

The Credit Crunch

How the use of movable collateral and credit reporting can help finance inclusive economic growth in Nigeria.

CENTRAL BANK OF NIGERIA, IFC



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01 FOREWORD

Nigeria is an entrepreneurial economy with an estimated 37 million micro-, small-, and medium-sized companies in the country, and their contribution to economic growth and job creation is significant. There are also a large number of self-employed entrepreneurs who support themselves and their families by supplying goods and services to the economy. Many of these businesses have the potential to become bigger and more prosperous, but their growth is restricted for a variety of reasons. Access to finance has been singled out as a crucial prerequisite to the growth of these businesses.

This report identified collateral as the missing link between the small-scale business sector and the financial institutions that could provide the necessary capital for them to grow. Smaller firms often lack the assets/collateral required to access formal loans, such as land or fixed property, making them risky clients in the eyes of the financial sector.

This means formal lending is virtually inaccessible for these small businesses and entrepreneurs, who instead rely on informal, unregulated, and unpredictable credit in order to expand their operations.

Of the 840 MSMEs surveyed throughout Nigeria for this report, only 31 percent¹ had obtained a loan from a bank or microfinance institution. Instead, the most common sources of business financing for MSMEs are personal savings and reinvested profits/retained earnings. This strongly suggests that there is a steady demand for capital in the small-scale business sector, and this demand could be met if it were possible for such businesses to use a broader range of collateral to access finance.

To improve access to finance and promote inclusive economic growth, the Central Bank

of Nigeria (CBN), in partnership with the International Finance Corporation (IFC), a member of the World Bank Group and the largest global development institution focused on the private sector in emerging markets, has established the National Collateral Registry and is supporting the development of a modern credit reporting system in Nigeria.

This new financial infrastructure will allow for increased use of moveable and reputational collateral to make it possible for more MSMEs to access financing through the formal sector.

¹ This ratio is 11.4 percent according to the World Bank Enterprise Survey (2014) and 16 percent according to the 2014 EFINA survey, against a Sub-Saharan Africa average of 23.7 percent.

02 EXECUTIVE SUMMARY

This report is based on research commissioned by the Central Bank of Nigeria and IFC to understand the awareness, perceptions, and behavior of micro-, small-, and medium-sized enterprises with regard to access to finance and financial services. The objective was to gain an understanding of the current knowledge and use of credit, credit information, credit bureau services, and collateral in Nigeria.

The research was conducted in Lagos, Rivers, Anambra, Abuja, Kano, and Bauchi states and surveyed a total of 840 micro-, small-, and medium enterprise owners, 480 individual employees of MSMEs, and 180 representatives of financial institutions (deposit-money banks and microfinance institutions) who are directly involved with loan applications. It took place over a period of six weeks in August and September of 2015.

The survey methodology was a combination of qualitative and quantitative techniques. The quantitative survey was based on a structured questionnaire, while the qualitative study was conducted in focus groups and individual in-depth interviews using a set question guide. The areas investigated included:

- Basic financial knowledge and practice
- Use of credit and provision of credit
- Knowledge and use of credit information and credit bureaus
- Knowledge and use of collateral
- Perceptions of the concept of a collateral registry.

The study found that access to credit among small-scale businesses is low, with only 31 percent of the MSMEs surveyed for this report stating that they have accessed credit through the formal banking system. In fact, most MSMEs use alternative means to finance their business: among micro-entrepreneurs, 71 percent use personal savings, 14 percent source financing from friends and family, and only 11 and 10 percent have taken out loans from deposit-money banks and microfinance institutions, respectively. It is worth noting that among medium-sized businesses, the share of formal lending is much higher, at a total of 51 percent.

Three key factors make it challenging for MSMEs to access credit from banks: the lack of required collateral, high interest rates, and a lengthy documentation process. Among the financial institutions surveyed, inadequate collateral is the biggest challenge when granting loans to the small-scale business sector (82 percent). This is followed by a lack of proper information about the

applicant (information asymmetry) and inadequate documentation.

One of the key findings of the study is that very few loan applications made by MSMEs and their employees are actually rejected by financial institutions: according to the survey, the vast majority of loan applications by MSMEs are successful (87 percent). While this does not indicate that financial institutions are more lenient on collateral requirements, it may indicate that smaller businesses who perceive that they will not meet the lending criteria do not bother to apply for bank loans. Out of the employees of MSMEs surveyed who reported they wished to apply for a bank loan, but did not apply because they felt their application would be rejected, 69 percent reported this was because they felt they did not meet the collateral requirements. Furthermore, out of those respondents who applied for a bank loan but were rejected, 48 percent reported that, in their opinion, they were rejected because they did not possess tangible assets to use as collateral.

Although a large proportion of small businesses who do apply for a formal loan are approved, the collateral requirements, whether actual or perceived, are prohibitive to many MSMEs and their employees. The survey revealed that MSMEs and employees feel discouraged by what they perceive as a “one-size-fits-all” approach by financial institutions towards loan applications and, as a result, are more likely to borrow from informal sources like family and friends or use reinvested profits to expand their business.

The new collateral registry will address this pain point by making it possible for financial institutions to register security interests in movable assets such as machinery, equipment, livestock, accounts receivables, and inventory, among others. The collateral registry and the secured transactions in movable assets regime will provide the institutional and regulatory framework needed to facilitate greater lending to MSMEs in Nigeria, even without access to land or buildings. When briefed on the basics of the collateral registry, an overwhelming majority of MSMEs and employees of MSMEs across Nigeria stated that they believe a collateral registry is relevant in Nigeria (91 percent), as did virtually all representatives of financial institutions. A majority (69 percent) of all respondents also believed that a collateral registry can work in Nigeria.

