to SMEs are numerous and require deep-seated reforms to address. These include a very weak creditor rights regime, where debts require a time-consuming and expensive process to secure, and even then provide only limited certainty of enforcement; a lack of credit information on which to base credit decisions due to the only nascent operation of credit bureaux and lack of a functioning national identity system; dysfunctional and manually-operated collateral registries; and widespread irregularities in the police and judiciary, exposing lenders to an unreliable court system during debt enforcement. In combination, these factors create a high cost/high risk environment for SME lending, driving down its risk-adjusted marginal profitability and making it unattractive relative to other credit activities. The environment is made more risky by difficulties in extending and collecting trade credit which drive up working capital requirements and restrict sales growth, and the problem of securing title to real estate assets, limiting the ability of SMEs to provide bankable collateral.

Why Don't SMEs Borrow from Banks?

Many Nigerian businesses that require credit do not apply for bank loans and rely instead on their own internal resources thereby drastically limiting their growth potential. They offer four reasons for not applying for loans; (i) short maturities, (ii) high interest rates, (iii) inaccessible collateral requirements, and (iv) cumbersome loan procedures.[4] However, even within this environment banks have found ways of overcoming these constraints making it attractive to move down market by changing the business model and adopting new techniques such as those championed effectively by one Nigerian bank (Box 1).

Previous Attempts at Addressing the Problem

Nigerian authorities have long struggled with the problem of how to expand credit to SMEs. A few notable schemes have been piloted largely with poor results. They are explained briefly as follows:

- *NACRDB*: The Nigerian Agricultural Cooperative and Rural Development Bank emerged from a merger between various public sector forerunner banks. It is focused on lending to SMEs in the agricultural space. The bank is hampered by inadequate governance structure, insufficient emphasis on selection of clients, poor loan recovery, concentration on government structures and partnerships, and inadequate range of products. The bank loans are seen as part of the national cake and are rarely repaid (70.0 per cent non-performing loan portfolio) which has further weakened the credit culture in rural areas. The bloated branch network and staffing results in a situation where the overhead costs represent 150 per cent of net new lending. The capped interest rate (8.0 per cent) has led to the bank making structural losses which have eventually led to its effective bankruptcy.[5]

- *SMEEIS fund*: The Small and Medium Enterprises Equity Investment Scheme was launched in 2001. It mandated commercial banks to set aside 10.0 per cent of their pre-tax profits to be invested in SMEs. As the banks were not consulted prior to the launch of the scheme and had neither the appetite nor the know-how to take equity stakes, most investments yielded a poor return. The CBN failed to sufficiently monitor the scheme closely and the banks gradually and quietly abandoned the scheme long before it was officially closed down.

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[4] World Bank Investment Climate Assessment 2009.

[5] A complete analysis of NACRDB including a menu of reform options and a governance review was concluded by the World Bank and presented to the Federal Ministries of Finance and Agriculture in 2009.

- *CBN Agricultural Fund*: This scheme guarantees up to 87.5 per cent of banks' lending to the agricultural sector (75.0 per cent guarantee plus another 12.5 per cent based on surrender of collateral in the form of government deposits). The guarantee has since 2005 been combined with an interest rate rebate of 40.0 per cent for those borrowers servicing their loans on time. However, despite these assurances, banks have only developed limited appetite for lending to this risk-prone sector.

- *CBN SME guarantee facility*: The CBN has been running an SME guarantee

Box 1 : A Nigerian Bank Successfully Grows its SME Business in the Toughest Climate

Unlike its competitors, one Nigerian bank has aggressively sought to capture a large share of the SME credit market. As its large corporate customers paid down their debts and as the bank sought to limit its exposure to single obligors, the bank was forced to look for new markets. The SME market seemed like an enticing opportunity but the bank had neither the systems nor the know-how to tackle the market successfully and like many Nigerian banks already had a checkered history of previous attempts to grow this market segment.

