

MSMEs Access for Finance in Zambia

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Abstract

Micro, Small and Medium Enterprises can act as the engine of national economic growth for Zambia's economy if they have access to market resources, including financing, and the right enabling environment.

This survey examines the level of MSMEs access to Bank Finance in order to determine the demand for and supply of financial services to the MSME sector, and the potential for broadening and deepening existing linkages between the banking community and MSMEs.

The survey finding shows that MSME operators understand little about the basic principles of commercial bank lending and borrowing practices. The survey also shows that commercial banks have limited experience with the MSME sector and lack the know-how to assess the associated credit risks, and are therefore unwilling to meet the sector's growing demand for financial services. Banking institutions are concerned many MSMEs do not understand how to work with financial institutions and need to improve their business and credit practices before banks can look at the sector as a viable and profitable business. As a result of these historical perspectives, both the supply of and demand for MSME financial services are not being adequately addressed in Zambia.

For these sectors to understand each other very well, the BDS providers must intervene in reducing the level of mistrust by providing training that will help the MSMEs to be attractive to banks and organize workshops and technical training for bank staffs to better understand the MSMEs. This way the prospect for access to finance for Zambian MSMEs may improve.

Key words: Micro, Small, and Medium Enterprises; Business Development Service, Access for Finance

1. Introduction

Micro, Small, Medium Enterprises (MSMEs) play a major role in economic development in every country, developed or developing. Studies indicate that in both advanced economies and developing countries MSMEs contribute on average 60 percent of total formal employment in the manufacturing sector (Ayyagari et al, 2007). For African economies, the contribution of the MSME sector to job opportunities is even more important. Taking into account the contribution of the informal sector, MSMEs account for about three-quarters of total employment in manufacturing (Ayyagari et al, 2007).

A crucial element in the development of the MSME sector is access to finance, particularly to bank financing, given the relative importance of the banking sector in serving this segment. According to World Bank, lack of access to finance is a major obstacle in doing business. A number of studies have shown that financing is a greater obstacle for MSMEs than it is for large firms, particularly in the developing world, and that access to finance adversely affects the growth of the MSME sector more than that of large companies (Ayyagari et al, 2007).

1.1 Objectives

MSME information is required to have objective, direct, specific, detailed information on which to base decisions regarding both MSME demand for financial services and how best to support financial service providers in Zambia in supplying those needs with appropriate and affordable services. The research has three major objectives:

- Assess the real demand for financial services in selected cities (Kabwe & Lusaka) in Zambia by MSMEs;
- Determine the training and technical assistance needs necessary to reorient commercial lending toward MSMEs in these cities;
- Provide recommendations to Financial Institutions and other service providers for MSME training to increasing the sector's attractiveness to potential commercial bank lenders in Zambia.

1.2. Research Design and Approach

To better understand the demand side, individual, in-person interviews were held with MSME staff or owner utilizing a structured questionnaire. The questionnaires were designed to determine sector type, business development services needed, and overall perceptions of currently available financial service providers. The research included questions intended to determine what current impediments exist to commercial lending to the MSME sector. The research also questioned MSME operators on standard financial management issues as a way to identify gaps in their current performance that could be addressed through training and technical assistance. The research was designed to profile, analyze, and document the diversity and structure within the selected

MSME sectors. The research is also intended to provide a breakdown of financial service products demanded by sector and institution type, and current financial services utilized by the sector. The research data managers drew two samples for the survey, an MSME sample comprising of 200 MSMEs of which 187 were interviewed from both Lusaka & Kabwe and a financial institutions sample targeted at all registered commercial banks in Zambia, both of which were divided into the sector and financial service provider categories.

On the supply side, questioners about the supply of MSME services by the 18 commercial banks. The Bank of Zambia (BOZ) report and other secondary sources are also considered for the analysis of the supply side of the financial services to MSMEs. The questioners aimed at addressing the following issues:

- Strengths and weaknesses of commercial financial institutions (with a focus on commercial banks);
- Challenges these institutions face in lending to the MSME sector;
- Types of interventions necessary to remove structural impediments to the flow of resources from these institutions to the MSME sector.