The credit reporting system will also help to relieve this hindrance to credit by supporting reputational collateral. The data collected by credit bureaus makes it possible for small-scale business as well as low-income individuals who lack fixed collateral to borrow money against their satisfactory credit history. It also introduces greater transparency, information, and efficiency in the financial sector. Although the Central Bank of Nigeria Act of 2007 and the Guidelines for licensing, operations and regulation of credit bureaus were issued in 2009 (amended in 2014), there are currently three established credit bureaus operating in Nigeria. This survey shows that only a small fraction of MSMEs (15 percent) and employees of MSMEs (11 percent) are aware of the credit reporting system and its potential benefits to borrowers. However, 85 percent of MSMEs and 75 percent of employees of MSMEs surveyed believe

that the credit reporting infrastructure is relevant or very relevant to Nigeria, as do all respondents of financial institutions. A majority of MSME respondents (82 percent) believe that the credit reporting system can work in Nigeria, against 58 percent of representatives of financial institutions.

A large majority of MSMEs (79 percent) surveyed for this report believe that the business environment for MSMEs will improve in the next five years. This belief is founded on a combination of factors, including the economy becoming more diversified; increased access to finance; the entrepreneurial strength of the Nigerian MSME sector; and government policies in support of the small-business sector.

It is evident from the survey that there is a need to deepen access to finance in the small-scale business sector of the economy that is not readily met by financial institutions. The new collateral registry and credit reporting systems could provide the opportunity for many small scale businesses and entrepreneurs to grow their business through formal and more affordable financing. They could also provide a great opportunity for the financial sector, which could diversify its products and grow its lending portfolio to include more MSMEs. For this to happen, it is crucial that financial institutions, MSMEs, and their employees become fully aware of this new financial infrastructure, its benefits, and of how to use it.

This survey looked at the provision and use of credit of micro-, small- and medium-sized enterprises across Nigeria. Since the overall sample was relatively small compared to the size of the Nigerian population and economy, results should be taken only as indicative. The conclusions and judgments contained in this report should not be attributed to, and do not necessarily represent the views of, IFC, its partners, or the World Bank Group. IFC and the World Bank do not guarantee the accuracy of the data in this publication and accept no responsibility for any consequence of their use.

03 SURVEY FINDINGS

THE BUSINESS ENVIRONMENT FOR MSMEs

This section investigates and highlights the respondents' perception of the state of the business environment for MSMEs in the next five years. It also looks at what factors are considered likely to be critical to the business environment during this time. Overall, there is optimism about the economy in the next few years, although the qualitative interviews showed that there is considerable concern regarding the exchange rate and the effect of the depreciation of the Naira on the overall economy.

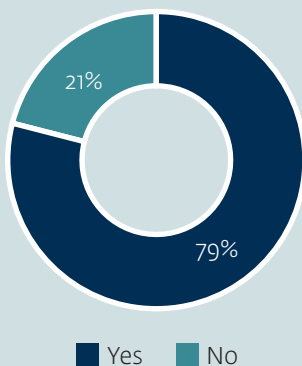
Among MSMEs, qualitative interviews with respondents showed a number of reasons for optimism, including a belief that the economy is diversifying, that financial

institutions will become more willing to lend to smaller-scale businesses, and that Nigerians are resilient business people. Financial institutions found their slightly

more cautious optimism on increased access to finance for small-scale businesses through microfinance as well as a high level of government support for MSMEs.

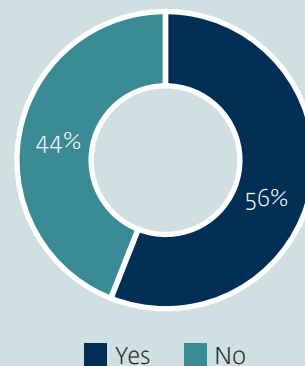
MSMEs' perspective on the business environment in the next five years

Will the business environment improve over the next 5 years?
(% of total MSMEs)



Financial Institutions' perspective on the business environment for MSMEs in the next five years

Will the business environment improve over the next 5 years?
(% of total financial institutions)



“...The financial system is fluctuating right now; it is not stable because of the dollar (exchange) rate. It is really affecting everybody...people are careful about giving out money, even the banks. They don't give loans like that again and it is affecting businesses...”

Medium Scale Business, Lagos

PROVISION AND USE OF CREDIT

This section looks at how businesses and individuals access finance for business expansion and personal projects. It examines the respondents' perspectives on access to credit, what credits are used for, and the provision of credit.

A substantial number of MSMEs (44 percent), consistent across location and business category, confirmed that they have sought financing in the form of loans at some point, from a variety of sources. Of the 44 percent that had sought external capital, 71 percent did so formally, approaching a deposit money bank or a microfinance bank for funding, and 29 percent accessed financing through exclusively informal loan sources. A smaller proportion of employees of MSMEs have applied for bank loans (15 percent).

Although, on the whole, relatively few of the MSMEs surveyed had taken out a loan from a deposit money bank or microfinance bank (31 percent), this number varies significantly according to the size of the enterprise. When considered separately, over half of medium-sized enterprises had used formal financing, with 47 percent having taken out a loan from a deposit money bank and 4 percent borrowing from a microfinance bank.