Bringing in international expertise the bank launched new products and value propositions for its customers. Firstly, it scrapped its Commission on Turnover (COT) which effectively penalized its customers for growing their deposit accounts. Charging a tiered, fixed rate for banking its SME customers (capped at ₦6,000 per month) quickly resulted in a rapid growth of the bank's SME liabilities.

The bank then introduced a peripatetic system of quarterly seminars where SMEs gathered together to hear various success stories and gain valuable information and expertise from SME bankers and other businesses. The bank introduced an "entrepreneur's guide book" along with a business club where SMEs could network and develop valuable business relationships. The bank also prospered from the introduction of new clients. The bank sought term facilities from international partners able to provide it with long-term finance at a reasonable cost along with technical assistance support for venturing into non-traditional areas such as agriculture and health care. This allows the bank to provide SME loans with maturities of up to 4 years.

The bank launched an unsecured credit card, building its collections team in the process to ensure that recoveries exceeded planned targets. The SME loans and credit cards proved to be a profitable and quickly growing business segment. To address it, the bank had to introduce new infrastructure and develop new skills for credit, risk management and recoveries. The bank had to be creative in its approach to the market to overcome the existing deficiencies in the local market, the poor physical address system (for client identification) and known weaknesses in the credit information system. However, it has successfully grown the business and proved that Nigeria's SMEs are credit worthy. The bank is facilitating the growth of Nigeria's most dynamic and innovative small and medium sized companies. And until the time that other commercial banks decide to follow suit they are operating without competition.

facility for some years. The scheme allows participating banks to share the credit risk for SME loans with the CBN. However, the banks are not keen to participate. When a loan does go into default, the CBN insists that the banks prove that they are taking action to recover the loan. As such recovery procedures often take several years in court, the current set-up does not encourage banks to make further SME loans.

- *CBN Microfinance fund*: In January 2008, the CBN announced a microfinance fund of ₦50 billion. The CBN also announced that state governments would set aside 1.0 per cent of their budgets to support microfinance. It was not clear whether the state governments had the capacity to establish commercial microfinance organizations and it was not clear where the remainder of the funds would come from. In practice, the scheme never materialized.

A brief review of the various schemes launched in this area indicates that the Nigerian public sector does not have a comparative advantage in the provision of financial services. The theory behind the schemes has often been flawed, e.g. capped interest rates, taxes on commercial banks or state governments. Schemes that appeared promising on paper often ran into hitches once implemented. The schemes are usually not discussed with the stakeholders. Most government schemes have wasted scarce public resources.

In the case of guarantees, the level of guarantees – considerably in excess of the internationally-recommended norm of equal 50/50 risk-sharing – has further weakened the credit culture. Capping the level of government guarantees at around 50.0 per cent is important so as to provide incentives for banks to assess credit risk and to collect on delinquent loans. Where the level of guarantee is too high, the cost of collecting on delinquent credits quickly rises to exceed the value of the banks' exposures. The World Bank Doing Business Indicators suggest that the average cost of recovering a delinquent loan in Nigeria is 22.0 per cent of the loan amount. If banks are offered an 80.0 per cent guarantee and can only expect to recover 78.0 per cent of a delinquent, they simply will not attempt to recover the loan and the guarantee scheme will result in a huge number of defaulted loans being transferred from the balance sheets of the commercial banks to the CBN or Federal Ministry of Finance.

Most importantly, the schemes have never been actively monitored or evaluated to determine their strengths and weaknesses and, therefore, the lessons of failed attempts have never been captured or internalized before embarking on the

next scheme. This has resulted in policy failures. Adopting a more open and consultative approach to policy-making would help to avoid such policy pitfalls.

