Investment Climate and Business Environment Research Fund

TRUSTAFRICA IDRC | CRDI

Supply-Side Opportunities and Constraints of Bank Credit to MSMEs in Zambia: Lessons and Implications for Policy

By

Chrispin Mphuka[a*],
Joseph Simumba[b],
Mashekwa Maboshe[a],
Bernard Banda[b]

ICBE-RF Research Report N0. 60/14

Investment Climate and Business Environment Research Fund

(ICBE-RF)

www.trustafrica.org/icbe

Dakar, January 2014

[a] *Department of Economics, University of Zambia, Lusaka, Zambia*
[b] *Zambia Institute for Policy Analysis and Research, Lusaka, Zambia*

[*] Contacts: mphukac1@yahoo.com (C.Mphuka), jsimumba@zipar.org.zm (J.Simumba), maboshecm@yahoo.com (M.Maboshe), bbanda@zipar.org.zm (B.Banda)

This research was supported by a grant from the Investment Climate and Business Environment (ICBE) Research Fund, a collaborative initiative of TrustAfrica and IDRC. It's a working paper circulated for discussion and comments. The findings and recommendations are those of the author(s), and do not necessarily reflect the views of the ICBE-RF Secretariat, TrustAfrica or IDRC

Acknowledgement

We thank TrustAfrica and IDRC for financial support and Bankers Association of Zambia for coordinating the survey of banks and giving substantial inputs on the study design. We also thank Bank of Zambia, Ministry of Commerce Trade and Industry (MCTI), Ministry of Finance, Zambia Development Agency (ZDA) and Zambia Chamber of Association of Small and Medium Enterprises (ZACSMBA) for active representation on the study technical committee. We also thank all the commercial banks that responded positively in the study. The study benefited from participants of the dissemination workshop held on 23rd August at Radisson Blu Hotel in Lusaka.

Abstract

The low volume of formal bank credit to Micro, Small and Medium Enterprises (MSMEs) in many Low-Income Countries (LICs) has caused much concern among policy makers, legislators and entrepreneurs. This study analyzes the patterns and extent of commercial bank credit to MSMEs and the significance of factors that enable banks to provide credit to MSMEs, using bank data collected in Zambia. The results show little evidence to support the significance of relationship lending. Banks that don't serve MSMEs do it purely on corporate strategy enacted by their parent banks mainly domiciled abroad. Broadly, banks that allocate high volume of credit to MSMEs are relatively older and find the MSME credit business to be relatively less competitive. Overall, all banks that deal with MSMEs reported a positive forecast of the growth outlook of MSMEs in the next one to five years.

JEL Classification: G21; G28; L23; O12; O16

Key words: Micro, Small and Medium Enterprises; Bank Credit; lending obstacles; Economic Growth

Contents

1 Introduction

The critical role played by Micro, Small and Medium Enterprises (MSMEs) in contributing to productivity growth and driving job creation in Low-Income Countries (LICs) is a well-established fact. MSMEs account for the largest number of firms and employ a substantial share of the labor-force. They also present an option for broadening the tax-base and promoting competitiveness in these economies. At the same time, a sizeable number of large firms today started as small business entities. Nonetheless MSMEs in LICs face various constraints that explain much of their dismal productivity performance. The notable obstacles include the existence of weak institutions, intensive competition from imports, poor infrastructure and lack of adequate finance to expand and grow.

Lack of access to adequate finance and the high cost of finance are major obstacles that adversely affect MSMEs (Banerjee & Duflo 2004, Beck et al. 2005, Schiffer & Weder 2001). MSMEs also find limited access to credit as a challenge that disproportionately affects them more than large corporate firms (Beck et al. 2005, 2006). A strong desire to attain or maintain high economic growth and create plenty of jobs especially among the youth, has ignited renewed policy interest in the financing of MSMEs in many LICs. This follows the recognition that facilitating broader access to finance spurs economic growth and socioeconomic development by helping innovative enterprises that would otherwise have been financially constrained to flourish and replace the ineffective ones i.e. the creative destruction argument.

Various interventions such as the establishment of enterprise funds like the Citizen Economic Empowerment Fund in Zambia and the removal of barriers to microfinance credit have been proliferated. However, formal bank finance still remains a relevant and perhaps, the most important external source of finance for most MSMEs in LICs. This is due to almost non-existent venture capital and embryonic equity markets. At the same time, formal bank finance is available for relatively bigger amounts and longer tenure than microfinance credit. Furthermore, bank finance is mostly insulated from politics that frequently rim public credit initiatives in LICs.

This study seeks to understand the supply-side constraints of the bank-to-SME lending relationship in Zambia. Broadly, this paper explores the extent and patterns of formal bank financing to the MSME sector in Zambia. It characterizes the significance of factors that promote or inhibit commercial bank provision of credit to MSMEs based on a survey of commercial banks. There are several reasons why formal bank credit may not be adequately supplied to MSMEs at reasonable prices from a commercial bank's perspective.

First, the importance of MSMEs as a business segment to each commercial bank may vary substantially such that the impetus of the banking sector as a whole to lend to MSMEs may be puny. Second, MSMEs are often opaque and lack 'hard' credit information such as audited financial statements and collateral that can easily be analyzed by commercial banks. This might present difficulties to banks that lack proper information technologies and organizational structures to process 'soft' qualitative information. Such banks might perceive MSMEs not to be bankable. In addition, the size of MSME loans are usually small such that fixed transaction costs for a bank to process all MSMEs credit requests might be enormous. Taken together, these factors might cause some banks to be reluctant to provide adequate finance to MSMEs at reasonable prices due to the high operational costs that might be involved. Consequently, MSME credit might be provided by fewer banks, a scenario that could restrict market competition. Equally, competition might be stifled if MSMEs credit products are highly differentiated across commercial banks.

Third, the prevalence of credit default among the MSMEs when compared to other commercial bank credit customers might be a self-reinforcing vicious cycle that compels banks to limit their risk exposure to MSMEs. On the contrary, MSME credit default might be a consequence of the risk assessment and management regimes within the commercial bank sector. Fourth, the macroeconomic and regulatory environments might affect the availability of funds and the extent to which commercial banks can potentially lend to MSMEs.

A modest number of cross-country studies provide empirical evidence on obstacles that constrain the flow of formal bank credit to MSMEs from a supplier perspective (e.g. Beck et al. 2012, De la Torre et al. 2010, Berger & Black 2011). However country specific lessons, especially among LICs, are generally missing. Therefore, many LICs tend to rely on anecdotal evidence and sparse data to enact reforms aimed at consolidating bank lending to MSMEs. This has adversely contributed to staggered policy and legislative reforms characterized by substantial administrative inertia.

Zambia provides an interesting setting to study bank provision of credit to MSMEs. The country is currently grappling to sustain its splendid economic growth rate that averaged above 6% for most part of the twenty-first century. Economic growth forecasts indicate that the country is likely to attain real growth above 7% per annum until 2015 as long as the global price of metals remain buoyant (International Monetary Fund [IMF] 2013). The concentration of economic activity in the mining sector has been blamed for the highly skewed income distribution, the existence of widespread poverty and high level of unemployment. Population based estimates indicate that 7.9% of approximately 5.9 million people in the labor force are unemployed while headcount poverty is estimated at 60.5% (Central Statistical Office [CSO] 2011, CSO 2013).

The country has prioritized the development of the MSME sector as a conduit to transform the economy so that value addition in manufacturing and service sectors should surpass mining as the major source of economic growth (Government of the Republic of Zambia [GRZ] 2009). Therefore, the MSME sector represents the next generation of Zambia’s vibrant private sector.

Results indicate that more than three quarters of banks serve MSMEs. Profits, low competition, sufficient capital and Infrastructure to deal with MSMEs and a universal projection of positive growth outlook among MSMEs are significant drivers of bank credit provision to MSMEs. Banks that don’t serve MSMEs do it purely on corporate strategy enacted by their parent banks mainly domiciled abroad. These banks have also never attempted to conduct a market research on MSME business. Banks that serve MSMEs substantially use products that have relatively less tenure and require less collateral such as trade finance and bond guarantees rather products that first order effects on productivity growth such as commercial and industrial financing or supply-chain finance.

In addition, banks that lent above the median of total bank lending to MSMEs in June 2012 are less likely to rely on credit scores or proprietary information in their lending decision of a particular product. This is contrary to banks that lent below the median that reported universal use of proprietary information and credit scores for each MSME product. Coupled with the concentration of MSME loan approvals at the credit committee level composed of senior bank management at the bank headquarters, this finding casts doubt on the significance of relationship lending to MSMEs.

1.1 Study Objectives

Broad Objective

The broad objective of this study was to explore the extent, pattern and determinants of SMEs access to formal bank credit with a view to recommend policies that will promote an investment climate that is favourable for private sector growth in Zambia.