For small enterprises, the equivalent figure was slightly lower at 45 percent (22 percent from a deposit money bank and 25 percent from a microfinance bank), and this figure dropped sharply to 20 percent for micro-enterprises. The employees of

MSMEs surveyed were generally less likely (14 percent) to have used formal financing than MSMEs themselves, with only 9 percent of employees reporting having received a loan from a deposit money bank and 6 percent from a microfinance bank. They were, however, much more likely to use personal savings as a source of financing (81 percent, compared to 63 percent for MSMEs).

Even though it is quite common for MSMEs to take out loans, non-loan financing remains the most common way to finance a business. Overall, the survey found that the most common sources of business financing for MSMEs were personal savings (used by 63 percent of MSMEs surveyed) and reinvested profits (used by 29 percent of MSMEs surveyed). Additionally, a substantial number of MSMEs reported having borrowed money from friends and family (12 percent).

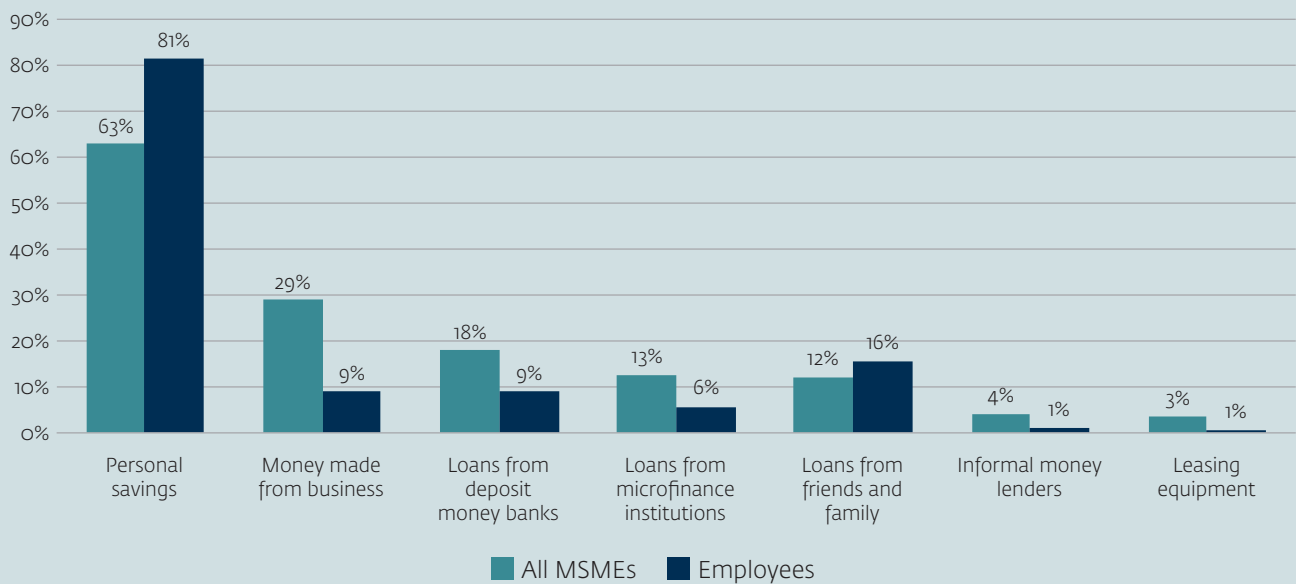
Relatively few MSMEs had successfully turned to deposit money banks and microfinance banks for loans (18 and 13 percent respectively). The main reasons given for not opting for formal lenders were that personal savings are easily accessed and loans from friends and family come with low or no interest. Indeed, a quarter of respondents said they paid no interest on loans received from friends and family,

and those who did pay interest on informal loans reported lower rates than those available at deposit money banks during the same period.

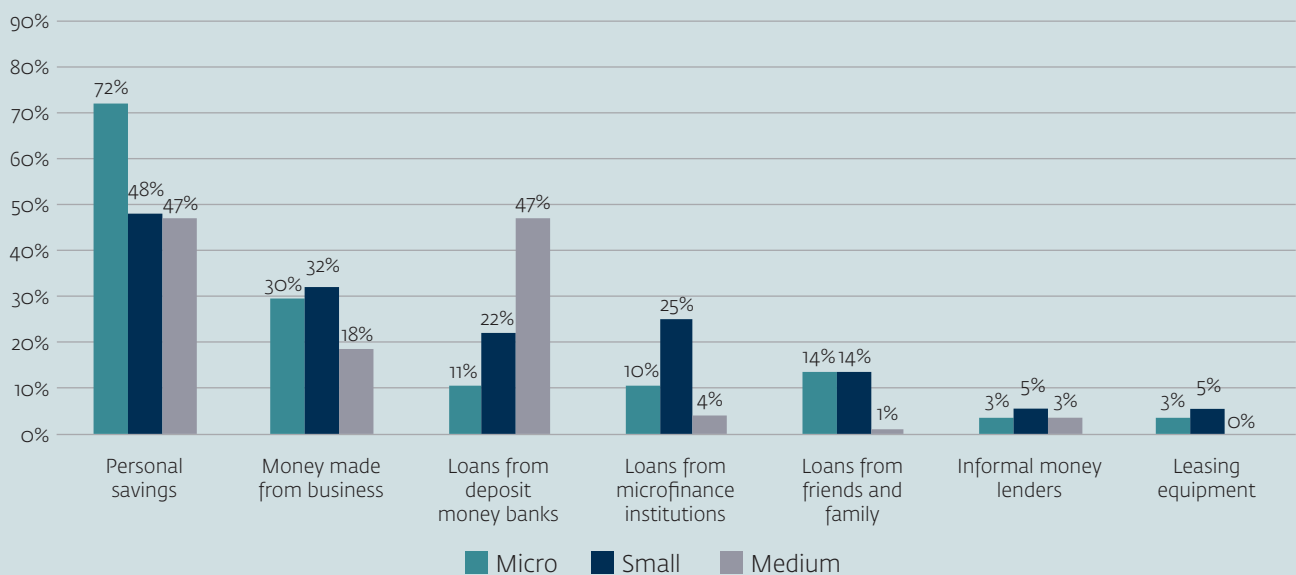
One striking phenomenon that emerged from this data was the success rate of loan applications. The vast majority of applications for formal loans are successful (87 percent). This is the case across enterprise sizes, with even micro-enterprises seeing 76 percent of submitted applications resulting in loans. The difference between different-sized enterprises comes in the number of applications made in the first place, with only 26 percent of micro-enterprises reporting having applied for formal loans, compared to 51 and 52 percent of small- and medium-sized enterprises, respectively. This does not, however, imply that small enterprises had less of a need to borrow. Indeed, micro-businesses are just as likely to borrow from informal sources such as family and friends (18 percent) as their medium-sized counterparts (17 percent).