Supply-Side Constraints: Market-Driven Changes Should Promote SME Credit Expansion

Other countries (such as Kenya and the former communist states of Central and Eastern Europe) have seen rapid expansions in SME lending despite severe business and credit environment problems. The drivers of credit expansion to the real sector in these countries have been threefold:

i. Restructuring of the banking system to remove liquidity pressures caused by insolvent banks and introduce strong competition between banks (often driven by the entry of foreign banks with technical capacities and products required to downscale lending);

ii. Maintaining sound fiscal policies to prevent the crowding out of private sector borrowers and ensuring that the marginal profitability of lending to the government remains below that of lending to the private sector; and,

iii. The commitment of respective governments to credit and business environment reforms building confidence that banks investing in downscaling would see a steady improvement in the overall business environment.

Current trends in Nigerian interest rates point to the emergence of an environment where, *if fiscal discipline is maintained*, banks will face markedly reduced profitability in 2010 and the probability of operating losses – or at best very weak profits – in 2011 and future unless their portfolios can be redeployed from government securities and interbank lending into higher earning assets such as loans.

The short tenor of most corporate loans will also increase pressure on banks' net interest margins by allowing borrowers to negotiate rates downward in the short-term rather than being locked in to high rates, while already very low deposit rates severely limit banks' ability to maintain spreads by reducing their cost of funds. Further to these factors, the resolution of the eight distressed banks should support a significant increase in competition in the banking sector: as in other countries, if these banks are sold to strong strategic investors, the infusion of capital, technology and capacity such investors can provide should sharply intensify competition within the system and, thus, force the pace of downscaling.

The CBN is also moving to increase the supply of SME finance by establishing a ₦200 billion SME loan guarantee fund. The fund would provide a credit guarantee of 80.0 per cent of principal (meaning up to ₦240 billion of loans could be covered) for loans to SMEs with 11 to 300 employees and assets – excluding land – of less than ₦500 million. The maximum loan size would be ₦100 million. The CBN has designed the facility so that guarantees will be paid as soon as a loan becomes non-performing according to the CBN prudential regulations, which responds to banks' reluctance to use the existing guarantee facility due to long delays in receiving the proceeds from the guarantees.

The World Bank believes that the facility is well designed but that a lower level of guarantee should be applied – also allowing greater leverage from the guarantee commitment – in order to provide banks with a greater incentive to monitor and recover guaranteed loans. A level of up to 50.0 per cent is more consistent with successful guarantee schemes operating in other countries.

Increasing Competition also Poses Significant Risks

The potential for rapid transformation in banks' business models as a result of shrinking margins on banks' traditional activities and the emergence of increased competition from strategic investors creates a significant probability that there will be a rapid build-up in risk within the system, with potentially severe consequences. The primary risk faced by the banking system could emerge from bank's moving aggressively into new types of lending as they are forced to seek higher yielding assets: analysts (and many bankers) agree that the banking system lacks the credit and risk management skills required for prudent SME lending on any scale, and given the environmental risks which are an unusually large factor in Nigeria, the possibility of large losses being incurred is high.

While a suite of measures to improve financial sector supervision and regulation have been announced, it is not clear that supervisory institutions have themselves built the capacity to effectively enforce the new regulations (a number of banks raised this concern in meetings with the World Bank). In cooperation with donors, the authorities have designed a comprehensive financial sector capacity building program to address this problem, and start addressing other problems relating to the lending environment, but implementation has been stalled since early 2010. This situation sends a strong signal to the market that the authorities are not really serious about addressing the problems in the banking and securities markets which led to the 2009 crisis and is likely to undermine the willingness of banks to downscale lending if there is no real prospect of any improvement in the environment. Similarly, foreign investors and lenders are likely to remain extremely

wary of Nigerian debt and equity offerings (both of which will be needed for infrastructure and other real sector developments) so long as the supervisory framework remains short of the capacity to enforce international standards of transparency and financial reporting.

