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SME's Finance as a Panacea for the Eradication of Corruption in the Banking Industry

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Abstract

Over the years sundry interpretations has been given to corruption. It is the misuse of position to obtain personal and narrow interests over and above collective interest. Besides corruption, the inability of the SMEs to provide needed collateral, institutional bottlenecks, delay in processing and disbursement of loan have made the SMEs to prefer informal sources of finance over and above the formal sources. In this connection, the paper examines the credit system available to SMEs in Nigeria using the ordinary least square regression equation and it was observed that the formal banking sector precludes the SMEs in disbursing its loan. In this wise, the paper observes that at least eighty percent of informal agents in Ghana and Nigeria reported no delinquent borrowers and all expected virtually one hundred percent repayment within three months of the date-due. The paper therefore recommends the need for the government through the Central Bank of Nigeria to generate regulatory reforms that could cause institutional development and physical investment among the formal and informal financial institution in the country. The consolidated funds need be injected into the small-scale industries through direct partnership with the informal finance agents.

of reducing transactions and search costs. Second, Banks assist in creating liquidity in the economy by borrowing short-term from investors and lending long-term to the entrepreneurs. Third, they reduce information costs, provide risk management services and reduce risks involved in financial transactions. Fourth, the intermediaries bring the benefits of assets diversification to the economy. Fifth, mobilized savings from individuals for investment, thereby solving the problem of indivisibility in the financial transactions. Finally, mobilized savings are invested in the most productive ventures irrespective of the source of savings (Gibson and Isakalatos 1994).

No economy in the world has grown without contribution from its Small and Medium Enterprise (SMEs). It serves as the engine room used to energize the economy for better performance. For instance, presently, seventy percent of exports from Japan can be traced to the efforts of the SMEs in that country. Also, the SMEs with fewer than 300 employees account for 99.5 % of the factories in Tokyo and employs 74 percent of the work force there. This situation is similar to what obtains in other Asian countries and have propelled them into world leaders in poverty reduction, wealth and employment generation and industrial output.

Over the years, the ratio of Commercial Banks loans to credit advanced to SMEs in the country have continued to decline. Hence, the need for sound alternative sources of funding SMEs is pertinent.

Table: 1 Ratio of Loans to SME'S by Commercial Banks (N = Million)

YEAR	LOAN TO SME'S	BANKS TOTAL CREDIT	% OF TOTAL CREDIT
1992	20,400	41,810.0	48.8
1993	15,462.9	48,056.0	32.2
1994	20,552.5	92,624.0	22.2
1995	32,374.5	141,146.0	22.9
1996	42,302.1	169,242.0	25.0
1997	40,844.3	240,782.0	17.0
1998	42,260.7	272,895.5	13.6
1999	46,824.0	353,081.1	13.3
2000	44,542.3	508,302.2	8.8
2001	52,428.4	796,164.8	6.6
2002	82,368.8	954,628.8	8.6

Source: Central Bank of Nigeria (2002).

The percentage of loans to small and medium enterprises (SMEs) has continued to decline. From 48.8% in 1992, it fell drastically to only 8.6% in 2002. This represents a decline of 40.2%. Also for this period, the number of fraud in the banks steadily increases. The performances of banks exhibited a deteriorating trend as the number of satisfactorily banks has declined steadily from 63 in 2001 to only 51 in 2004. More so the number of banks that are marginal has increased

from eight in 2001 to sixteen in 2004. Also unsound banks have increased from nine to ten in 2004. Reports also showed that nine banks failed to meet the required minimum capital adequacy ratio of 10% as at December 2004, which led to their being classified as unsound (New Age June, 2005: 22).

Informal Financial Institutions

The concepts of Informal Financial enterprises are legal business that however takes place outside the regulatory authorities of the government. They have wide range of scopes and exhibit different characteristics. While some are group or community based, others relate on individual basis. The financial repression school as championed by Mc Kinnon and Shaw (Akanji, 1998), posits that informal finance was an offshoot of multiple and unstable regulations of the formal financial system. These regulations and institutional rigidities do result into corruption, administrative sluggishness, high management costs, payment delays, high interest rates and structural rigidities. The promotion and development of informal financial institutions was to checkmate these inefficiencies that were often observed in the formal financial institutions. The structuralists on the other hand view the genesis of informal finance as products of forces other than Economic (Hugon, 1990). They concur that informal financial system was aimed at serving social goals rather than profit maximization. As observed in many African countries, the informal financial institutions came about as a result of social interactions and welfare of members.