One possible explanation for the high success rate of loan applications is that smaller businesses may have a good sense of whether they will meet the lending criteria of financial institutions, and only those who expect to be successful apply.

Share of MSMEs and their employees using different financing sources



Use of different financing sources by MSME size



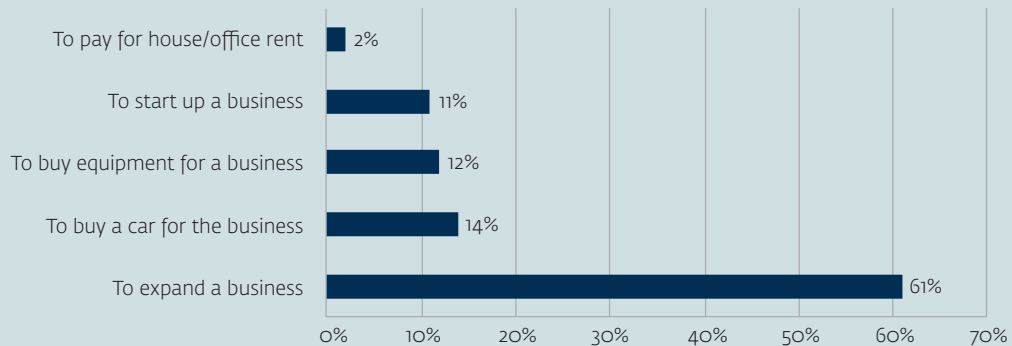
Even though respondents said that the demand for immovable assets as collateral, high interest rates, and stringent documentation requirements, make access to formal finance difficult, it should be noted that the qualitative interviews showed that a majority of respondents would have preferred loans from deposit money and

microfinance banks if possible, rather than from friends and relatives. This is because a larger amount of capital can be acquired through formal financial services.

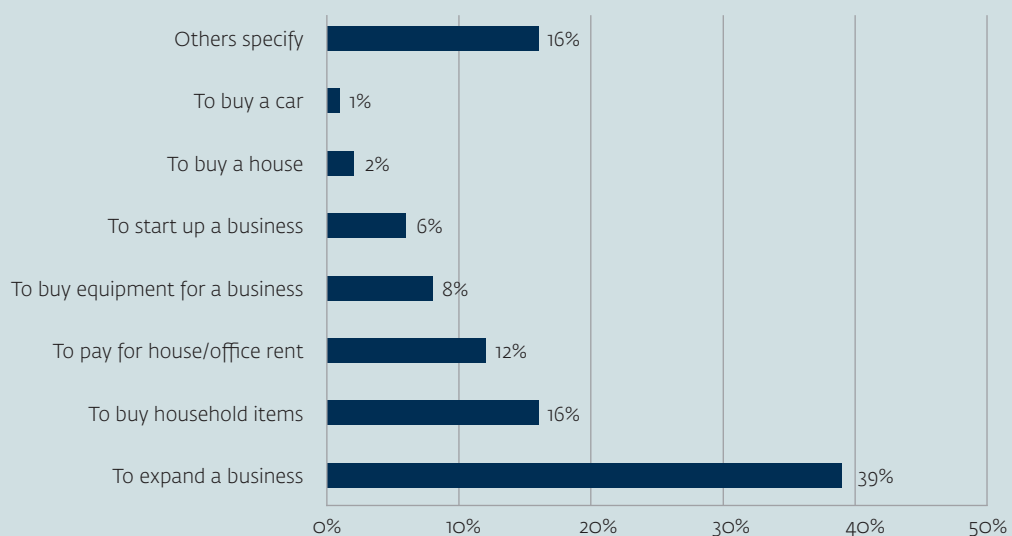
The survey shows that credit received by both MSMEs and individual employees is generally used for productive means. Most

loans taken out by MSMEs were used for business expansion or business-related expenditure. Similarly, most employees who had sought external financing used it for a business project.