In a similar vein it will be important that the authorities move expeditiously and effectively in resolving the situation of the eight banks currently benefiting from the liquidity support of the CBN and CBN's blanket guarantee of all interbank exposures. It is, indeed, encouraging that the legal framework for the Asset Management Corporation of Nigeria (AMCON) is now in place. For example, the authorities will need to deal effectively with the unjustified court challenges being mounted by disgruntled shareholders, in establishing even-handed criteria for setting prices for assets to be assumed by AMCON, and in moving expeditiously to determine which among the eight banks are to be liquidated (passing these to NDIC) and which banks might be able to benefit from intervention by AMCON. [6]

Some Suggestions [7]

A list of possible interventions designed to overcome some of the key obstacles and challenges to SME finance is presented below.

- **Business development services (BDS):** Pilot BDS programs in Nigeria provided by government agencies like the SME Development Agency of Nigeria (SMEDAN) and donor programs such as the World Bank MSME project have been successful in developing the effective demand for credit.[8] There is also increasing international evidence that providing BDS programs alongside credit schemes results in far more successful development of credit markets. BDS programs can be structured around promising value-chains and matched with access to finance. The programs would address some of the key issues on the demand side such as the ability of SMEs to produce bankable business plans and overcome cumbersome loan procedures.

- **Credit information, identification of borrowers and registration of movable property:** Despite recent progress on this front, more support is needed to

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[6] In March 2008, the World Bank completed analysis on the Banking Sector which highlighted the risks of a potential banking sector crisis and made detailed recommendations on strengthening accounting, reporting and disclosure which remain to be implemented. Following the crisis, the World Bank produced a series of technical notes regarding the bank resolution process.

[7] A detailed analysis of SME finance, Microfinance and Mobile Banking was completed by the World Bank and presented to government in June 2008.

[8] A review of Business Development Services in Nigeria, BDO 2008.

improve the regulatory framework, capacity, and equipment in this area. For example, the credit information framework is inadequate in terms of requirements as regards sharing of information so that it can be made readily available to the competing credit bureaux as regards all bank borrowers; the quality of the data available and the capacity of the systems available are also in need of improvement. The development of credit bureaux with a comprehensive information-set at their disposal is essential for deepening of the credit markets. Importantly, this information will allow banks to move away from bank lending based on collateral, which is not readily available to many potential borrowers, is costly and time-consuming to register, and also expensive to foreclose upon in case of a borrower's default. Another major issue for providers of credit information is the lack of a reliable national identity system. Government also needs to push forward the timetable to implement a national identity management system with biometric data as well as upgrading the national street address system. The moveables registry also needs to be strengthened. While the Corporate Affairs Commission (CAC) manages a workable registry of floating claims on company assets, the registry does not identify individual assets, and only incorporated businesses can make use of it. Reforms are urgently needed to improve the registry and legal system for liens on moveable assets.

- **Capacity building/technical support to strengthen the legal and regulatory framework for SME financing:** Based on a needs assessment to be carried out, capacity building and technical support could be provided for necessary reforms of the legal/regulatory framework to support, inter alia, the leasing sector, finance companies, developing commercial courts and/or alternative dispute resolution mechanisms etc.

- **Product/Scheme Innovation:** The consultations held by the World Bank with stakeholders in recent months have made it clear that product/scheme innovation have stagnated in the country and there is a need to draw on successful lessons learnt from other countries and schemes run so far in Nigeria to come up with innovative ways to improve access to finance. In this context, the following proposals are suggested:

  a. **Bank Downscaling Program:** Nigeria's deposit money banks are not used to lending to SMEs. Most do not have the required infrastructure and human resources required for sound credit and risk management policies needed to successfully serve this market. Technical Assistance

programs along with guarantee schemes and/or credit lines would serve to introduce new techniques proven in other countries to address SME lending.

b. **Credit Guarantee Scheme:** A credit guarantee scheme such as that currently administered by the CBN could play a role in encouraging banks to develop and roll out SME products. It is important that the mechanism is designed so as to rely on deposit money banks for the assessment of credit risk and loan recovery, with the role of the government agency being limited to funding and managing the mechanism. As discussed above international best practice would limit the guarantee to 50 per cent of the credit.