2. Literature Review

2.1 The Economic Importance of MSMEs

It is often argued that governments should promote MSMEs because of their greater economic benefits compared to large firms-in terms of job creation, efficiency, and growth. In most developing countries, microenterprises and small-scale enterprises account for the majority of firms and a large share of employment. In Ecuador, for example, firms with fewer than 50 employees accounted for 99 percent of firms and 55 percent of employment in 1980; in Bangladesh, enterprises with fewer than 100 workers accounted for 99 percent of enterprises and 58 percent of employment in 1986. (IFC Discussion Paper No40, 2000)

The relative importance of small producers varies significantly across countries and, within a given country, across stages of development over time. Comparative studies of manufacturing show a common pattern in the transformation of the size distribution of firms as industrialization proceeds. In low-income countries, the vast majority of firms are micro- or small-scale, existing alongside a few large-scale enterprises. In middle-income countries, medium-scale enterprises begin to account for a relatively larger share of production and employment. In most countries, the trend toward larger firm size continues as per-capita income increases. The exceptions to this rule are found mainly in Asia. In Taiwan, China for example, the size distribution of firms has remained relatively constant over the past thirty years, even as the structure of production changed from labour-intensive manufacturing to high-tech computer industries. On average, however, some economists' believed that small-scale enterprises play a declining role as countries develop despite the recent shift in emphasis from large multinational firms to MSMEs as witnessed in USA and Europe mainly due to the financial crises and economic downturns. (IFC Discussion Paper No40, 2000)

2.2 Business Environment

The performance of all firms-small as well as large-is affected by the business environment in which they operate. A stable macroeconomic, an open trade and investment regime, and a competitive financial sector establish the fundamental conditions for a vibrant private sector. A well-developed physical infrastructure-transportation, warehousing and port facility, communications networks-expands markets and facilitates transactions throughout the productive sector. Social infrastructure investments in education and health care build the capabilities of the productive sector workforce. Nevertheless, there are certain aspects of the business environment that are of particular relevance to MSME competitiveness: those that affect market access, the cost of acquiring information, transactional efficiency and risk, and the fixed costs of doing business.

In most countries, these MSME-specific aspects of the business environment would include; expensive and time-consuming regulatory requirements such as licensing and registration; official and unofficial levies that discourage small enterprises from growing and becoming formal; the legal framework for commercial transactions and the resolution of disputes, that can affect transactions with unknown firms;laws governing the protection of business and intellectual property, and the use of property as collateral; tax structures that distort incentives and discriminate against small firms;Government procurement procedures that discourage successful bidding by MSMEs; and labour market rigidities that make hiring and firing workers difficult and expensive, and limit the flexibility and mobility of the labour force.

2.3 Financial Services

MSMEs often complain that their growth and competitiveness are constrained by a lack of access to financing and the high cost of credit. Recent events in Latin America and East Asia lend credibility to the argument that MSMEs are more likely than larger firms to be denied new loans during a financial crisis. In most developing countries, because competition in the banking sector is limited, banks have not been under pressure to develop their lending to smaller clients. In addition, MSME access to the formal financial sector is constrained by the high risks and transactions costs-real or perceived-associated with commercial lending to that segment of the market. Lenders are faced with a lack of reliable information on borrowers, difficulties in enforcing contracts (the result of inadequate legal frameworks and inefficient court systems), and the lack of appropriate instruments

for managing risk. Often, the problem is compounded by supervisory and capital adequacy requirements that penalize banks for lending to enterprises that lack traditional collateral (security). (Ravi, S. (2009)

3. Survey Findings

This section presents the survey finding categorized in to: Form of Business and Financing currently utilized by MSMEs in Zambia ;MSME demand for commercial bank services and level of service utilizations in Zambia;Current level of MSME satisfaction with commercial bank services in Zambia; and constraints commercial banks face in expanding lending to MSMEs in Zambia.