What loans were used for - MSMEs (percentage responses)



What loans were used for by employees (percentage responses)



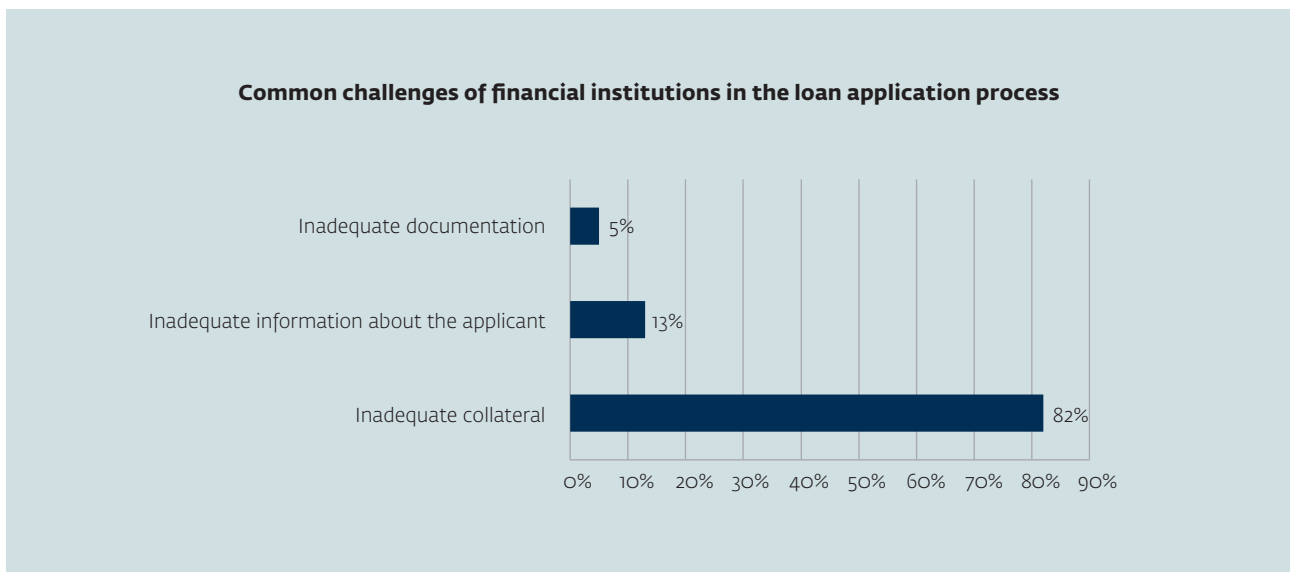
A majority of representatives of financial institutions (55 percent) agrees with respondents in the MSME and employee categories that the process of obtaining a bank loan is cumbersome due to substantial documentation process. However, respondents from financial institutions believe that there's a need for this process to act as a guarantee when most MSMEs lack collateral. Indeed, the most common

challenge in granting loans from the point of view of the financial institutions is inadequate collateral (82 percent).

The survey shows that financial institutions ask for fixed assets such as land or buildings as collateral in 98 percent of loan applications. To some degree, they also offer some flexibility, with deposit money banks sometimes accepting movable collateral

in addition to immovable property. Only 52 percent of MSMEs surveyed that had accessed formal loans stated that they had used a piece of land or a house as collateral for a loan.

76 percent of representatives of deposit money banks and microfinance banks surveyed reported that most borrowers do pay back their loans on time.



“It is very difficult to access loans from banks for small businesses. ...It is not difficult for the rich people but it is difficult for us common men to get loans....”

MSME, Rivers

“...I finance my business from assistance received from relatives..... The attraction here is that it comes with no interest rate...but it would have been better with the bank loan because I will get more money to do business....now I am forced to make do with what I can get from relatives. I tried a loan from a microfinance bank, it was not easy, a lot of requirements...”

MSME, Lagos

KNOWLEDGE AND USE OF COLLATERAL

Although collateral requirements are the biggest challenge when it comes to formal access to finance for MSMEs and entrepreneurs in Nigeria, the possibility of using different types of collateral – including moveable assets like vehicles or machinery – could make it much easier for the small-scale business sector to obtain loans from financial institutions.