Specific Objectives

Specifically, the study:

i. Identified and compared banks that offer SME tailored banking products from those that do not and probe the plausible reasons for provision or non-provision of SME dedicated banking;
ii. Assessed the lending technologies and organizational structures which banks use when serving SMEs and their effect on SME access to bank products ;
iii. Examined factors that determine bank-to-SMEs borrowing rates, non-interest bank charges on SMEs and SME acquisition of bank products;
iv. Assessed the extent and impact of SME delinquency and bankruptcy on bank lending and the statutory and regulatory provisions for dealing with them;
v. Assessed the role of the regulatory regime, macroeconomic policies (fiscal and monetary) and institutional organization of the formal banking system on the bank-SME lending relationship.

1.2 Organization of the Study

The rest of the paper is organized as follows. Section 2 describes the commercial bank sector in Zambia. Section 3 describes the MSMEs in Zambia. Section 4 provides the review of the literature. Section 5 describes the data. Section 6 presents the results. Section 7 concludes.

2 Background

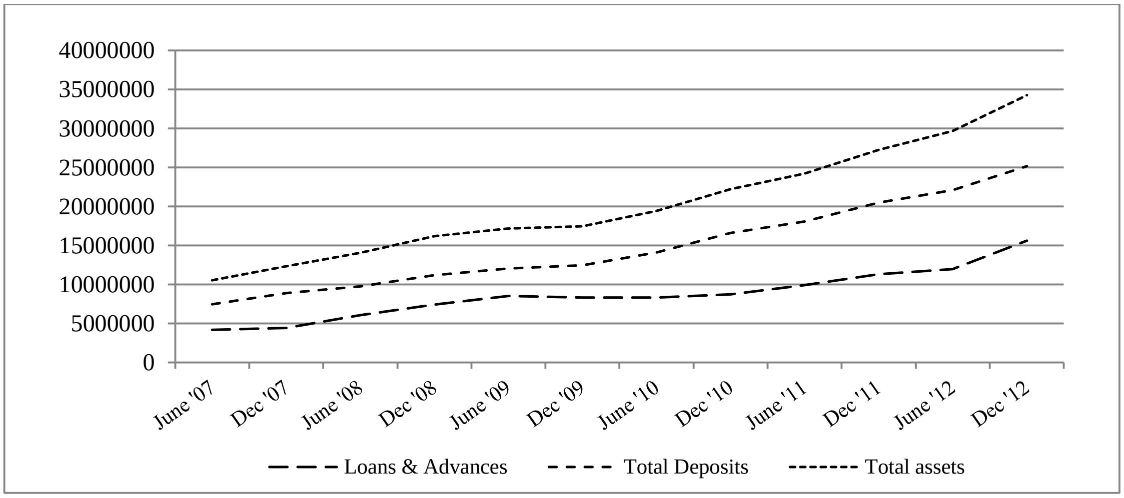
2.1 The commercial bank sector in Zambia

Currently, there are nineteen registered commercial banks that operate in Zambia. According to the central bank called Bank of Zambia, 16 banks are registered under foreign ownership while 2 are registered under local investors. The remainder is registered under a joint partnership between the Republics of Zambia and India. When a threshold of 50% and above on voting rights by foreigners is used to categorize foreign bank ownership, 15 banks qualify under foreign ownership. Between 2005 and 2008, one foreign owned bank entered the market which had only 14 banks previously. The other four banks entered the market between 2008 and 2012.

Despite a notable entry of new banks, the banking sector still remains concentrated both on deposits and assets since the collapse of many commercial banks prior to 2000. Mwenda and

Mutoti (2011) report that the largest four banks, which are all foreign private owned banks, account for 74.6% share of total banking assets and 67% share of total deposits. Figure 1 shows the evolution in the banking sector deposits, loans and assets from 2007 to 2012 in nominal terms. Over this period, loans and advances grew in absolute size but less so as a proportion of assets.

Figure 1: Nominal bank deposits, loans and assets



Plot based on Bank of Zambia data

The Bank of Zambia regulates the banking sector based on the Banking and Financial Services Act (BFSA) of 1994 which was amended in 2000 and the Bank of Zambia (BoZ) Act which was also amended in 2013 to grant the central bank legislative powers to regulate interest rates and other charges in the financial sector. In the last two decades, the country intensified the implementation of market based financial sector reforms whose overarching goal was to improve financial sector infrastructure, competition and access to financial products. For example, sizeable measures on prudential regulation were introduced in 2000 following the amendment to the BFSA Act.

Between 2004 and 2012, the reforms in the financial sector were guided by the Financial Sector Development Plan (FSDP). The FSDP has been both a vision statement and a comprehensive strategy of financial stakeholders aimed to address weaknesses in the financial system. It has guided efforts towards the creation of an efficient financial sector that could mobilize necessary financial resources to support economic diversification and sustainable growth. Some of the notable progress attained during the FSDP includes creation of a credit reference bureau in 2007, establishment of a credit guarantee scheme for MSMEs borrowing from commercial banks worth US$ 2.1 million in 2009 and the launch of a financial literacy strategy in 2012. Since 2012, the central bank publishes charges and payments on various products and services for each commercial bank in the daily tabloids and its webpage as a means of public improving knowledge and hopefully competition in the sector. Since January 2013, interest rate charges in the banking sector are capped at 18.25%.

Notwithstanding these recent improvements in policy as well as in technology and infrastructure, the banking sector in Zambia still ranks relatively low in the Southern Africa Development Community (SADC) region. For example, bank penetration ratio measured as a proportion of deposits to Gross Domestic Product is approximately 19% compared to 40% in

Botswana and 21% in Mozambique and Tanzania respectively (Napier 2008). The utilization of financial services is also remains low. Estimates from the FINSCOPE survey conducted in 2009 show that about two thirds of the adult population does not have access to any financial service while less than 18% have access to formal bank services (Trust & Heights 2010).

2.2 The MSME sector in Zambia

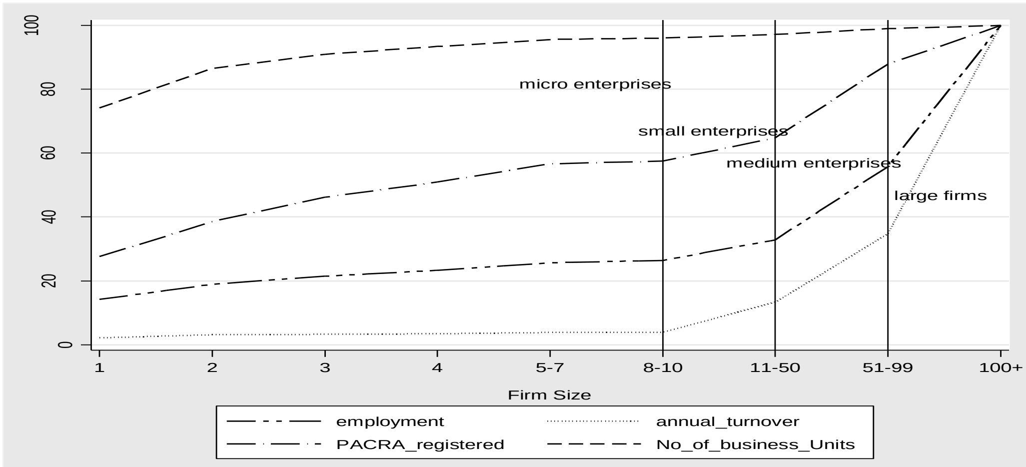
MSMEs in Zambia are classified based on a combination of variables that include total fixed investment excluding land and buildings, annual turnover, number of employees and legal status.[1] Although the MSME policy requires that a business has to be legally registered before it can qualify to be classified as an MSME, there are many MSME equivalent sized firms that are not formally registered and they are called informal MSMEs. Kedia-Shah (2012) estimates that there are between 943, 000 and 1.2 million informal MSMEs compared to 30,000 that are formally registered by the national tax authority. Figure 2 shows the cumulative percentages of employment, annual turnover, formal registration with the Patents and Companies Registration Authority (PACRA) and the number of business units by the size of the firm enterprise computed from pooled data drawn from the 2008 World Bank Small and Large Business Surveys in Zambia.[2] In this section, the number of fulltime employees is used to indicate the size of an enterprise.