c. **Credit Line:** Through this mechanism a government agency would act in the capacity of a wholesale institution, on-lending funds to a pre-selected group of deposit money banks. The participating banks in turn would make sub-loans to SMEs, thereby, providing needed working capital and investment finance, while taking on the credit risk of their borrowers. This measure would effectively address the need for medium-term financing while being coupled with needed capacity building as regards bank down-scaling and BDS.

d. **Reverse Factoring:** A reverse factoring mechanism could be set up so that large creditworthy firms participating in the program could invite their suppliers to join their chain and post their receivables on line. Participating financial institutions could bid to factor such receivables, with suppliers choosing the best interest quote, while the factor is paid when due by the buyer to the intermediary. The latter would on-lend funds borrowed from a government agency that acts as the wholesale funds provider.

e. **Warehouse Receipt Financing:** The CBN has expressed interest in setting up a system whereby accredited warehouse operators would store a range of graded commodities in exchange for receipts that are transferable and would permit their owners to obtain credit using them as collateral.

f. **Equipment Leasing:** Aside from the support to be provided to strengthen the regulatory and legal framework around leasing activities, further support could be provided to set up a system of

leasing schemes and registered stores to facilitate the leasing of equipment for Nigerian SMEs.

Expanding Housing Finance[9]

It is widely acknowledged that the Nigerian construction sector holds huge potential for the creation of millions of new jobs over the next decade. The construction and real estate sector remains limited: it currently accounts for less than 2.0 per cent of GDP. There are an estimated 16 million units in terms of gap, most of which are needed in Lagos and other large urban centers. This is largely the result of the absence of housing finance. There are an estimated 40,000 mortgages in Nigeria, most of which are held by bank employees. Developing a housing finance market would not only allow this sector to take-off and achieve its potential but it would also allow entrepreneurs to use their property as collateral to raise low-cost, long-term loans that can then be used to finance business ventures as in many other countries.

There are currently a number of constraints to the emergence of a functioning housing finance market, the most significant of which is the time and cost taken to register property. The Land Use Act, 1978, vested the ownership of all land in the Governor of each State. All transactions in property require the consent of Governors and registration with land registries. The process is time-consuming (taking six months or more) and very costly. The total fees have risen to 37.0 per cent of the property value in Ondo state. In aggregate, Nigeria comes in last among 178 countries in the ease and cost of registering property.[10]

Despite the unfavorable environment, there is a growing mortgage market in Nigeria. Loans are provided by the retail deposit money banks and to a much lesser extent by the primary mortgage institutions. Loans are financed by retail deposits. The maturity mismatch is largely mitigated by the use of the adjustable rate mortgage and loans rates are typically being tied to banks' prime lending rates. In most countries, a key element of the underwriting process is examining the financial history of the borrower, particularly in respect of his record in repaying other loans. Bankers regard this as the single most important piece of information that they need in order to underwrite loans effectively. In Nigeria, as mentioned above, there are still serious issues hampering the effective operation of the three licensed credit bureaux.

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[9] In March 2008, the World Bank provided a series of reports on housing finance to the CBN including; (i) a detailed analysis of the Nigerian housing finance market, (ii) An analysis of opportunities for low-cost social housing and (iii) a concept paper for a housing finance liquidity facility.
[10] World Bank Doing Business Indicators 2010.

Lenders require the borrower to have clear title for that property and will normally take a legal mortgage, although in some cases they may use an equitable mortgage. To further protect themselves lenders will normally deal with borrowers only from certain specified employers – typically the public sector and large corporations. Mortgage repayments are made by deduction from wages, and there may also be some informal support from the employer.

The result of this situation is that most pieces of land are not registered: in Lagos just 80,000 titles are registered whereas the number should be 4 – 5 million. The main effect of the plethora of controls and taxes is that transactions either do not happen or happen in the informal sector. Transactions in the formal sector are costly and time-consuming, partly because of the efforts that are made to mitigate risks associated with the lending environment. Ultimately, Nigeria's huge real estate assets remain unleveraged and are unable to play a useful role in promoting economic growth and creating new jobs.