The informal financial agents succeed through information based on personal and social networks. It uses bilateral, character-based relationships to achieve high repayment rates. The near absence of commercial incentives from loans and financial assistance from families', friends and relatives has threatened these sources of informal business finance. Often, no interests are charged and no collateral required before the fund is made available to the beneficiary. The short fall of this process is the inability to access the multiplier effects of these informal agents in the economy, similarly, the inherited capital from family members. The Commercially motivated informal finance on the other hand can be grouped into three: World Bank Group (1996). The first category specializes in the credit side of the market. Those that operate on the credit side of the market provide fund even when the traders have no previous savings with them. The Moneylenders and traditional mortgagers operate in this side of the market. Loans are usually given out to the trader at a predetermined rate of interest and to be repaid at a specified time period. Unlike the money lenders, the traditional mortgagers provides loans that are interest free, no time bound for the repayment of the loan, but the trader is expected to mortgage either human being or his property (wife, children or farm land e.t.c.). The provider of the fund will use freely the collateral

as his own profit until the trader offset the loan obtained until full re-payment of the loan. The short fall of this form of credit are that funds available are often limited in relation to the demand for it, hence very little intermediation in terms of mobilization of funds from other source (banks inclusive) in case there is shortfall of fund (excess demand). The second categories are those that operate from the savings side. Savings collectors (Ajo) or Ato are common in this side of the market. A trader can only participate in this source of business finance based on the financial relationship earlier established. These savings collectors take regular deposits (daily or weekly) of an amount determined by each trader and return the accumulated sum at the end of a stipulated period less 1 day's contribution which serves as commission to the collector. Ordinarily, credits are not extended to the clients, they only gets as much as the amount saved¹. The short fall of this form of finance is that the amount to be saved is often predetermined from onset. It does not give room for fluctuations in the economy. Assuming, at the middle of the month, where sales dropped and the trader cannot meet up with the established sum, what then happen? The third category mobilizes and lends funds to the general public. They may be registered legally as a cooperative society or the savings and credit arm of a cooperative formed for other purposes. All recipients under this category but the last receive the pooled sum sooner than they had saved the same amount individually. Unlike the Ajo, Esusu traders pay a predetermined sum of money at regular intervals into a common pool. These funds are often made available to each in turn. According to the World Bank Group (1996), at least 80% of informal agents in Ghana and Nigeria reported no delinquent borrowers, and all expected virtually 100% repayment within three months of the date due. This makes this form of finance safe and applicable to the Nigerian economy.

Research Methodology

The conventional simple form of ordinary least square model which assumed an exact relationship between two variables has been used in this study (See also Ilesanmi 2007). Data used were collected from carious editions of the Central Bank of Nigeria (CBN) and Federal Office of Statistics (FOS) statistical bulletin. Although obtaining direct information from respondents is a way of increasing the commitment of the major stake holders, yet past studies have shown that information obtained from them is often faced with biases from respondents.

Model Specification

For simplicity and an attempt to obtain a stochastic model, the paper assumes that the Banks main business is to finance Large and the Small and Medium Enterprises (SMEs). The core objective for the establishment of Banks is to

maximize profit. On apriori, we are of the notion that Banks will invest more in the Business or sector that will guaranty a high rate of returns. Hence, the profit of Banks is a function of the investment in the large and the SMEs.

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + U_i$$

Where Y = profits of Banks

β_0 = intercept

β_1 and β_2 = are the slope

X_1 = amount of loan from Banks to Large Enterprise

X_2 = amount of loan from Banks to the SMEs and ;

U_i = standard error terms

Analysis of Data and Interpretation of Results

Using the Data collected from the CBN and FOS statistical bulletin various issues, the result of model is hereby presented as follows;

$$Y = 136.79 - 2.62 X_1 + 4.78 X_2$$

$$\text{S.e} \quad (13.900) \quad (0.002)$$

$$R^2 = 0.94 \quad (R^2) = 0.96$$

$$\text{F-Ratio} = 9.80 \quad \text{DW} = 2.97$$

To determine the significance and reliability of the model, the coefficient of determination (R^2) was computed and used to test the goodness of fit. More so, the value of the DW test is used to test the presence of auto-correlation or serial correlation.