As expected, most firms are micro enterprises meaning that they employ less than 10 fulltime employees. This type of enterprises accounts for almost 96% of roughly about1.5 million total firms in the nation as shown in Figure 2. The dominance of microenterprises is very strong given that enterprises that employ fewer than three fulltime employees account for greater than ninety percent of all firms in the nation. However, micro enterprises employ 26.4% of all fulltime employees and account for a total share of 57.8% formally registered enterprises with a marginal contribution to annual turnover of 3.3%. This shows that national turnover is concentrated among medium and large enterprises. The total MSMEs sector accounts for 99% share of all business enterprises in the nation and contributes 56% to fulltime employment. It also accounts an 80% share of formally registered enterprises and contributes 35% to turnover per annum. This illustrates the relative important role of the MSME sector in Zambia in terms of job creation and value addition.

[1] See appendix A for full details on MSME classification in Zambia

[2] The full description of the data can be found at http://siteresources.worldbank.org/INTAFRICA/Resources/zambia_biz-survey.pdf. This is the most recent dataset available that focuses on MSMEs

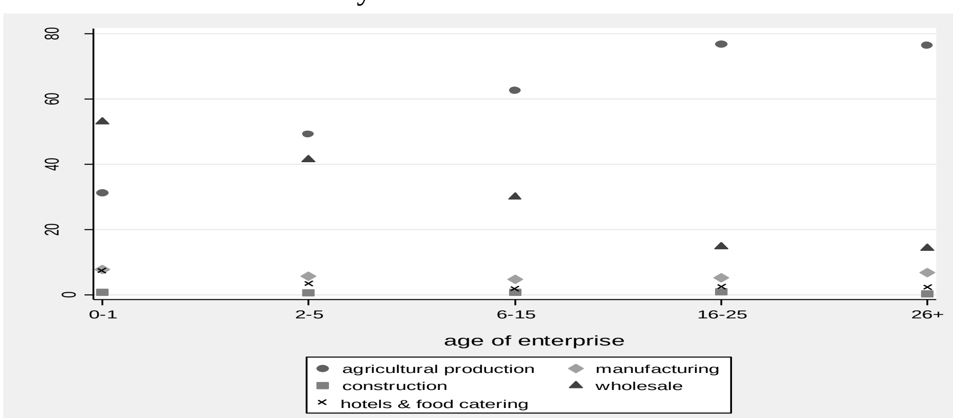
Figure 2: Share of MSMEs based on the number of fulltime employees



Plot based on WBBS 2007 data

Given that MSMEs dominate the number of firms in the nation, we explore the type of business activities these enterprises do. Among both formal and informal MSMEs, the majority of enterprises engage in agriculture activities followed by wholesale and retail trading. Figure 3 shows that entry of MSMEs is highest in wholesale and retail trade sector than in the agriculture sector. However more enterprises are likely to survive for a substantial period of time in agriculture than wholesale and retail trade. The proportion of enterprises that enter into manufacturing, construction and hotels and food catering is low but exhibits fairly constant rates of survival indicating minimal exits in these sectors.

Figure 3: Survival of MSMEs by economic sector



Plot based on WBBS 2007 data

Furthermore, we investigate the motives that drive entrepreneurs to venture into business as a way to understand some aspects that might underlie the predominance of microenterprises and might be key targets for promoting productivity growth in this segment of firms. To achieve this, we compare the proportions between microenterprises that employ one fulltime employee against the rest of the micro and small enterprises that employ more than one fulltime employee along an array of start-up motives. The motives range from the desire to try out a business idea or some innovation that is typical among nascent entrepreneurs to livelihood and income support that is typical among entrepreneurs that hardly innovate and grow. The latter type is known to be prone to mortality and dismal patterns of productivity. Table 1 shows that among both micro and small enterprises, the most compelling reason for establishing an enterprise is to supplement income from other sources such as wage earnings.

The supplementation of income ranks much higher among enterprises that employ only one fulltime employee whom in many instances will be the owner of the business. Rendering support to the family ranks much higher among microenterprise that employ more than one fulltime employee. The desire to try out a new business idea is significantly higher among firms with more fulltime employees (13%) than among the lone employee enterprises (10%). However the considerably entrepreneurial spirit based on these low proportions indicates that entrepreneurial spirit that is anchored on taking advantage of a product or market opportunity remains is rare in Zambia. This is despite the first-order importance of this type of entrepreneurs in business development and hence value addition of enterprises.

Table 1: Motive for establishment of business by enterprise size

	1 fulltime Employee	More than 1 employee	Difference
I was fired/retrenched from a previous job	5%	6%	-1%
I couldn't find a job elsewhere	18%	16%	2%
To support me/my family	14%	20%	-6%
To supplement other income	82%	75%	8%
To try out a business idea	10%	13%	-3%
I hoped to make more money working for myself	6%	10%	-3%
I had nothing else to do	1%	3%	-2%
Other	13%	11%	2%

Computations based on World Bank small business survey data

Although various administrative, institutional and regulatory reforms seeking to improve the environment in which business is conducted in Zambia have been enacted and others are still on-going, MSMEs still report a considerable number of serious obstacles that affect their businesses. Table 2 shows that tabulation of these obstacles reported by MSMEs in the World Bank small business survey for Zambia. The obstacles have been ranked from the least important up to the most notorious one. As expected, the level of access to finance is the most noticeable obstacle to doing business among MSMEs in the nation.

For small and medium enterprises business licensing and issuance of permits seem to be a notable challenge opposed to smaller firms. This pattern is also observed for electricity supply and the macroeconomic environment. This could be attributed to the low prevalence of formalization among micro enterprises and perhaps their fragmented business nature since they are mainly located at the household level and hardly seek sizeable supporting facilities at the macroeconomic level. Micro firms indicate the cost of finance as a notable obstacle to doing business but not corruption, which is the opposite among small and medium enterprises.

Table 2: Most serious obstacle to MSME business by enterprise size

	Fulltime employees			
Most serious obstacle to business	Less than 5	5 to 10	10 to100	Total
business licensing and permits	1.1	1.9	8.3	1.4
political environment	1.5	1.7	0.0	1.5
Electricity	3.4	4.5	8.4	3.8
macroeconomic environment	4.5	2.4	10.0	4.1
Corruption	4.4	3.7	5.6	4.2
cost of finance	8.1	7.7	2.7	7.9
crime, theft, disorder	9.3	6.4	4.6	8.5
access to land for expansion/relocation	13.1	15.8	8.5	13.7
Transportation	20.0	30.7	21.9	22.7
access to finance (e.g. collateral)	27.7	21.0	26.4	26.0

Obstacles with minute percentages are not shown here. Therefore total sum need not to be 100

Reliable estimates of MSMEs access to formal credit are mainly lacking in Zambia. However scanty estimates based Small and Medium enterprises only indicate that about 13.5% of MSMEs had at least one line of credit in 2007 based on the World Bank's Enterprise Survey. Bank credit accounted for the largest source of MSME credit holdings at 72%. More than two-thirds of credit was held by medium enterprises classified as business units that employed between 20 and 100 employees. While the sample for this survey is restricted to firms that are located within four prominent towns all lying along the line of rail, its results coupled with the fact that MSME report access to finance as the most notable obstacle, confirms that access to bank credit by MSMEs is very low.

3 Literature review

3.1 Introduction

Our study is related to three interlinked strands of literature. The first strand deals with the issue of bank financing obstacles to MSMEs also broadly referred to as small business lending from a traditional commercial bank credit rationing argument. The second strand examines the influence of bank size, ownership, organizational structure and lending technologies on small business lending. The third strand looks at the role of bank institutional structure that include regulatory, economic and market structure on small business lending by banks. The first two strands of literature can be broadly categorized into a group of studies that characterize bank level obstacles while the last strand of literature characterizes banking market level constraints to MSME lending.

3.2 Bank Financing Obstacles to MSMEs

A vast literature suggests that frictions in financial intermediation caused by asymmetry of information between lenders and borrowers and agency costs explain why credit is often rationed and might not flow to firms that have profitable investment opportunities (Diamond 1984, Stiglitz & Weiss 1981, see Bhattacharaya & Thakor 1993 for a review). These market frictions imply that lenders are unable to screen for good borrowers when information is imperfect and costly to gather such that they fear to select adverse borrowers. Equally, the high costs involved in monitoring borrower projects by lenders entices borrowers to embark on high risk activities that lead to moral hazard. The implication of this literature is that banks have to rely on sorting devices to discriminate and choose among borrowers. These include demanding collateral and covenants and varying the maturity of contracts among others. A number of studies that develop on the predictions of this literature also show that borrowers can overcome market frictions through the production of 'hard' credit information.

It is widely acknowledged that MSMEs are disproportionately more discriminated when accessing formal bank credit than large firms. In fact some evidence based on cross section surveys indicates that MSMEs not only report the limited access to formal credit as a major obstacle they face but they also indicate that they find obstacles that impede access to finance more binding among themselves than large firms (Beck et al. 2006, Beck et al. 2005) . This is mainly attributed to the opaqueness and less transparent information among small businesses.