Public Sector Attempts to Address the Situation

As in the case of support to SMEs, the public sector has piloted well-intentioned attempts to improve the situation, but again with largely counter-productive results. The most notable public schemes in housing finance include the following:

- *The Federal Mortgage Bank of Nigeria (FMBN)* administers the National Housing Trust Fund (NHTF) provident scheme and also has other functions, although at present it is not a mortgage bank. Like other public institutions its bloated structure (including 8 zonal and 38 district offices) and limited income sources has led to its racking up huge losses.

- *The National Housing Trust Fund (NHTF)* is a compulsory provident scheme, the proceeds of which can be used only for house purchase. The NHTF was established under decree No 3. of 1992 and is designed to ensure access by workers to housing finance. Self-employed workers and employers of workers earning more than the minimum wage are required to deduct 2.5 per cent of wages and pay the amount into the NHTF. The accounts are held in the names of the individuals who should receive annual statements. Contributions receive a rate of interest of 2.0 per cent. By law, the Government and financial institutions are required to contribute to the scheme. The contributions plus interest are repayable at age 60 or on death. After contributing to the scheme for six months workers are entitled to a mortgage loan of up to ₦5 million (US$43,000), at

a rate of 6 per cent for 30 years. The loan is for a maximum of 90 per cent of value, so the borrower needs to have a ₦500,000 (US$4,300) deposit. The loan must be used for house purchase, house expansion, or building on a plot which is owned.

This scheme is theoretically attractive to potential home buyers. After saving just 2.5 per cent of their income for six months they can borrow ₦5 million (US$43,000) at an interest rate of 6.0 per cent, which compares with an open market rate of 17 per cent, to buy a house at significantly below market value. In addition, the house purchase is exempted from some taxes.

However, the scheme has never, and will never, work as designed. The amount raised through contributions is not sufficient to fund loans for more than a tiny proportion of those eligible for loans. The scheme is in effect a compulsory regressive tax: the majority of workers will never earn enough to afford to buy a house. They are being forced to contribute part of their income to a scheme, receiving a return well below the rate of inflation, to finance cheap loans for the better off, most of whom are probably civil servants. The recent changes (rate of interest cut from 9 to 6 per cent, the loan ceiling increased from ₦1.5 million (US$13,000) to ₦5 million (US$43,000), the maximum term increased from 25 to 30 years and minimum borrower contribution reduced from 20 per cent to 10 per cent) exacerbated the regressive nature of the scheme.

The scheme has also faced practical difficulties. A loan can be obtained only if the borrower can produce clear title to the property he is buying. This is impossible in the majority of states and accordingly no loans have been made in those states. Loans can be made only through PMIs and there are no PMIs in at least 10 states. In such cases a potential borrower can apply to a PMI in another state, but it seems unlikely that this happens to any significant extent. Many PMIs do not qualify to distribute loans. The FMBN will not disburse through a PMI more than 25 per cent of the PMI's capital, and it requires a bank guarantee for the loans it does disburse.

- *Primary Mortgage Institutions (PMIs)* disburse subsidized loans financed by the NHTF, and these are often combined with open market loans funded by retail deposits. Their role is to collect retail deposits and to make mortgage loans, both on the open market and as the only institutions through which loans from the NHTF are distributed. However, they have

low capitalization and poor governance. They are distrusted by the public, which has meant that they have been unable to raise deposits. Most PMIs are very small, have made no loans at all and engage in various real estate activities to keep themselves going. Some are owned by the states. Most of the larger PMIs are either subsidiaries of banks or are connected with banks. The PMIs currently serve little useful purpose. The CBN closed down a large number of terminally distressed PMIs in 1999 when they took over their supervision from FMBN. The poor quality of PMIs is illustrated by the fact that FMBN checks each loan application, introducing further delay and cost into the system, because it cannot rely on PMIs' procedures. PMIs are likely to lose out to the commercial banks as they become increasingly involved in this area.