3.1 Form of Business and Financing Currently Utilized by MSMEs

3.1.1 Form of Business and Size by employment

According to the survey conducted in the two cities combined; about 80% of the respondents fall in the category of Micro Enterprises and about more than half of those firms are registered as a sole proprietorship. This size of the firm is an important factor considered by the banks or formal financial institutions in granting loans. This implies that Micro enterprises may fail to provide enough collateral security to satisfy the loan conditions of financial institutions. The size of the firm also directly reflects the firm’s capacity of generating revenues as it depends on the size of the asset. For the purpose of this study; it is only the number of employees which considered as a basis of classifying the respondents as Micro, Small, or Medium. The other challenge is the form of business: in this case the sole proprietorship is dominant form of business; which is characterized by unlimited liability or risk. This characteristic is the mainimpeding factor for financial institutions in providing loans or finances to these forms of business.

Figure 1 below shows the different categories and form of business.

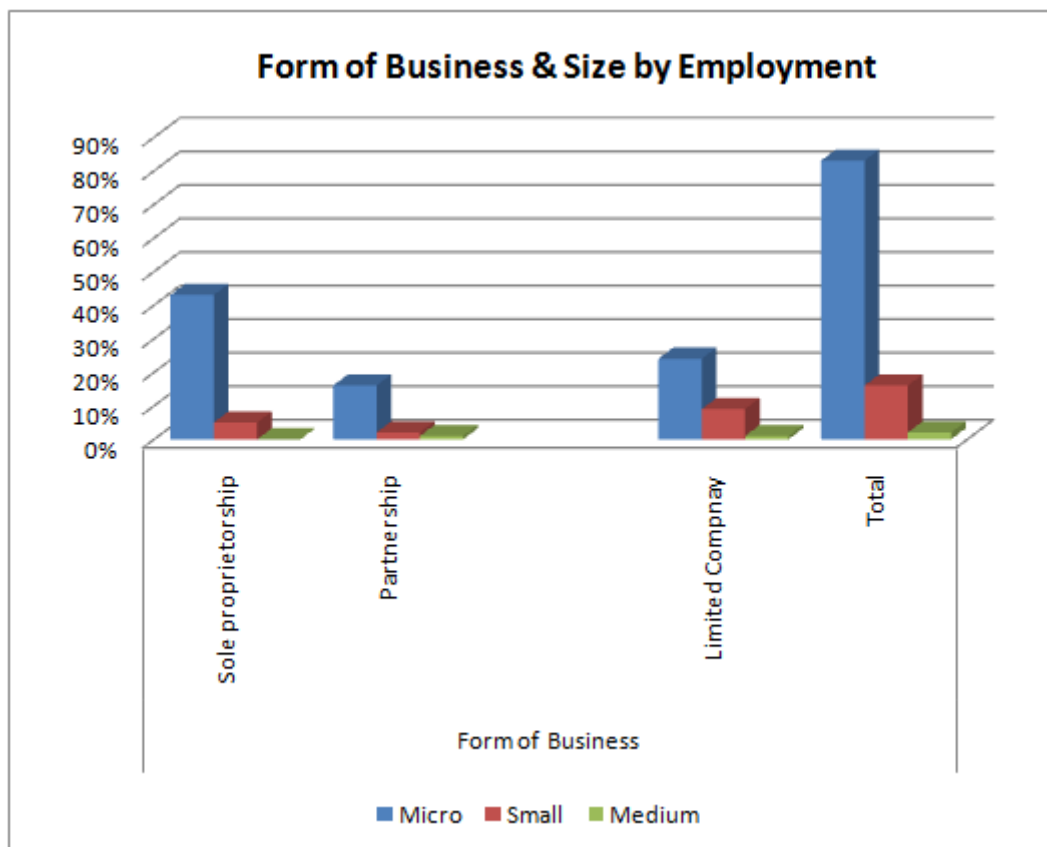


Fig.1. Form of Business & Size by Employment

3.1.2 Financing Currently Utilized by MSMEs

There was a wide range of responses regarding the current institutions through which Zambian MSMEs access funds to operate their businesses, and the types of instruments they use. The following list is in ascending order from the most informal to most formal sources. Respondents’ satisfaction with each product or methodology is indicated when available. Overall, MSMEs responded that they utilize formal institutions more frequently than informal institutions as a source for debt financing and for keeping business accounts, while utilizing personal savings and cash from family and friends more for working capital. The utilization of formal of finance stood at 84% as shown by figure 2 below.