3.3 Relationship Lending

Is relationship lending the same as…..influence of bank size, ownership, organizational structure and lending technologies on small business lending? That is what was given in the introduction to literature review above.

The second strand of literature emphasizes the adoption of relationship lending as an alternative and powerful technique to resolve market frictions caused by the existence of asymmetric information and agency costs in the credit markets. Boot (2002) defines relationship lending as the provision of finance by a credit supplier that: (i) invests in obtaining customer-specific information which is often proprietary in nature; and (ii) evaluates and monitors the profitability of various investments by the same customer through multiple interactions over time. This definition shows that relationship lending entails collection of borrower specific information that is proprietary or 'soft' through continuous interactions between a lender and a firm but does not entirely preclude the need for some quantitative information. This lending technology contrasts transaction based lending that are based on 'hard' information analysis such as financial statements, collateral and/or credit scoring. Transaction based lending methods involves more arms-length interaction between a borrower and a lender.

There are various studies that provide support for the importance of relationship lending technology in improving the availability of formal bank credit and its contractual terms to small businesses (Cole 1998, Cole et al. 2004, Cull et al. 2006, Elsas & Krahnen 1998, Petersen & Rajan 1994). These studies conventionally argue that small banks are better suited to exploit relationship lending. This is attributed to the difficult in transmitting abstract and subjective information in a bureaucratic environment where the distance between a loan officer who collects information and the loan approving authorities is long. Consequently, Berger and Udell (2002) have demonstrated that it's only banks with a small hierarchical structure and a few managerial layers that are better suited to assimilate soft information because 'soft' information held by loan officers plays a significant role in the credit decision in smaller banks.

The comparative advantage of small organized banks and other financial institutions in 'soft' information lending has been shown in Liberti & Mian (2009), Carter & McNulty (2005) and Carter et al. (2004). Liberti (2003) provides further evidence which shows that delegation of authority and reduction of oversight improves in a bank increases the provision of effort by relationship managers because they spends less time reporting to bosses and they recognize that their effort has greater impact on outcomes. This is consistent with the view that transmission of, and reliance on, soft information are higher when there are more incentives towards increased decision making and accountability at lower levels than at higher centralized levels (Qian et al. 2010).

The conventional view that it is small and niche banks that possesses an advantage to serve small businesses through their supposedly comparative advantage in relationship lending has been challenged by De la Torre et al. (2010). In a cross country sample of emerging economies, all types of banks indicate that they cater to small businesses with large multiple-service banks exhibiting notable comparative advantage in offering a range of products and services on a large scale. They attribute this result to the use of new technologies, business models, and risk management systems among large banks that never diminished during the 2007–2009 financial crises regardless of ownership or bank size. In fact, many banks indicate that they find small businesses as a core and strategic business and intend to intensify their involvement with this segment. Berger & Black (2011) show that although small banks have a comparative advantage in relationship lending based on a broader measurement of fixed-asset or 'hard' information lending technologies than in earlier studies, they notice that it only appears to be strongest for lending to larger and not small firms.

Beck et al. (2012) provide evidence that suggests that foreign and domestic banks tend to cater to the same clientele including small businesses but the former relies on transaction-based lending techniques while the later uses relationship-based lending techniques. Foreign banks are found to charge lower interest rates, but grant loans at a shorter maturity with their pricing largely based on credit ratings and collateral pledges.

Despite the traditional view that large banks are structurally inefficient to deal with MSMEs, De la Torre et al. (2010) observe that (i) increased competition in retail and corporate business have provided incentives for large banks to pursue business with MSMEs (ii) the rise in credit reference bureaus and other credit information sharing initiatives that provide hard information have facilitated better usage of arms-length transactional lending technologies such as credit scoring for MSMEs (iii) increasingly, big banks enjoy economies of scope on fee-based non-lending products and other cross-selling products that are sought by MSMEs, and lastly (iv) banks have now design incentive-driven mechanisms that increase the likelihood of repayment by MSMEs without depending on the governments to guarantee risks.

3.4 Industrial Organization, Law and Institutional Economics

The third strand draws on literature from industrial organization, law and institutional economics. It is widely noted that, limited provision of credit to small businesses can be attributed to the existence of transaction costs, uncertainty about project outcomes and information asymmetry at the market level. It is precisely these frictions that lead to creation of organized or formal financial markets. However, the macroeconomic environment, market structure, and the level of information transparency critically determine the efficiency of a financial market to overcome these frictions. For example, in markets that contain information sharing platforms for creditors such as credit registers or credit reference bureaus, contract delinquencies and defaults tend to be low especially when firms are informationally opaque although it does not loosen lending standards (Doblas-Madrid and Minetti 2013). This is merely because sharing of default information among lenders acts as a borrower discipline device.

The legal environment in which banks operate is known to influence their lending composition through its impact on the 'lending infrastructure and therefore the extent to which banks are limited to certain types of lending. An important component of the infrastructure relates to the commercial and bankruptcy laws that determine creditor rights and their enforcement by the courts. Legal institutions may thus affect the composition of bank lending. For example, the allowable risk tolerance limits, the relative role of collateral value and range of permissible assets that can serve as collateral (such as movable and immovable assets) and the relative allowance of soft information over hard information affects the lending to MSMEs over large corporate firms.

4 Data

Our main results are based on data from two complementary sources. First, we analyze patterns and trends on bank lending to MSMEs using data collected by the Bankers Association of Zambia over a period covering December 2010 to June 2012. This data records the total value of credit allocated to MSMEs by each commercial bank and the average interest rates that are charged across ten economic sectors. While all commercial banks are required to submit this information, the response usually varies between 11 and 15 banks. This data is used by the banking lobby group to report on the progress attained on the implementation of access to bank finance under the National MSME policy implementation. Where was this specified as the objective of the study?

Second, we use data that was collected by the research team based on a questionnaire that was issued to all the nineteen commercial banks during the month of October 2012. Why? What was the objective?

The questionnaire gathered information pertaining to banks' strategic interest in MSME lending, the organizational structure of MSME business within each commercial bank and financial products banks use to serve MSMEs. It also included questions on strategies that banks employ to reach-out to MSMEs, the type of lending technologies, risk management practices and the effects of economic and regulatory factors on banks involvement with MSMEs. The questionnaire received input from the Bankers Association of Zambia that also facilitated informed consent from banks, Bank of Zambia, Zambia Development Agency, Zambia Chamber of Small and Medium Business Associations, Ministry of Finance and Ministry of Commerce, Trade and Industry.

In all cases, commercial bank staff with the help of a research assistant completed the questionnaire. The interviews and data processing were confidential and banks were assured that their information will never be disclosed to any third party regardless of the circumstances. A total of 17 banks successfully completed the questionnaire out of the 19 commercial banks registered in Zambia. Among the banks that completed the questionnaire, 13 indicated that they currently serve MSMEs. Out of the 13 banks, 10 have more than 50% voting rights held by foreign residents. In total, we have matched data for 8 banks because there are some banks that responded in the survey but didn't submit information to the Bankers Association of Zambia and vice-versa.

Table 3 shows the range of amounts on total assets, turnover, deposit and credit requested and the number of employees that are used to classify enterprises into micro, small or medium categories by commercial banks. The range of amounts and number of employees varies significantly across commercial banks. This indicates that the definition of a Micro or a Small or a Medium enterprise is not homogenous among banks.[3] Nevertheless, there is a consensus among banks that a micro enterprise is different from a small enterprise which is also different from a medium enterprise rather than the tendency to lump micro and small enterprises together. However, the definition of micro enterprise among some commercial banks is riddled by the inclusion of home-mortgages. The value of home mortgage loans in the data banks submit to the Bankers Association of Zambia on MSME lending varies between 0 to 78% in some cases. In this study, we dropped home-mortgages from the reported MSME lending because it cannot be strictly identified as enterprise lending even if some enterprises may procure homes as part of their business or fixed-asset capital investments.

Similarly, the classification of MSMEs among banks differs from the categorization stipulated in the national MSME policy. We note that practices among banks that are generally perceived to be large in size are mainly responsible for much of the discrepancy.[4] In order to capture bank practices, we ignore the variation in the definition of MSMEs across banks and the deviation from the national MSME policy. We focus on MSMEs as perceived by each commercial bank. Although this complicates comparison across banks, we follow this approach because bank-specific practices are of first-order importance to our study rather than theoretical constructs of what could be comparable MSMEs across commercial banks.