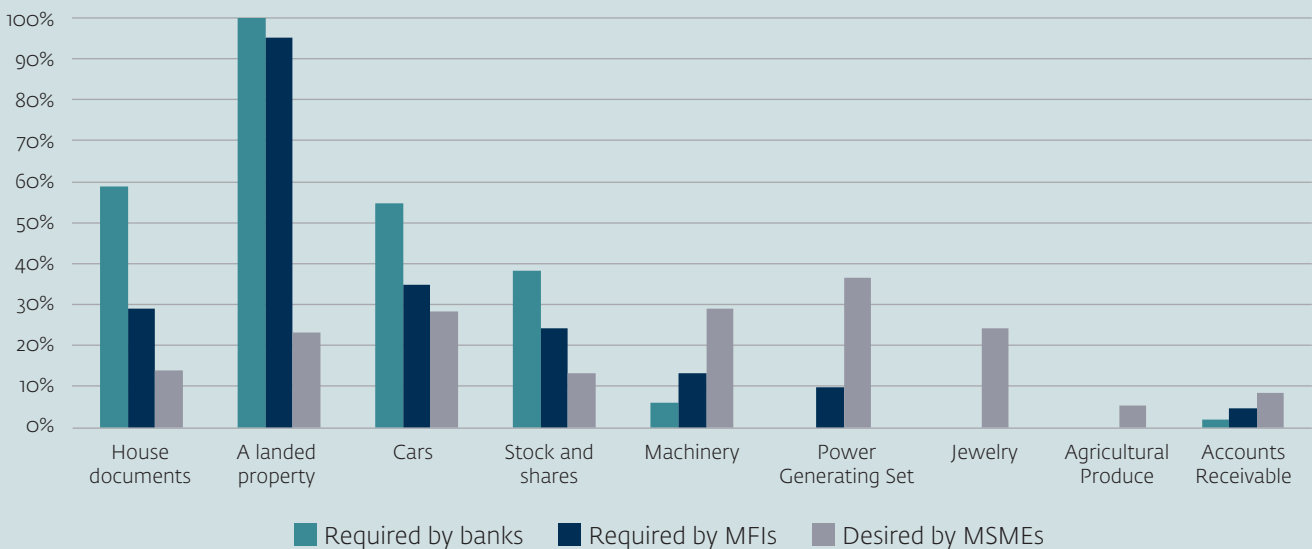
The survey looked at the types of collateral required by financial institutions and the type of collateral offered by MSMEs. It shows that financial institutions generally prefer land or other fixed assets as collateral, and those MSMEs that have successfully acquired loans have used land and fixed assets to

do so. The data also shows, however, that MSMEs would prefer to use movable assets, such as power generators, machinery, and cars to access finance.

The survey indicates that most MSMEs that have acquired loans use land and houses as

collateral (52 percent), followed by cars and stock or supplies. When asked what type of collateral they would prefer to use to take out a loan, however, MSMEs showed a strong preference for moveable assets, such as power generators, machinery, or cars.

Sources of collateral required that banks require compared to what MSMEs would prefer to provide



Respondents from financial institutions indicated that the reason fixed assets are their preferred form of collateral is that these assets are more easily valued and are easier to recover in the case of a non-performing loan. Movable assets, on the other hand, are considered riskier than fixed collateral and are more difficult to value and hence they are rarely accepted as part of bank policy.

The concept of a collateral registry is still relatively new to Nigeria, and survey respondents across all categories showed low levels of awareness of this concept: only 24 percent of MSMEs, 24 percent of employees, and 52 percent of financial institutions reported that they were aware of the concept of a collateral registry. In order to get their perspective about the relevance and feasibility of a collateral registry in Nigeria, MSMEs, their employees,

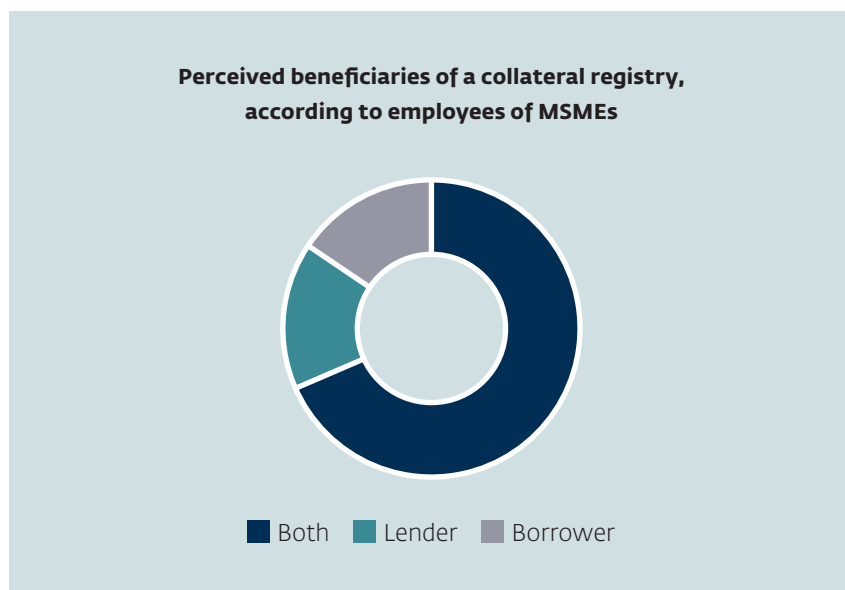
and financial institutions were first informed about the concept of a collateral registry, and then were asked two questions: whether they thought that a collateral registry was relevant to the Nigerian context, and whether they thought, practically speaking, that a collateral registry could work in Nigeria.

After being informed about the concept of a collateral registry, an overwhelming majority of MSMEs and employees believed that it was relevant to Nigeria (91 percent) and could work in Nigeria (69 percent). Interview responses indicated that there is some concern that corruption may affect the success of a collateral registry in Nigeria, and that some people would attempt to circumvent the system.

When asked the same question, 100 percent of respondents from financial institutions

found the collateral registry either relevant or very relevant to the Nigerian context (61 and 39 percent, respectively). As with the MSMEs, financial institutions were overwhelmingly positive about whether a collateral registry could work in Nigeria, with 69 percent agreeing that it could be successful. Financial institutions thought that success would depend on the degree to which a collateral registry makes loan application processes easier and faster, and enhances risk assessment. The general risks involved in dealing with movable assets as collateral and the current stage of development in Nigeria were the primary reasons that respondents from financial institutions doubted that a collateral registry will work in Nigeria.

Most employees of MSMEs believe that both lenders and borrowers will benefit from a collateral registry.



“...They give loans to people who have collateral, apart from that there is no way they can give you a loan, even when you are banking with them...”