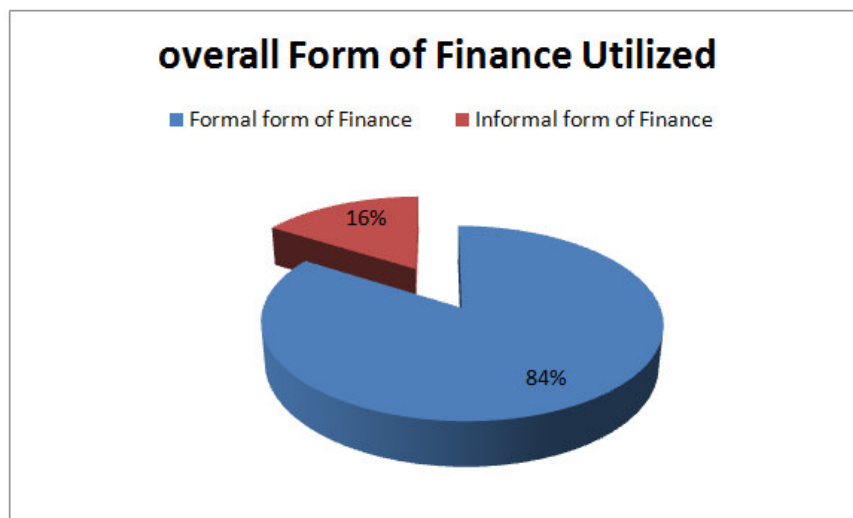


Fig.2. Form of Finance Utilized by MSMEs

Personal savings

The majority of entrepreneurs interviewed indicated that personal savings are a primary source of working capital. About 42% of the respondents replied that new investment is generally financed from retained earnings and from funds provided by family and friends. This is mainly attributed to the fact that the form and size of the business poses a limitation in accessing debt financing.

Informal sources

16% of the respondents said that they acquire working capital and funds for new investment either from friends and family, or through informal lending schemes. Other semi-formal institutions, such as the Communal Church Loan fund also provide loans to MSMEs.

Microfinance Institutions (MFIs) and Cooperatives

Savings and loan associations are recognized as the main sources of finance for Micro and Small enterprises. However, this is not the case due to the fact that the interest rates charged by Zambian microfinance are extremely high for these Micro and Small enterprises, despite the recent introduction of an interest rate cap of 40% by (Bank of Zambia) BOZ. Similarly the cooperatives provide very little support to their members in meeting their financing needs. Only less than 10% percent of respondents stated that they keep general business accounts with Savings and Loan institutions, a much lower percentage than those who maintain accounts with commercial banks. And approximately 6% of respondents indicated that they have accessed loans from microfinance institutions. The low percentage shows the extent to which microfinance is unattractive to MSMEs in Zambia. See the appendix for the interest rate charges by MFIs.

Government sources

Government owned Development Finance Institutions (DFIs) such as Citizen Economic Empowerment Commission (CEEC) currently provide about 4% of MSME's debt finance. The low rate of access to funding from this institution is attributed to factors such as length of time it takes to process the application due to large number of applicants, limited funding received from the government and positional rent (Bonger et al.2012) involved by authorities.

Commercial bank financing

Nearly 56 percent of MSME respondents stated that commercial banks are the primary source of their debt finance. Nearly 85% of enterprises maintain business accounts with commercial banks, and over half of these expressed satisfaction with their bank services. While the majority of respondents indicated that personal savings and retained earnings comprised the bulk of new finance and working capital, Figure 3 below shows the type of financing accessed from commercial banks. Finally, approximately 30% of those interviewed who maintain accounts with commercial banks stated they have overdraft features associated with these accounts which bear the highest interest.