Table 3: Enterprise definition in the National MSME Policy and from Banks practices

Enterprise	Source	Net Assets	Annual sales	employees	Deposits	Loans
		K' range	*K' range*	*Count*	*K' range*	*K' range*
Micro	MSME Policy	below 80	Less 150	below 10	Na	Na
	Bank Survey	below 80	50-500	below 10	up to 8	below 500
Small	MSME Policy	80-200	150-250	11 to 50	Na	Na
	Bank Survey	80-150	50-3000	2 to 50	8-500	10-4700
Medium	MSME Policy	200-500	300-800	51-100	Na	Na
	Bank Survey	51-500	200-10000	7 to 100	250-500	500-5000

Notes: The MSME Policy and banks both require formal business registration regardless of enterprise size; Net assets exclude land and buildings; deposits are reported as average per annum; monetary values reported in thousand kwacha; Na=non-applicable.

5 Results

5.1 Bank lending to MSMEs: December 2010 to June 2012

The quantitative data that we obtained from the Bankers Association of Zambia shows that bank lending to MSMEs has significantly grown in the last few years. It more than doubled within a six-month period in 2012 even after marginally dropping in 2011. For instance, total bank lending to MSMEs in 2010 was approximately K388 million or 4% share of total banking loans, K301 million or 3% share of total banking loans in 2011 and K854 million or 7% share of total banking loans in June 2012 (BAZ and BOZ). While some few banks increased their total volume of lending to the MSMEs by December 2011, the aggregate portfolio value at the twenty fifth and median banks reduced remarkably and led to a net reduction of total banking credit to

[3] This is despite BAZ's indication that banks fully conform to the MSME policy definitions.

[4] We do not have current data to objectively measure bank size

MSMEs. There is some overlap in the distribution of bank lending to MSMEs for the years 2010 and 2011. However, there is unambiguous rightward shift of the distribution in the first half of 2012 which clearly indicates that all banks rapidly increased their allocation of credit MSMEs. As a result, there is a more than twice increase in the share of MSME credit within the total bank loan portfolio. Banks that dominate the banking market led the growth of credit to the MSME sector.

Table 4: Distribution of bank lending to MSMEs

year	Total Bank Loans[a]	Total MSME Loans[a]	Mean	1st	10th	50th	90th	99th
2010	9,561,077	388, 111	29855	1013	3290	20870	61694	69658
2011	11,979,117	301, 382	27398	1400	2571	10070	88789	91315
June 2012	12,912,855	845, 363	84536	9486	9552	53491	253844	339972

Notes: [a] These values are indicative because some banks have never reported their lending to MSMEs. However almost banks that are notably large are captured; Values in thousands kwacha.

Because our bank survey was conducted three months after the final date on which BAZ had portfolio data (31st June 2012), we use the median of the distribution of bank lending in June 2012 to delineate our sample of banks into two categories consisting banks that lend above the median and banks that lend below the median. This will help us to identify patterns that underlie the allocation of credit to the MSME sector and the extent to which these patterns are associated with volume of financing to MSMEs.[5] Before we report results that compare the two groups of banks along some array of factors that might influence or inhibit flow of credit to MSMEs, we first report the findings on the products banks use to serve MSMEs. Each bank was requested to indicate whether it provides a named product or not to MSMEs, the interest rate that it charges for the product, non-interest rate charges that apply such as loan arrangement fees, the number of days it takes to process an application and the maximum tenure that is permitted for the product.

Table 5 shows the results aggregated across all responding banks that serve MSMEs. Fewer banks have provided MSMEs with finance for commercial and industrial property acquisition, supply chain financing, factoring and invoice discounting and unsecured loans. The first two financing lines are cardinal to support tangible or real productivity growth among enterprises. The significantly lower percentage of banks offering unsecured financing to MSMEs confirms that banks find many MSMEs to be untrustworthy. On the contrary, most banks indicated that they provide trade finance and bond and guarantees with all banks indicating that they offer working capital to MSMEs. Trade finance and bond and guarantees where also reported as the mostly demanded products with almost 90% of applications that were recorded in excess of 130 in some banks being successful.

This shows that many banks offer intangible or “cosmetic” financing of MSMEs. This type of finance largely supports MSMEs to conduct their daily operations and business transactions but

[5] Among banks that lend above the median the share of MSME loans in the total bank portfolio ranges between 21%-69% with the average share equal to 40% while among banks lending below median, the share of MSME loans is ranges between 5% and 30% with the average share equal to 15%. In terms of deposits, MSME average shares are 26% and 19% among the former and latter groups respectively. This shows higher MSME lending shares among banks that provide relatively more credit to MSMEs.

offers very little scope for the enterprises to expand their productivity and eventually grow their businesses. This can also be noticed from the lower maximum tenure of "cosmetic" financing products when compared to the maximum tenure for "tangible" financing products. Implicitly, this observation may be reflecting difficulties of banks to issue long-term credit. This can be as a result of limited availability of loanable funds due to low capitalization, for example, or generally portfolio mismatching as a result of liquidity constraints some of which may be artificially arising from regulatory barriers. On the contrary, this may indicate the lack of collateral and poor product knowledge among MSMEs. Banks mentioned that most MSMEs seek transactions that are largely classified as cash transactions. It is useful to mention that all banks indicated that they do not offer business advisory services as a product to MSMEs.

Table 5: Banking products for MSME clients

Bank Product	Bank percentage with product	Interest Rate	Other charges	Processing (in days)	Max. Tenure (Months)
Commercial and Industrial Property Financing					
Mean		17.7	1.8	12.2	73.7
Range		(16-20)	(1-2.5)	(5-28)	(12-180)
Percentage	69.2				
Supply Chain Financing					
Mean		19.3	2.3	11.1	39.5
Range		(16-26)	(2-2.5)	(3-30)	(3-120)
Percentage	69.2				
Trade Finance					
Mean		19.2	2.0	20.0	29.5
Range		(16-26)	(1.5-2.5)	(3-90)	(2-84)
Percentage	84.6				
Bonds and Guarantees					
Mean		18.2	2.0	10.2	24.6
Range		(10-24)	(1-3)	(2-30)	(2-60)
Percentage	84.6				
Working Capital					
Mean		19.8	1.9	12.5	26.4
Range		(15-26)	(1-3)	(2-30)	(12-60)
Percentage	100				
Factoring/Invoice Discounting					
Mean		18.5	2.2	13.7	29.8
Range		(15-24)	(1.5-3)	(2-30)	(2-90)
Percentage	61.5				
Unsecured Loans					
Mean		18.3	2.0	6.8	49.2
Range		(15-20)	(2-2)	(3-14)	(18-60)
Percentage	38.5				

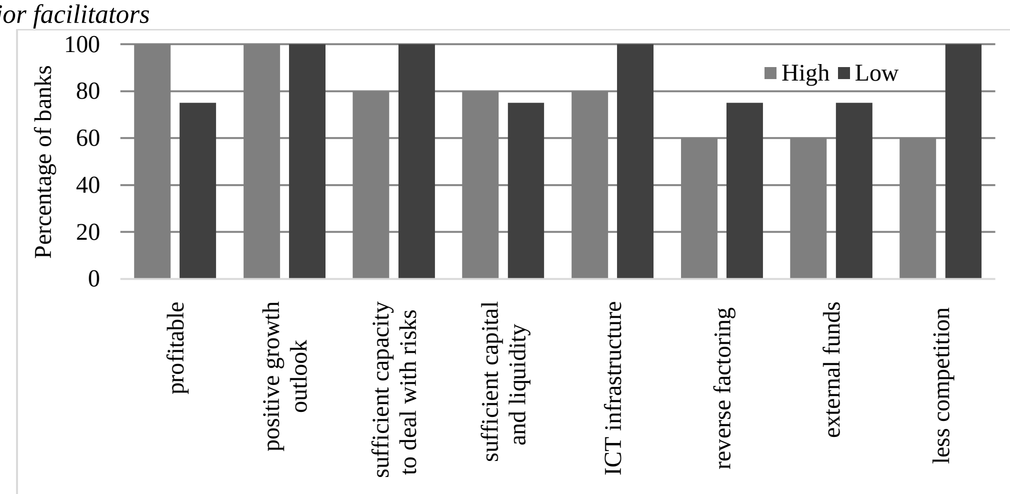
5.2 MSMEs as bank clients

The MSME lending sector is arguably a core business for many banks in Zambia. It contributes between 26% and 50% to total bank income on average and between 25% and 40% to total bank without any systematic pattern of loan portfolios size to MSMEs. Typically banks had employed between 9 and 20 loan officers with identical averages of 14 against 12 loan officers per bank between banks that lend relatively more and those that lend lesser respectively in the 2011 financial year. During the same period, banks received approximately 220 and 175 MSME loan applications while the total number of MSME loan held by banks averaged between 144 with a range of 10 to 335 compared to an average of 125 with a range of 50 to 200 among high and low lending banks respectively. Banks significantly find provision of credit to MSMEs to be relatively more costly than retail loans but less so than corporate loans.