Micro-Business, Kano

KNOWLEDGE AND USE OF CREDIT INFORMATION AND CREDIT BUREAU SERVICES

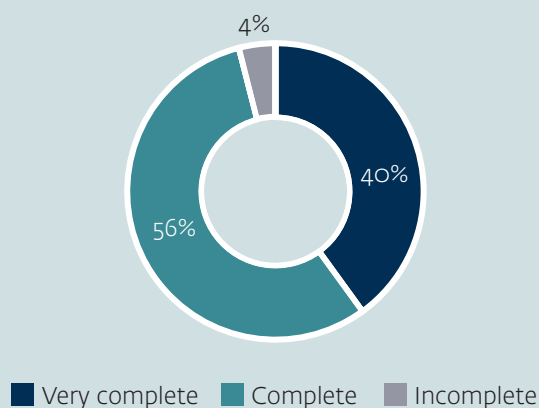
Even though credit bureaus have been established in Nigeria since 2009, there is still a relatively low level of awareness on the benefits of the services that the credit reporting system can offer to the financial sector and the economy. A vast majority of MSMEs (85 percent) and employees (89 percent) surveyed for this report stated that they are not aware of the credit reporting system. However, 100 percent of respondents from financial institutions were aware of the credit reporting system already in place.

Of the relatively few MSME and employee respondents that reported being aware of the credit reporting system, 41 percent and 56 percent had seen their credit reports, respectively. Of those who had seen their credit reports, 96 percent of MSMEs believed the report to be accurate. A large majority of respondents believe that credit reporting

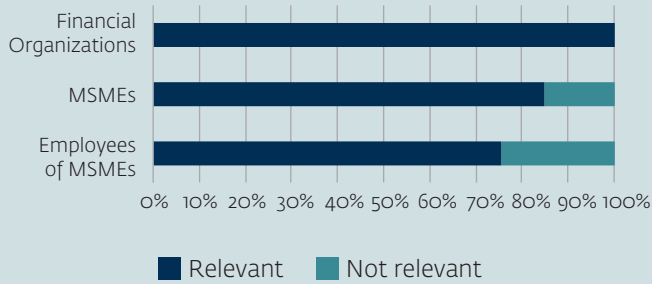
is either relevant or very relevant to Nigeria (100 percent of financial institutions, 85 percent of MSMEs, and 75 percent of their employees), and a large majority of MSMEs and employees surveyed also believe that the credit reporting system can work in Nigeria (82 percent of MSMEs and 79 percent of their employees). The number

is slightly lower among respondents from financial institutions, with 58 percent stating they believe the credit reporting system can work in Nigeria. The greatest perceived benefit reported by respondents across all categories is that detailed information on a borrower's past loan performance makes processing a loan application easier.

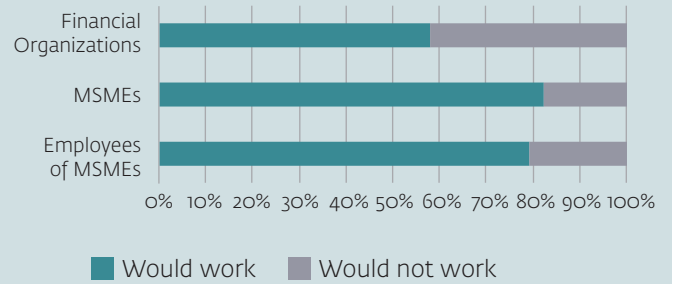
Share of MSMEs who considered their credit report to be complete



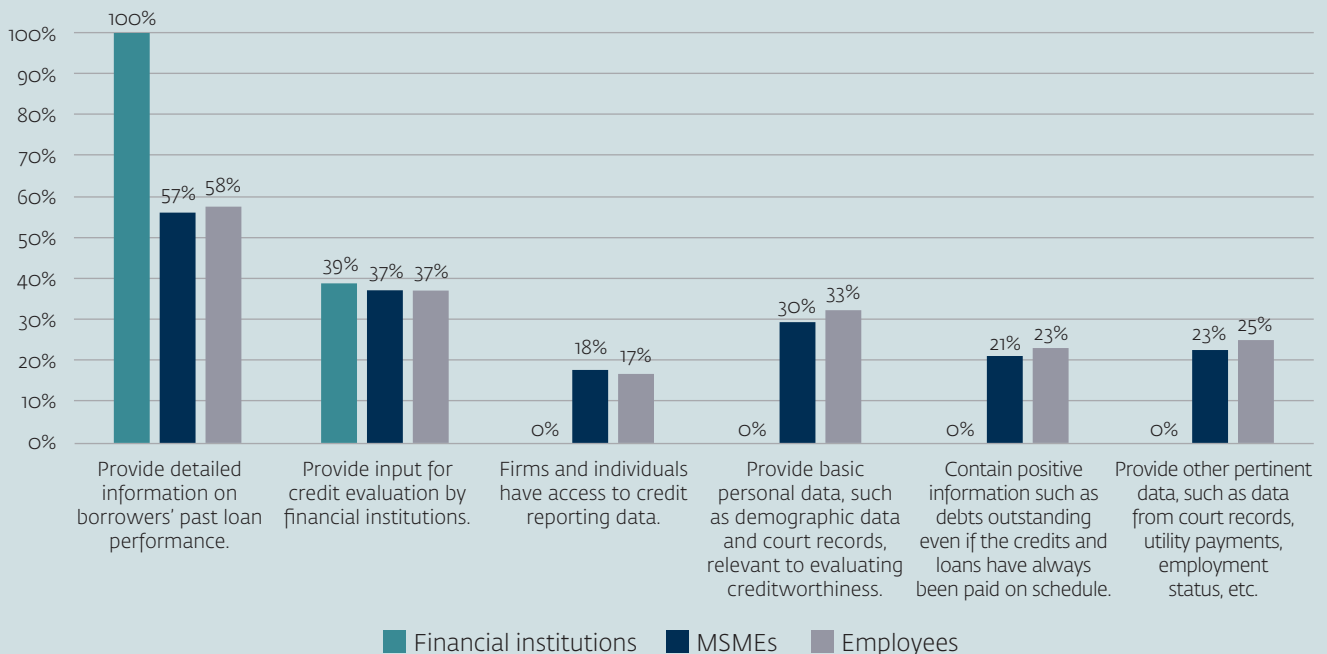
Relevance of credit reporting to Nigeria