Approximately 15% of respondents currently utilizing commercial bank facilities with marginally reduced interest rates are required to pledge collateral in the form of land, building, fixed assets or homes. Otherwise there are general arguments from the public that cost of financing for Zambian business is very high which stands now between 20% for banks and 42% for MFIs. The very low utilization commercial bank financing is attributed to:

- Interest rates and collateral requirements are considered to be excessively high;
- Banks do not have the interest, or ability, to meet MSMEs' long-term financing needs;

- The commercial banking sector lacks sufficient understanding of the sector in which MSMEs operate and, correspondingly, lacks the internal expertise to interact with this sector – a constraint repeated by many commercial banks.
- very few Zambian commercial banks have an MSME department to deal with the needs of MSMEs

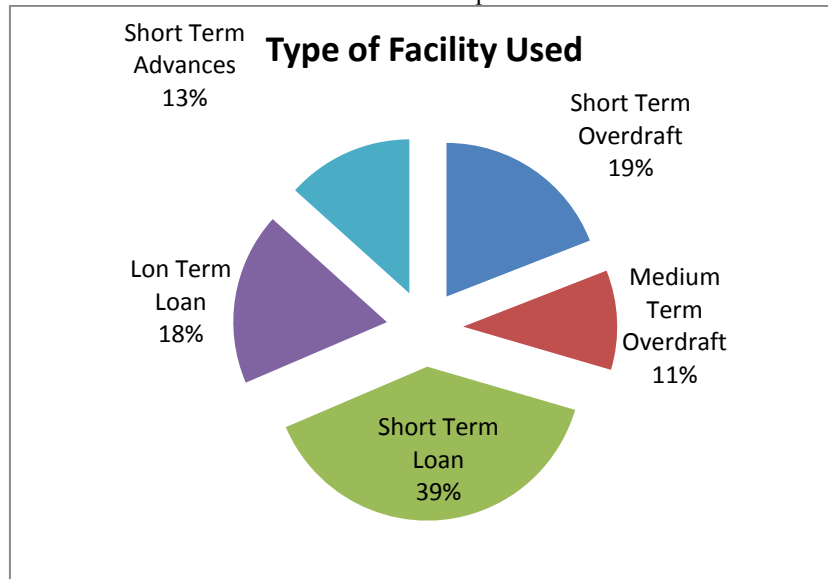


Fig.3. Type of Facility Used from Commercial Banks

3.2 MSME Demand for Commercial Bank Financial Services

In order to expand their utilization of commercial bank services, MSME survey respondents expressed a preference for the following financial products and services, in order of preference: overdraft and credit facilities, lease financing, , and business development services.

3.2.1 Overdraft facilities and Short and Long term Loans

Respondents were divided in expressing the need for loan products that are available with commercial banks. The different stakeholders do perceive that there is a unmet demand for MSMEs financial services. **However, on average about 58% of the respondents expressed that they do not need any** of the different loan facility provided by financial institution. It would be very difficult to generalize, as the size, legal form of businesses of respondents and type of business are Micro, sole proprietorship and Trading and Service respectively. The other reason for disinterest by the respondent's is that due to the high rate of interest charged by financial institutions. Figure 3 above and the following figure 4 shows the demand for various loan products. Among the 42% of the respondents who indicated the need for these financial services, considered Short and long term Loan facilities as most needed. The reason why the MSMEs responded for no need for commercial bank services is due to the size and the form of the business operated, which in turn is not attractive to commercial banks.