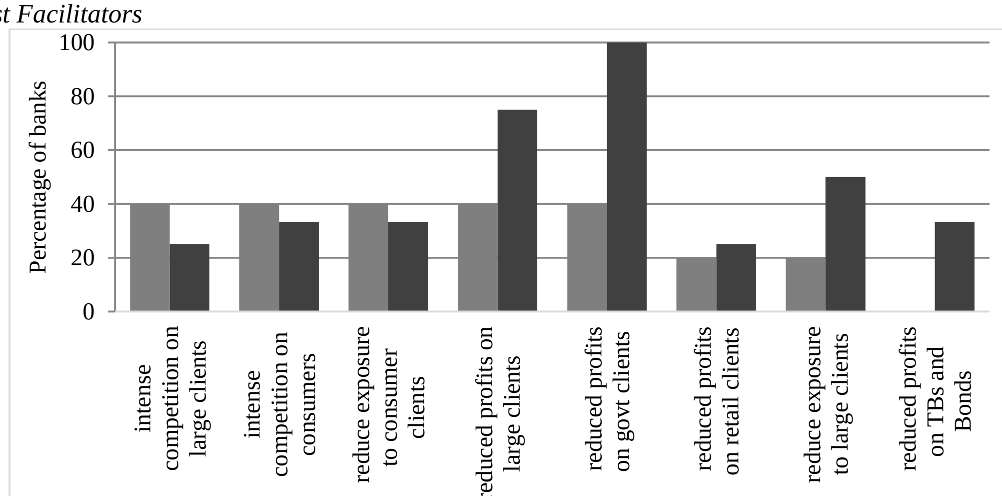
Bank involvement with MSMEs is driven by a number of factors whose importance varies significantly across commercial banks. The banks that don't deal with MSMEs indicated that they do it purely out of corporate strategy. Economic sectors that experienced a reduction in the amount of credit received from banks between 2010 and 2011, received the highest growth in the amount of credit in the first half of 2012. These were agriculture and related activities, manufacturing, restaurants and hotels and wholesale and retail trading. The switch in allocation of credit over the two periods demonstrates that banks do not have a strategic focus of a particular sector currently. Instead there is an array of factors that stimulate banks to engage and provide credit to MSMEs as shown in Figure 3.

Figure 3: Factors influencing banks credit provision to MSMEs

a. Major facilitators



b. Least Facilitators



The market for MSME financing among commercial banks, like the overall market for bank lending in Zambia, appears to be less-competitive. Over half of banks that lent above the median in June 2012 (high category) and all the banks that lent below the median (low category) indicated that they engage with MSMEs because competition within this business segment is still significantly lower. Competition within the large clients and consumer customers segments is not significant in driving banks to lend to MSMEs. This provides support towards the claim that competition in various market segments does not significantly motivate banks to engage into MSME lending. Instead, it is less competition within the MSME lending business that drives banks to engage with MSMEs. There is also no systematic pattern suggesting that banks that have majority voting rights held by domestic banks tend to lend more in absolute value. However, we note that most banks that lent below the median threshold are relatively new entrants in the banking market and are still growing their markets shares and loan portfolio.

The drive to harness profits from MSME lending is linked to high credit provision while positive growth outlook among MSMEs is a major determinant why banks lend to MSMEs. While less than 85% of banks that lend below the median threshold indicate that profit is a significant factor that influences their involvement with MSMEs compared to 100% among response among banks above the median, thinning profits on large and government clients are very significant determinants among the former group. This means that the scope for profits is favorable in the retail and the MSME segment for this group of banks.

All commercial banks have a positive projection on the growth prospects of the MSME sector in Zambia. The survey asked banks to indicate the outlook of the MSME segment relative to the overall portfolio of the bank on a number of dimensions shown in Table 6 at 1 and 5 year periods. The group of banks that lend below the median has higher than maximum and minimum percentages than the group that lend above the median both at one and five year horizon but significant overlap exits between the two groups. This pattern is expected to lead banks that are below the median to catch up with banks that are above the median in terms of lending to MSMEs in the future. The contribution of MSMEs to banking income and loans is projected to rise across all banks indicating that the importance of the MSME segment is expected to be more nuanced in the foreseeable future.

Table 6: Outlook of MSMEs to banks

	1-year			5-year	
	0	1		0	1
value of outstanding loans	20-50	3-60		10-80	10-65
number of outstanding loans	20-80	3-30		10-90	10-50
value of deposits	50	6-45		50-65	10-60
number of deposit accounts	50	20-65		60-80	50-55
number of clients	70-90	20-80		80-90	50-60
banking income	40-50	4-40		70-80	10-70

The other factors that banks considered to significantly drive their engagement with MSMEs were the anticipation or current availability of sufficient capacity to assess and manage MSME risks, information communication technology infrastructure and capital and liquidity. A reasonable fraction of banks in both groups also indicated that they receive or expect to receive funds from external sources such as the African Development Bank, European Union and the International Finance Corporation to mention a few, for the provision of MSME credit. This helps banks to significantly involve their participation in MSME financing. Banks also mentioned that they leverage on their relations with large corporations to identify and target MSMEs who are suppliers or contractors to these firms.

5.3 Banks business model and lending technologies for MSMEs

Most banks use a combination of interventions to reach out to MSMEs and attract more enterprises. Direct marketing activities are by far the widely reported form of outreach. Almost all banks that serve MSMEs also serve retail consumer customers, government agencies and large corporate clients but only about half do cater for international non-governmental organizations. All the banks indicated that they don't finance business registration costs for MSMEs. As noted in Table 3, banks only deal with already registered MSMEs that have also established themselves already and not start-ups. A large majority of banks accounting for over 90% also indicated that they do not support MSMEs to develop business plans or conduct market research. This proportion fell to 71% for banks that reported they don't finance product branding and packaging among MSMEs.

The MSMEs business units are mainly organized as dedicated departments whose responsibilities are separate from those of other departments such as retail or consumer lending except for 25% cases were banks reported that MSMEs business housed either within retail lending, operations or credit departments. However, bank officers in separate MSME unit interact and cooperate extensively with other bank employees both at headquarter and at branch levels. To understand the nature and extent of bank bureaucracy and its implications on MSME loan approval process, the survey asked banks to sketch the organizational structure of the MSME business unit by indicating all the hierarchical levels from the branch up to the executive board level. At the same time, banks were asked to indicate the title of the responsible officers at each hierarchy level, the nature of the decision they make with respect to the size of the loan categorized either as a small or medium or large loan and the credit limit applicable in case an officer retains the authority to approve a loan.

Results show that the majority of banks have either five or six hierarchical levels through which a loan has to pass through before the final decision is made with very little variation being observed across loan size. The general tendency among banks is that while individual bank officers are required to provide their assessment within their jurisdictions such financial analysis or credit scoring or management rating, the final decision on the loan application is collectively made by the loans review committee which is also called the credit committee.

The loans review committees are always centrally housed at commercial bank headquarters and their membership comprise almost all banks core senior management officers. Banks indicated that the main role of the branch is usually to ensure that all loan applications satisfy the requirements during submission in addition to facilitating loan recovery once it has been granted. There are no significant differences that we observed between the hierarchical levels among banks that provided above or below the median lending to MSMEs in June 2012. At the same time, we note that the credit limits reported for individual officers including executive officers are prohibitively low and seem to have been designed only to facilitate overdrafts which may be deemed to have insignificant consequences on bank exposure.

Therefore, we do not find a consistent pattern that seems to suggest that banks which lend more to MSMEs have significantly less red tape. Similarly, we couldn't deduce that loan officers within banks that lend less to MSMEs exert disproportionately little influence in the lending decision process than their counterparts in banks that lend relatively higher amounts. We attribute this observation to a guideline the central bank issued to commercial banks in 2006 that requires all banks to have a loans review committee and maintain an inventory of its deliberations and decisions in line with corporate governance for prudential regulation recommended in the Basel framework.

As noted by Berger and Udell (2002), small business or MSME lending in our case, by financial intermediaries or banks, can be categorized into four major distinct lending technologies. These are: financial statement lending, asset-based lending, credit scoring, and relationship lending. The first three lending techniques are collectively known as transactional or 'hard' information lending while the last one is based on the use of 'soft' information. This type of information is often qualitative and mainly relates to the proprietorship of the enterprise and the characters of its owners as gathered by the bank over a period of time. The survey asked banks to indicate for every lending technology described above whether the bank used it or not to lend a particular product. Each bank was further asked to briefly explain the variables of interest and the type of analysis that it conducted for each product-lending technology pair.