Some Suggestions

Phase 1 presents the priorities that are capable of being "quick wins" – essential to put momentum into the reform process. The recommendations are proposed to be implemented within two years. These five recommendations can all be implemented without legislative changes:

- Substantially improve the transaction process by reducing the time taken to achieve the necessary consents and reducing the costs from the current level of 20-30 per cent of the value of the transaction to about 5.0 per cent. This is by far the most important single measure; if action is not taken on this the other measures will not succeed.
- Either abolish the NHTF or significantly reform it so as to redress the balance between contributors and borrowers.
- Substantially increase the capital requirement for PMIs, and make loans through the NHTF, if it is to continue, only to those that meet this and other requirements.
- Increase the capital base of the FMBN and develop its role as the source of knowledge, statistics and expertise on the mortgage market, and facilitator of market improvements.
- Implement through the FMBN a simple mortgage liquidity facility which would help pave the way for the use of covered bonds and mortgage-backed securities in the longer-term.

Phase 2 measures are those that are not essential to stimulate the market and may take longer period to implement due to the need for new legislation. They could be implemented over a five-year period. These are as follows:

- Put in place arrangements through the FMBN that would allow covered bonds and mortgage-backed securities to be issued. This may require some legislative changes.
- Reform the arrangements for foreclosure by one or both of improving current processes within the current legal framework and by providing for extra-judicial procedures.
- Develop a mortgage insurance program in conjunction with a commercial insurance company and facilitate common standards for underwriting and documentation.
- Remove the need for Governor's consent for land transactions, which will entail changing the Constitution or persuading Governors to delegate this power.
- Introduce large-scale land registration programs and facilitate the acquisition of title by existing occupiers of property.
- Introduce comprehensive building codes and provide protection for buyers of houses during the course of construction.

Expanding the Supply of Term Finance

Structural Weaknesses Hinder the Supply of Term Finance

The supply of term finance from private sources in Nigeria is extremely limited. Without an adequate supply of term finance there are extremely limited resources for projects, housing and infrastructure financing. Since SME and housing finance have been addressed above, this section focuses on long-term financing for infrastructure as poor infrastructure is both a cause and consequence of Nigeria's current economic challenges.

Infrastructure finance - a case study in securing term finance in Nigeria[11]

Infrastructure requires a variety of sources of finance, depending on its scale and complexity. For mega- and large-scale projects of national or transnational

[11] A potential World Bank Project to support the development of PPPs for infrastructure in Nigeria has been developed in consultation with FMOF and the Infrastructure Concession Regulatory Commission (ICRC) and is currently awaiting National Assembly and Executive Council approval.

scale, multi-national and large domestic commercial banks, investment banks, international financial institutions (IFIs), and large international and domestic debt and equity investment funds and facilities are all likely to have the asset bases. For small- and medium-scale projects of local and regional scope, a different mix of institutions is likely to be appropriate, including domestic commercial and investment banks, domestic equity and debt funds and facilities, and pooled lending facilities.

Core infrastructure requires reasonably priced, locally denominated, and long-tenor capital. Sources of capital to meet such criteria are typically found in local markets, but may also be accessed in international equity and debt markets, particularly where cost-efficient, mid- to long-term foreign exchange hedging is available, or when foreign exchange risk is borne by infrastructure service beneficiaries through the project revenue stream (e.g., tariffs or taxes). Nigeria also has the option of tapping from IFI and bilateral donor assistance.