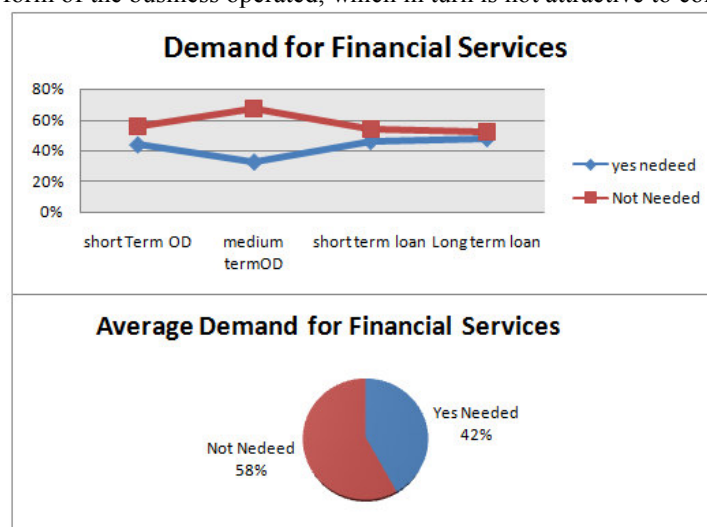


Fig.4. Demand for Financial Services

3.2.2 Leasing

Nearly 47 percent of MSMEs interviewed expressed interest in using leasing arrangements. Of the total number of respondents currently using lease financing, approximately 42 percent were satisfied with this type of product and would like to see more of this type of service offered through the commercial financial institutions. The low percentage for the interests in leasing service is that, most of the respondents were not aware that the services as well as its requirements are similar to that of commercial bank loan requirements. Micro and small enterprises are naturally excluded by leasing service providers because of their legal form and ownership structure and which have dominated the respondent profile for this survey.

3.2.3 Business development services (BDS)

Nearly 87 percent of MSME respondents indicated that they currently keep proper financial records through an outsourced accounting function, and 45 percent of the respondent had their financials reviewed by External Auditors and that they consider these outsourcing costs, a high component of their overall operating expenses. They also stated that Financial Institutions in collaboration with other BDS providers should help MSMEs in areas of business development, such as basic training in debt finance accounting and the provision of regular information, on how MSMEs can compete effectively in both local and international markets. Currently about 88 percent of the MSMEs maintain a business account with one or more bank.

3.3 Current Level of MSME Satisfaction with Commercial Banks

Despite the criticism expressed by MSME operators and Government about commercial banks, 61 percent of respondents were satisfied with their bank. However it is difficult conclusively determine the level of satisfaction and corresponding services received, and type of business in which the MSME is engaged. However, the same MSME operators expressed concern that requests for loans is not easily entertained.

3.4 Commercial Bank Constraints in Supplying MSME Financing

The majority of commercial banks operated in Zambia are foreign banks. The following are some of the constraints attributed to limited supply of commercial bank services to MSMEs as obtained from secondary sources include, lack of confidence in management; inadequate security; MSME unfamiliarity with good borrower practices; high costs; and, Insufficient bank knowledge of the sector.

3.4.1 Lack of confidence in MSME management

The general problem banks face in dealing with business that are in Micro and Small category is that, they do not have a properly defined organization structure for the running of the business. In such cases decisions are made abruptly and pose greater operational risk. Over 99 percent of MSME operators interviewed are Micro and Small enterprises thus possibly validating the commercial banks' concern regarding proper management of the business and financial management in particular.

3.4.2 Inadequate Collateral or Security

All commercial bank and some MFIs require collateral or security on loans, which a major challenge when lending to this sector. Of those MSMEs interviewed, all indicated that collateral was required on overdraft provisions of accounts they held with commercial banks.

The form and size of MSMEs interviewed imply that it is difficult for them to supply collateral which satisfies the requirement of the Commercial Banks.

It is generally accepted that enforcement of existing collateral mechanisms is time consuming and difficult, thus making the introduction of alternative, non-traditional collateral and security arrangements more uncertain.

3.4.3 High cost of lending Most commercial banks in Zambia consider the cost of lending to the MSME sector to be considerably higher than lending to other sectors. High costs are attributed to the relatively greater amount of time necessary to monitor MSME loan compliance. Commercial banks do also factor in a premium for risk when determining the interest rate. The risk premium usually is different from business to business and sector to sector. As discussed earlier sections the Micro and Small enterprises will have a higher risk premium due to the fact that most are sole proprietorship, which imply high risk.

3.4.4 Commercial banks lack of knowledge of MSME sector

Very few Commercial banks in Zambia have specifically established a department that will address the needs of MSMEs. Currently some commercial banks are trying to provide loans to the MSMEs with sector Specifics- such as Manufacturing or Agri- Business. The banks which are at the fore front include INDO- ZAMBIA, ZANACO, FNB, and INVEST- TRUST Bank. However the profile of the respondents shows that they are into trading and service business, which for now is not part of the target group by the banks. Due to this and other factors Commercial banks lack of knowledge and understanding of the MSME markets and those activities in which they engage.