Whether or not credit reporting could work in Nigeria



Perceived benefits of credit reporting systems



The qualitative survey, based on interviews with select respondents, revealed that the credit reporting system in Nigeria is

perceived as reliable and straightforward. The survey revealed a preference among these selected respondents for the credit

reporting system to be accessible to the public, but for it to be run by private credit bureaus rather than a public credit bureau.

“...Like us, we don’t do car, houses, land, what we do is integrity. In credit we have 6 Cs of credit and the basic one is character, if a person has character he will pay, and that is the main thing. So if you can get a guarantor that will give you post-dated cheques, that is the collateral for us and the second thing we do is, if you are asking for a loan that is more than ₦200,000, you deposit your car, not physical deposit but we will ask for the original particulars of the car, you will pledge the car that in case you cannot pay that we should take your car....”

Microfinance bank, Abuja

04 CONCLUSIONS

CONCLUSIONS

Nigerian MSMEs are optimistic about their future.

Although there is some concern among small businesses in Nigeria regarding the depreciation of the Naira and its effects on the country's overall economy, there is strong optimism that the business environment will improve over the next five years. This survey found that MSMEs also believe financial institutions will become more willing to lend to smaller-scale businesses.

Access to finance remains a challenge for the small-scale business sector in Nigeria.

Less than a third of MSMEs surveyed for this report had successfully obtained a loan from a financial institution. Instead, most of them used personal savings or reinvested profits as a source of business financing. The smaller the business, the less likely it was to have applied for, and

received, a loan from a deposit money bank or microfinance bank.

Collateral is key.

Respondents who had applied for a bank loan but were turned down gave the lack of fixed collateral as the main reason when asked why they believed their request was not approved. This perception – that having the right kind of collateral is the primary factor for an MSME or employee to obtain a bank loan – is reinforced by the financial sector responses: according to those representatives of financial institutions surveyed, the most common challenge in granting loans is inadequate collateral. In fact, financial institutions asked for fixed assets such as land or buildings as collateral in 98 percent of loan applications. It is unsurprising, then, that the overwhelming majority of those surveyed believe that a collateral registry

system and a credit reporting system are both relevant and useful in Nigeria, and would help increase access to finance for the small business sector by allowing for greater use of moveable and reputational collateral in bank loans.

There is little awareness on the current credit reporting system in Nigeria.

The lack of awareness among MSMEs and employees surrounding the current credit reporting framework in Nigeria may be hindering those who wish to apply for formal loans, but do not because they believe they do not meet the requirements. For instance, some may have sufficient good credit history to qualify for a bank loan despite not meeting the collateral requirements, but because they have not seen their credit report and are unaware of the potential benefits of the credit reporting system, do not expect to be successful and therefore do not apply for a loan.

05 SURVEY METHODOLOGY

This research report was carried out in order to determine the perceptions and behavior of the respondents regarding financial practices, including but not limited to:

- Personal and business finances
- Challenges surrounding lending and borrowing
- Business growth and management in the MSME sector
- Interaction with and understanding of the credit reporting system
- Understanding of the concept of a collateral registry

The respondents included entrepreneurs in charge of micro- (1-10 employees), small- (11-49 employees), and medium-sized (50-199 employees) businesses; employees of small- and medium-scale businesses; and

representatives (loan officers) of financial institutions (deposit money banks and microfinance institutions). A total of 840 MSMEs were surveyed, 480 employees, and 180 financial sector representatives

(1,500 participants in total). The study was conducted in urban as well as rural locations in six geo-political zones across Nigeria; Kano, Bauchi, Abuja, Lagos, Anambra, and Rivers.

| Location | FSPs | MSMEs | Employees | Total |
|----------|------|-------|-----------|-------|
| Kano | 30 | 140 | 80 | 250 |
| Bauchi | 30 | 140 | 80 | 250 |
| Abuja | 30 | 140 | 80 | 250 |
| Lagos | 30 | 140 | 80 | 250 |
| Anambra | 30 | 140 | 80 | 250 |
| Rivers | 30 | 140 | 80 | 250 |
| Total | 180 | 840 | 480 | 1,500 |

The survey methodology was a combination of qualitative and quantitative techniques. The quantitative survey was based on a structured questionnaire, while the qualitative study was conducted in focus groups and individual in-depth interviews using a set question guide. The areas investigated included:

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- Knowledge and use of collateral
- Perceptions of the concept of a collateral registry

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