Table 7 shows banks responses analyzed by whether a bank lent below or above the median of bank lending to MSMEs as at 31 June 2012. Specifically, it shows the percentage of banks that indicated that they used a named technology among banks contained in each of the two groups separated by the median lending threshold as mentioned earlier. Under hard information lending techniques, it is shown that all banks in Zambia regardless of their size of credit portfolio to MSMEs demand financial statements and collateral to lend. Slightly more banks among those in the high lending group impose or demand the use of loan covenants. All the banks in the low lending group reported that they use credit scores and proprietary information when lending to MSMEs opposed to only 60% and 80% respectively among banks that fall in the high lending category.

The usage of proprietary information at product level is also universal among banks in the low lending category but it is only about 59% among banks in the high lending group as shown in the bottom part of Table 7. While we cannot argue that relationship lending is unimportant, we are able to conclude from Table 7, that banks are able to engage with MSMEs based on transactions lending aspects. For instance, a sizeable fraction of banks indicated that they identify and deal with MSMEs that are suppliers of their large corporate firms. In this manner, banks are able to leverage on their relations with large corporations and use them to guarantee their lending to MSMEs.

Table 7: Lending technologies for MSME clients

Lending Technique	Low	High
Transactional "Hard" information	Percentage of banks	
financial statement	100	100
loan covenants	50	60
collateral	100	100
credit scoring	100	60
Relationship "Soft" information		
proprietary information	100	80
Usage of proprietary information across products (%)		
	Low	High
yes	100	58.8
no	0	41.2

5.4 Risk assessment and management for MSMEs

The ability of banks to provide adequate credit to MSMEs crucially depends on their capacity to efficiently assess and manage risks. Banks indicated that they manage to recover between more than 50% of their money lent to MSMEs. The average loan recovery rate is 71.4% among banks that lend high much higher to MSMEs and 45% among banks that lend relatively low to MSMEs. We find that 80% of banks in the high lending category have a dedicated loan recovery unit compared to only 20% among banks in the low lending category. Therefore, we attribute the significantly lower loan recovery rate among low lending banks to the low prevalence of dedicated loan recovery units among them.

For a long period of time, banks in Zambia used to complain about the poor repayment culture among borrowers, a situation that was often blamed for the prevalence of high lending rates. It is interesting to note that all banks demand collateral when lending to MSMEs. Most banks indicated that they demand collateral that ranges between 120% and 150% of loan value. However banks noted that most MSMEs are unable to provide collateral of acceptable value, a reason they claimed was the major cause for MSMEs failure to access credit. At the same time, all banks mentioned that they find the litigation process to liquidate collateral extremely slow.

A number of banks tend to ascertain risk based on credit scores. Banks crucially depend on credit scores from the credit reference bureau although a number of banks indicated that also tend to compute some indicative credit scores based on information solicited from applicants. The major reason some banks do compute indicative credit scores mentioned was that they find the credit reference bureau not yet matured having been effective only since 2009. Consequently, they find its information to be incomplete to produce robust credit scores. Interesting, majority banks mentioned that they have developed adequate systems to assess MSME risks, which is one of the major reasons they have taken up MSMEs business. While credit scores were reported to have a significant influence on the lending decision to an MSME, almost all the banks expressed concern at the poor quality of information MSMEs tend to submit.

Although banks in Zambia worry about risks relating to their business operations, liquidity position, their reputation, their legal compliance and those of contagion, credit risk seem to be of utmost importance when dealing with MSMEs. Currently, the prudential regulation regime in Zambia is still in transition towards a risk based management approach (BOZ 2011). Predominantly, the regulation of risk is guided by a small fraction of practices adopted from the Basel I framework. For banks that are subsidiaries of leading global banks, they disproportionately reported that they have inherited in-house risk systems from their parent banks that are compliant to Basel II. This subset of banks indicated that they do compute rigorous risk parameters for their entire credit portfolio that includes MSMEs. The notable parameters that they indicated to compute to include the probability of default, loss given defaults, exposure at default and value at risk as well as some portfolio stress tests. The rest of the banks that are unable to compute some the sophisticated parameters depend on monitoring trends on loan settlement, overdraft facilities, convent performance, the rate and number of non-performing loans and portfolio values at risk either in isolation or in some combination to discern credit risk exposure.

Banks that allocated credit to MSMEs below the median indicated that they monitor the portfolio to the MSME sector on a daily or weekly basis while banks that have relatively large portfolio of MSME lending indicated that they monitor at monthly intervals. Banks monitor their approaches using a combination of approaches. The former group of banks usually monitors exposure among MSMEs by borrower and product in addition the total portfolio. The latter group monitors also monitors by borrower and product besides portfolio but in addition they monitor by borrower sector and branch. This pattern shows that banks that have low portfolio sizes tend to have narrow branch network which enables them to manage monitoring on a daily basis and by client since they are fewer clients. On the other hand, banks that have relatively large portfolio sizes tend to have wider branch networks and more clients per sector which make monitoring on a daily basis difficult but sensible to conduct at the sector level on a monthly basis.

In order to diversify risks, banks indicated that the increase in the amount and number of MSME credit guaranteed loans, purchasing insurance on the loans and the trading of credit derivatives to hedge the MSME risks are important considerations except for hedging through credit derivatives trading among banks with relatively smaller MSME loan portfolios. There are relatively more banks that reported use of the credit guarantee facility and private insurance in lending to MSMEs among banks that lend above the median to MSMEs than those than lend below MSMEs. The percentage of banks reporting use of credit guarantee schemes among banks with low MSME lending is 33% compared to 60% while usage of private insurance it is 66% compared to 80%. The notable credit guarantee schemes that banks used were the United States Aid guarantee scheme, the African Development Bank scheme and the Development Bank of Zambia (DBZ) scheme.

Of particular mention, the DBZ scheme was initiated by the Government of Zambia in 2009 to help improve the access of MSMEs to bank finance. The scheme was established with a sum of USD 2.1 million to enable commercial banks claim up to 60% of the loan value in case of a default by an MSME contracting a loan ranging between K20 million and K300 million. Interesting, very few commercial banks utilized this facility. Banks claimed that documentation demanded by DBZ on borrowing MSMEs is voluminous and tedious to gather in view of the information opaqueness that exists among MSMEs. As a result the duration to process a loan through the scheme is significantly prolonged. At the same time, they noted that the ceilings are relatively low and tenure is short. On private insurance, banks indicated many private insurance companies lack prior experience in handling insurance for products that banks offer to MSMEs and the cost of insurance as the major challenges they face.

6 Conclusion and Policy Recommendations

6.1 Conclusion

This paper explored the extent and patterns of formal bank financing to the MSME sector in Zambia and characterized the significance of factors that promote or inhibit commercial bank provision of credit to MSMEs based on a survey of commercial banks. The evidence shows that there is little support for the importance of relationship lending or bank organizational structure in terms of hierarchical structure in the provision of credit to MSMEs. Instead, banks that lend relatively, more that is above the median of the distribution of lending to MSMEs in June 2012, have been in existence for a relatively longer period than banks that lend relatively lower or below the median. They also find the MSME credit business to be relatively less competitive. Interestingly, all banks that deal with MSMEs have a positive forecast of the growth outlook of MSMEs in the next one to five years. Banks that don’t serve MSMEs do it purely on corporate strategy enacted by their parent banks mainly domiciled abroad. This group of banks has never conducted market research.

Overall, banks that deal with MSMEs significantly increased their lending to the MSME sector by over two-folds in the first-half of 2012. Banks tend to provide more products to MSMEs that are more inclined to improve transactions or cash flows of enterprises than finance that is required to help them grow and expand their production base. The lack of collateral and credible data remains a daunting constraint for banks to deal with MSMEs. The role of the credit reference bureau is yet to be fully appreciated for MSME lending while the role of the public credit scheme housed at the Development bank of Zambia seem to have a very insignificant role in facilitating greater access of formal bank credit by MSMEs. Although there are some notable challenges in the use of private insurance to manage risks, especially among the relatively new banks, insurance is largely used by banks to secure their loans to MSMEs.

The implication of these results is that there is still a large scope for interventions required from all stakeholders in order to realize better access to formal bank credit by MSMEs. While the demand of collateral and financial statements among banks has been a traditional approach that has hindered their lending to MSMEs, banks have over a period of time instituted mechanisms that help them to lend to MSMEs without developing any significant relations with them. For example, banks now lend to MSMEs by leveraging on their relations with large corporations that subcontract MSMEs without initially necessarily developing relationships with these MSMEs. This result does not imply that relationship lending is not important but it highlights the fact that banks can still lend to MSMEs without incurring costs associated to relationship lending.