The F- test of 9.80 at both 1% and 5% level of significance, we conclude that the result of the regression equation is statistically significant. The Standard error of formal financial institutions of 0.002; $\text{Se}(\beta_i) > \frac{1}{2} \beta_i$ i.e. $0.002 > \frac{1}{2} (-2.62)$

Informal financial institutions; $\text{Se}(\beta_i) > \frac{1}{2} \beta_i$ i.e. $13.90 > \frac{1}{2} (4.78)$

Like wise for investments that affects the profit of formal financial institutions

From the results obtained above, banks profit, loan to large and SMEs and other variables, which affect the profit level of the government, all have causal relationships with the explained variable. But it is worthy of note, that, their levels of relationships are what matters. For instance, for every 200 million increase in loans to large industries the resultant effect would be 100,000 rise in profit level of the banks hence the need to energize the informal financial sector with excess income currently with the formal financial institutions. Durbin and Watson developed a test for serial correlation. Essentially, if $0 < d^* < 2$, there is some degree of positive serial correlation, which is stronger the closer d is to 0. More so, if $2 < d^* < 4$, there is some degree of negative serial correlation which is stronger the closer d is to 4. (Oyeniyi 1997:272). Considering the results obtained above, our d^* is 2.97 which means there is some degree of negative serial

correlation. But this does not significantly affect our result. Results obtained shows R^2 of 0.94 or about 94%. The meaning of this is that the explanatory variables (loan to large enterprise and the SMEs) explained the dependent variables (profits of banks) by 94%. This shows some sign of good explanation.

Conclusion and Policy Recommendations

The central question addressed in this study, concerns the use of informal agents to reduce corruption in the formal banking sector. Literatures have shown that no economy can grow without the SME. Hence, it represents the engine room for growth and meaningful development. The Asian tigers presently controlling a substantial part of the world's economy grew through contribution from its SMEs. As observed in the study, a major constraint facing this enterprise is finance and it was observed that the formal financial institutions preclude these core sectors (SMEs) of the economy. Corrupt acts such as bribery, extortion, nepotism, fraud, speed money, embezzlement, over invoicing, kick backs, insider training, dirty foreign exchange deals, circumvention of CBN and Government policy guidelines, false declaration of profits, concealment of liabilities as a ploy to deceive existing and prospective share holders, advance fee fraud, cheque kitting, counterfeit securities and among others have beleaguered the formal banking sector. The current desire to transform the formal banking sector into the desired structure is important and also expected to generate additional working capital. It is pertinent therefore, to institute policy guidelines that would ensure the protection of the interest of depositors by not only securing their interest in the Banks but also adding value to their investment. It need be emphasized that the distress in the formal banking industry is not as a result of inadequate capital, but corruption in all its facets as earlier identified. The informal financial sector as observed in the paper reported no delinquent borrower and all expected virtually 100% repayment within three months of the date due. The Nigerian government as a matter of urgency through the Central Bank of Nigeria should institute regulatory guidelines that would mandate the formal banking industries to open up offices in the rural areas. By so doing, these Banks would make fund available to the SMEs through the informal agent who in turn will recover these loans at the stipulated time. This will generate additional employment in the rural areas and make fund available to the SMEs for investment purposes. Second, the SMEs should be encouraged to form cooperative societies so as to benefit more in the loan disbursement of the Banks. As in practice with the formal financial institutions, government should expand the scope of the EFCC, ICPC, CBN and other relevant bodies to carry out routine checks on the records of these cooperative societies and the SMEs. Lastly, most of the SMEs don't keep proper and adequate records of their sales and financial transactions. This often hampers

their ability to harness investable funds from the Banks. They should be trained and encouraged to keep clean and clear records.

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