The recent international financial crisis has disrupted Nigeria's embryonic market for domestic financing of infrastructure. Private appetite for infrastructure investment is currently low due to such factors as short tenors for finance and high cost of issuance and trading in the Nigerian equity market.[12] In addition, the limited capacity for origination and project development also constrains the amount of financing deployed for infrastructure investment. In Nigeria, there is a very thin and limited long-term financing market: the depth of the Nigerian bond markets, which could offer the principal local source of long-term financing for public infrastructure, is limited. The Federal Government bond market, while growing and vibrant, only has a limited track-record. Domestic banks will, however, need to build capacity to assess and manage long-term credit risk. Similarly, pension and ongoing insurance reforms are encouraging growth in long-term savings as a natural source for long-term investment.

Structural bottlenecks to domestic term finance for infrastructure in Nigeria include (i) the absence of a long-term pricing benchmark, (ii) the absence of fixed-rate loans and securities, (iii) limited bank loan maturities, (iv) the absence of a corporate bond market, (v) lack of secondary market liquidity, and (vi) minimum rating and listing requirements for eligible investment by pension funds. In addition, the capacity to assess, structure, and monitor infrastructure project risks is severely limited across the commercial banking sector.

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[12] PPIAF, "Financial Institutions Appetite for Nigerian Core Infrastructure Financing in the Wake of Global Financial Crisis: The Short, Medium and Long Terms." Draft. June 2009.

However, recent corporate bond issues suggest that investors – particularly the developing pensions and insurance sectors – have demand for longer-term securities. For banks, term lending remains difficult due to the structure of their deposits, only 30 per cent of which are term deposits, and only a very small proportion are for longer than one year. Depositors' reluctance to provide term deposits reflects concerns about macroeconomic stability (inflation and devaluation) as well as limited confidence in the banking system.

One measure which might help to address this problem would be the development of active markets for interest rate swaps and foreign currency hedging instruments so that banks could prudently finance term lending with shorter-term liabilities and/or seek term financing in foreign currency which could then be lent in Naira to Nigerian non-exporters. In March 2010, the Government has moved to increase the supply of term finance for manufacturing, power, and aviation by providing a ₦500 billion of 10 to 15 year with 7.0 per cent fixed rate on-lending facility from the Bank of Industry (banks will borrow funds at 1.0 per cent to on-lend). The response to the launch of the ₦200 billion manufacturing sub-component of this facility has been very successful (₦111 billion has been released out of ₦130 billion that has so far been approved, with a further ₦90 billion in the process of approval). The take-up on this generously-priced longer-term funding has been impressive. The banks are given extra 'breathing space' to restructure their loans rather than declare them non-performing. However, the fiscal cost and potential distortions created by such favorable lending schemes will be considerable.

Some suggestions

Given the size of Nigeria's infrastructure deficit (estimated at US$100bn) and the limited nature of public resources, it is clear that tackling Nigeria's infrastructure financing will require a successful public-private-partnership (PPP) model. There are encouraging models of successful PPP projects in Nigeria, most notably the MMA2 domestic air terminal and the Lekki Toll Road both in Lagos. These projects indicate that Nigeria can successfully achieve this agenda. However, before embarking on measures to address infrastructure financing challenges, government must focus on developing the necessary skills and expertise required to develop a pipeline of PPP projects, strengthen the legal and regulatory framework for PPPs and then develop the necessary framework for project implementation. As far as the financing of the identified projects is concerned, it will be crucial to instill market confidence. With this aim in mind it is recommended that the authorities embark on the following reforms:

Phase 1 to be implemented within the first 18 months include:

- The institutional strengthening of SEC in the areas of regulation, supervisory capacity and enforcement of intermediaries, collective investments, and listed issuers.

- The institutional strengthening and development of the supervisory framework for the main market infrastructure institutions: the NSE and the CSCS.

- Addressing regulatory weaknesses in selected priority topics: clearing and settlement; corporate governance of issuers and the development of the corporate bond markets.

Phase 2 to be implemented in 1.5 to 5 years include:

- Institutional strengthening of SEC governance bodies and a more formal implementation of a risk-oriented supervision model.

- Improvement of the listing framework to increase the number of IPOs.

- Implementation of the demutualization strategy and the clearing and settlement model.