4. Conclusion

The primary objective of the survey was to assess the MSME demand for financial services in order to guide the expansion and growth of MSMEs in Zambia. A major assumption was that commercial banks lack sufficient understanding of MSMEs due to the nature, size, form and type of business, from which to build the capacity to

service this sector. It is also assumed that the MSMEs operators are not attractive to commercial bank finance services. While the results of the survey do support this assumption, they point to other underlying factors that impact the supply of commercial financial services to the MSME sector. These include the need to view capital constraints within, including the cultivation of a credit culture within the MSME sector itself and the development and consistent application, of lending practices within the banking sector aimed at developing the MSME sector.

In addition to these, the relationship between Banks, MSME operators and BDS providers is very important to facilitate understanding of one another. This is in spite of very low levels of mistrust between the banking and MSME operators, generally based on a lack of information and experience. Existing connections between banks and MSMEs provide a starting point that can be further supported through carefully designed interventions and with follow-up technical assistance.

The most consistent views from interviews with MSME operators in Zambia and that of Government is that lack of affordable loan capital, which is a major impediment to the growth and expansion of their businesses. The high rate of interest and bureaucratic bank lending procedures have led majority of MSMEs to stay away from commercial banks. Generally, MSME operators believe additional capital alone will solve the majority, if not all, of the problems they are facing. This perception applies to starting up and continuing their enterprises in a competitive marketplace. At present, banks are generally not meeting this demand. If MSMEs were to develop business planning documents, business plans, budgets and cash flow projections that lay out their long-term financing needs using standard financial projections and industry-accepted ratios and financial documentation, commercial banks would be in a better position to evaluate the viability of the enterprise and the use of bank debt within the enterprise's overall operations. The Zambian MSMEs sector will have a positive prospect in accessing bank financing if the missing link- Business Development Service (BDS) is strengthened specifically by providing training and advisory services to MSMEs so that banks will consider the sector for possible financing.

5. Policy Implications and Recommendations

Continue to Develop MSME Demand for Financial Services This survey is a start in the continuing process of expanding broad access to financial services for the MSME sector. Both MSME operators and those intending to provide technical assistance and training to this sector, need to be proactive in maintaining current information about demand for commercial financial products and working to bring this information both to the commercial banks and MSME operators, undertaking frequent demand assessment and profiling of the MSMEs and BDS providers can assist both the MSMEs and Banks to effectively communicate.

Reorient Commercial Banks to MSME Financial Services In addition to working on the demand side of the equation, technical assistance providers can work closely with commercial banks to reorient current lending toward the MSME sector. It is evident that Commercial banks lack a broader understanding of the MSME market. Workshops, technical training, study tours and other information sharing initiatives will be helpful in closing this knowledge gap. In addition commercial banks can integrate with micro finance intuitions, insurance companies and non-bank financial institutions in meeting the needs of the MSME sector. Commercial banks will need to reorient their investment priorities to provide funding for loans to the MSME sector.

The BOZ needs to work on issues related to bank capitalization, risk based supervision of banks and loan portfolios and the requirement for 100 percent traditional collateral, all of which impact on investment decisions the banks make. Technical assistance may be appropriate both on the policy and regulatory side and for banks, in assessing the portfolio risks and potential return from expanding into the MSME sector. In addition to banks' deposit base which is available for lending, banks must have access to funds from funding agencies and government aimed at boosting the access for finance for MSME sector

Some commercial banks are working on direct lending structures. For example, FNB, Invest Trust, Indo Zambia, and ZANNACO are in the process of strengthening the financing of MSME projects, even though it is currently sector specific

Commercial Banks Provide Training to MSMEs: Banks in collaboration with BDS providers to provide targeted technical assistance to prospective and current MSME borrowers. The potential benefits are twofold: MSMEs would acquire necessary business management skills; and banks would acquire a deeper understanding of the MSME sector. ***Business development services to improve MSME competitiveness*** if MSMEs could access regular information on how to market their products both locally and internationally and be given regular ***Basic business management training***, it will improve the prospect of their growth.

Banks have both the opportunity and incentive to support BDS training to MSME operators on basic lending and borrowing principles, in conjunction with a professional organization, such as the Bankers' Association. ZDA, DBZ and other BDS providers

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