A key limitation to the study is worth noting. This paper uses cross-section data to perform key analysis only on a subset of banks on a number of issues that have been previously examined in a cross-country setting. As such, it may not uncover issues that are influenced by time considerations or may have been hidden by banks that are not analyzed given that their non-inclusion was not randomly done. Studying banks at a time when they seem to be in a revolutionary mode with regards to MSME lending might lead to highly sensitive results overtime. Notwithstanding these limitations, we note that our main findings are reasonably consistent with much of the recent literature on bank financing to MSMEs.

6.2 Policy Recommendations

- Therefore banks universal demand of financial statements and perhaps collateral should not be viewed as a serious impediment. Instead, Government and other key stakeholders should ensure that statutes that govern credit in the nation are able to admit a range of arrangements and assets that can qualify to serve as collateral. It is worth mentioning that relationship lending does not mean the role of collateral and financial statements disappears. It only dwindles (see Boot 2000). This cause for creation or enhancing current efforts aimed at credit registry.
- There is need to ensure that banks should be able to lend tangible finance that can enable MSMEs to acquire technology that will expand their production rather than the current practice in which much lending goes to support enterprises to effectively execute transactions and not real productivity growth. Recapitalization of banks is one alternative. Banks viewed the announcement of the upward revision to minimum capital from USD 21 million and USD 100 million for foreign and domestic banks as a measure that might lead to increased lending volumes to their MSME clients. However the majority of banks also

expected that interest rates will inevitably rise. This demonstrates that deliberate strategies should be supported to ensure banks have access to facilities that can support long-term financing of commercial and industrial property and value-chains.

- Bank regulation should support long-term financing measures rather than prohibitively constrain banks especially with respect to measure aimed at preserving liquidity in the sector.
- Monetary policy and prudential regulations should be flexible and responsive to maintain a balance between liquidity and long-term lending. Here we urge Bank of Zambia to scrutinize more closely the portfolio mismatch in commercial banks so as to ensure a more enabling environment for long-term finance
- There is need to revise legal foreclosure procedures to ensure that banks are not impeded in their efforts to claim non-performing debts.
- In the wake of high firm mortality among small firms, there is need to create an accreditation system of monitoring firm status and graduation into various categories to ensure conformity between policy and practice.
- Ministry of Commerce Trade and Industry should increase its efforts of training and sensitizing MSMEs on the need to prepare and keep sound financial records.
- There is need to explore other means of lending that would not only unlock commercial bank credit to MSMES but would also strengthen business linkages between MSMEs and big business. An example would be enhancing the role of the credit reference bureau and also government must put in place mechanisms that would pilot wholesale banking via established business associations.

References

Banerjee, A. & Duflo, E. (2004), Do Firms Want to Borrow More? Testing Credit Constraints Using a Directed Lending Program. CEPR Discussion Papers 4681.

Beck, T., Demirguc-Kunt, A., Laeven, L. & Maksimovic, V. (2006), 'The Determinants of Financing Obstacles', *Journal of International Money and Finance* 25, 932–952.

Beck, T., Demirguc-Kunt, A. & Maksimovic, V. (2005), 'Financial and Legal Constraints to Firm Growth: Does Firm Size Matter?', *Journal of Finance* 60, 137–177.

Beck, T., Vasso, I. & Schafer, L. (2012), Foreigners vs. Natives: Bank Lending Technologies and Loan Pricing. EBC Discussion Paper, 2012-014.

Berger, A. & Black, L. (2011), 'Bank size, lending technologies, and small business finance', *Journal of Banking and Finance* 35, 724–735.

Berger, A., Miller, N., Petersen, M., Rajan, R. & Stein, J. (2005), 'Does function follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks', *Journal of Financial Economics* 76, 237–269.

Berger, A. & Udell, G. (2002), 'Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure', *Economic Journal* 112, F32–F53.

Bhattacharaya, S. & Thakor, V. (1993), 'Contemporary Banking Theory', *Journal of Financial Intermediation* 3, 2–50.

Boot, A. (2000), 'Relationship Banking: What Do We Know?', *Journal of Financial Intermediation* 9, 7– 25.

Carter, D. & McNulty, J. (2005), 'Deregulation, Technological Change, and the Business Lending Performance of Large and Small Banks', *Journal of Banking and Finance* 29, 1113–1130.

Carter, D., McNulty, J. & Verbrugge, A. (2004), 'Do Small Banks Have an Advantage in Lending? An Examination of Risk-adjusted Yields on Small Business Lending at Large and Small Banks', *Journal of Financial Services Research* 25, 233–252.

Cole, A. (1998), 'The Importance of Relationships to the availability of Credit', *Journal of Banking and Finance* 22, 959–977.

Cole, A., Goldberg, L. & White, L. (2004), 'Cookie Cutter versus Character: The Micro Structure of Small Business Lending by Large and Small Banks', *Journal of Financial and Quantitative Analysis* 39, 227–251.

CSO (2011), Zambia Living Conditions Monitoring Survey Zambia, Central Statistical Office.

CSO (2013), Zambia Labour Force Survey 2012: Preliminary Report, Central Statistical Office.

Cull, R., Davis, L., Lamoreaus, N. & Rosenthal, J. (2006), 'Historical Financing of Small and Medium Size Enterprises', *Journal of Banking & Finance* 30, 3017– 3042.

De la Torre, A., Martinez-Peria, M. & Schmukler, S. (2010), 'Bank Involvement with SMEs: Beyond Relationship Lending', *Journal of Banking and Finance* 34, 2280–2293.

Diamond, D. (1984), 'Financial Intermediation and Delegated Monitoring', *Review of Economic Studies* 51, 393–414.

Doblas-Madrid, A. & Minetti, R. (2013), 'Sharing information in the credit market: Contract-level evidence from U.S. firms', *Journal of Financial Economics* 109, 198–223.

Elsas, R. & Krahnen, J. (1998), 'Is Relationship lending special? Evidence from Credit-file data in Germany', *Journal of Banking and Finance* 22, 1283–316.

GRZ (2009), The Micro, Small and Medium Enterprise Development Policy, Ministry of Commerce, Trade and Industry.

IMF (2013), Regional Economic Outlook for Sub-Saharan African: Building Momentum in a Multi-Speed World, , International Monetary Fund.

Kedia-Shah, M. (2012), The Informal Sector in Zambia: Can it Disappear? Should it Disappear? International Growth Centre Working Paper 12/0425.

Liberti, J. (2003), Initiative, Incentives and Soft Information: How Does Delegation Impact the Role of Bank Relationship Managers? London Business School, IFA Working Paper No. 404.

Liberti, J. & Mian, A. (2009), 'Estimating the Effect of Hierarchies on Information Use', *Review of Financial Studies* 22, 4057–4090.

Mwenda, A. & Mutoti, N. (2011), ‘Financial Sector Reforms, Bank Performance and Economic Growth: Evidence from Zambia’, *African Development Review* 23, 60â€“74.
Napier, M. (2008), FinScope: supporting strategies for market-led financial inclusion.
Petersen, M. & Rajan, R. (1994), ‘The Benefits of Lending Relationships: Evidence from Small Business Data’, *Journal of Finance* 49, 1367–1400.
Qian, J., Strahan, P. & Yang, Z. (2010), The Impact of Organizational and Incentive Structures on Soft Information: Evidence from Bank Lending. Unpublished working paper.
Schiffer, M. & Weder, B. (2001), Firm Size and the Business Environment: Worldwide Survey results. International Finance Corporation Discussion Paper No. 43.
Stiglitz, J. & Weiss, A. (1981), ‘Credit Rationing in Markets with Imperfect Information’, *American Economic Review* 71, 393–410.
Trust, F. & Heights, A. (2010), FinScope Zambia Report: Top Line Findings Final Report,Government of the Republic of Zambia Financial Sector Development Plan (FSDP) Secretariat.

A. Definition of MSMEs

According to the MSME policy:

1) a *Micro Enterprise* is any business enterprise registered with the Registrar of Companies whose;
    a. Total investment excluding land and buildings does not exceed K80,000,000
    b. Has annual turnover that does not exceed K150, 000,000
    c. Employs up to 10 people.
2) A *Small Enterprise* is classified as any business enterprise formally registered whose
    a. Total investment, excluding land and buildings is between K80,000,000 and K200,000,000 in plant and machinery for the case of manufacturing and processing enterprises or up to K150,000,000 in the case of trading and service enterprises.
    b. Has annual turnover should range between K150,000,000 and K250,000,000
    c. employs between 11 and 50 people
3) A *Medium Enterprise* is defined as any business enterprise larger than a small enterprise whose
    a. Total investment, excluding land and buildings is lies between K200, 000,000 and K500,000,000) in plant and machinery in the case of manufacturing and processing enterprises or between K151,000,000 and K300,000,000 in the case of trading and services enterprises.
    b. Has annual turnover should be between K300,000,000 and K800,000,000
    c. Employs between 51 -100 people.