Bwalya K E Ng'andu: Financing small- and medium-scale industries in Africa

Keynote speech by Dr Bwalya K E Ng'andu, Deputy Governor (Operations) of the Bank of Zambia, to the United Nations Economic Commission for Africa Expert Group Meeting on "Financing small- and medium-scale industries in Africa", Lusaka, 26 June 2012.

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- ***The UNDP Resident Representative, Ms Khanni Wignaraja;***
- ***Director of UNECA, Southern Region office, Ms Beatrice Kiraso***
- ***The AfDB Representative, Dr Fred Kwesiga;***
- ***Officials from the Ministries of Finance of various countries;***
- ***Officials from various central banks; Development Banks, Commercial Banks and other financial institutions;***
- ***Private Sector Representatives***
- ***Participants;***
- ***Ladies and Gentlemen;***

I would like to firstly express my appreciation to the Director of UNECA, Southern Region Office for extending an invitation to me to deliver the keynote address at the start of the Experts Group meeting of Financing Small and Medium Scale Industries. I commend UNECA for this great effort to bring together this assembly of high level officials and experts from Government, the financial sector, private sector and academic institutions to discuss the vexing problem of enhancing financial flows to the SME Sector in Africa.

I note from the very elaborate programme for this meeting that you will in the next three days cover a wide spectrum of issues some of which will focus on factors that constrain SMEs access to finance and some of which will focus on what needs to be done to change this situation. The meeting is, therefore, an opportunity for us to face a number of challenges that characterize this sector. These will include revisiting strategies and approaches to SME financing currently in use as much as it will require a review of current institutional arrangements through which finance is directly delivered to SMEs, on one hand, and those which indirectly obstruct or facilitate this flow of resources, on the other.

However, I believe that probably the greatest challenge before this assembly is to attempt to narrow the gap between analysis of the problem and the implementation of measures and actions that work. Meetings, workshops, seminars, etc. on SME financing are plenty at national, regional and international levels. Some of you have had the opportunity to attend several of these meetings in the past. Indeed, some of you have become experts at talking about the subject. Barely two weeks ago, the Bank of Zambia held a financial sector forum here in Lusaka at which views of various stakeholders on what needs to be done to address binding constraints to the SME sector were considered. The fact that the discourse on SME financing continues underpins two significant positions.

Firstly, it gives recognition to the fact that we are all aware of the potential of this sector in generating employment, promoting economic growth and reducing existing poverty levels. In low income sub-Saharan African countries, SMEs and micro-enterprises make up about 90% of all enterprises. However, due to the various constraints they face, their overall contribution to GDP can in some countries be as low as 20% although estimates show that this could be scaled up to 60% with the greater realization of the sector's potential. Contribution to employment can be as high as 63%. For most low income countries, SMEs are the main source of jobs and income after subsistence agriculture. Particularly significant is that they are a great source of livelihood for women who own more than half of SMEs while over 70% of Africa's rural population survives through the formal and informal SME sector. There is little doubt, therefore, that SMEs form a solid basis for sustainable economic development on our continent.

Secondly, the continued discourse on SMEs reminds us of the possibility that we have probably done more talking about the problem than fixing it. Although the development of SMEs is varied extensively across Africa, what is clear is that in most countries a major obstacle to their growth is the lack of sustainable and cost effective financial products. South Africa and Mauritius in this region and North Africa have done a commendable job in developing flourishing SMEs sectors. Part of the reasons for success in these countries can be attributed to their modern financial systems and clear policies that support the growth of the sector. However, the fact still remains that for most African countries, a sustainable way of financing SMEs has yet to be found.

As I mentioned earlier, the programme for this meeting is broad and extensive. But I would wish to draw your attention to a number of broad areas of reflection which I believe can help in delivering greater finance to the sector.

The first area is that there is a need to accept that not all banks can or should even be expected to provide SME financing products. The cost structure and skills orientation simply make some financing institutions completely unsuitable to deliver SME products cost effectively.

The implication of this is that greater effort must be placed on developing financial institutions that see SME financing as the core business and therefore set out to develop the expertise required to finance the SMEs successfully.

Fairly often the discussion on SME financing is reduced to two diametrically opposed positions. On one hand, SMEs are considered by banks as representing a high risk and therefore, should be avoided or only dealt with cautiously and at a premium price. On the other hand, banks are accused of being inflexible and risk averse and consequently irrelevant to the sector.

It is important to understand where the truth lies in these two statements in order to advance the cause of SME financing. Firstly, it is a fact that SMEs present higher credit risk than well-structured corporate entities. SMEs may not have proper accounting records, may have severe governance issues which undermine accountability, have poor access to markets, poor skill levels including financial illiteracy by promoters, lack collateral which the lender can rely on in the event of failure, may not even exist in an appropriate legal form and even the assessment of the viability of a project might be difficult. Lending to SMEs can be a lenders nightmare for bankers. But it is also true that banks which are structured to deal with corporates are risk averse and inflexible when they deal with SMEs. Often when they bring inappropriate risk assessment tools, they may focus too much on collateral rather than project viability. They may even regard SME financing as peripheral to their business. Because of their limited knowledge of SMEs, they experience failure which itself reinforces the notion that SMEs are risky. What we want are financing institutions that are structured to respond to the unique characteristics of SMEs. Specialised SME lending institutions are more likely to handle the risk problem presented by SMEs as a challenge to be overcome with appropriate products and credit risk management strategies and not as a basis for inaction or avoiding the sector altogether. In short, lending strategies which ensure success with corporates do not necessarily ensure similar success with SMEs. Appropriate SME financing institutions must at the very least make lending to SMEs the core business.

The second area of reflection that I would urge this meeting to consider is that of building appropriate financing models that have been shown to work in Africa or other developing countries so that we all benefit from the best practices available. In South Africa, for instance, franchising which allows the use of brand names and building capacity have been an important driver of SME financing since it reduces the perceived risk of business failure. Warehouse receipt financing which guarantee loans with agricultural stock are extensively used elsewhere but not as much in Africa. In some countries in Asia, the use of the SME cluster model has helped to increase SME financing by building greater confidence between lenders and SMEs. The cluster model is based on members of an SME entity seeking financing together and providing collective guarantees to financial institutions. The cluster also ensures credit compliance by members while facilitating constant interaction with financial institutions. Naturally, one must guard against the temptation to adopt other experiences without serious reflection – but, what appears desirable is the need to build financing models that are appropriate and therefore can deliver sustainable financing. We do not always require to re-invent the wheel in this process.

The third and last area of reflection for me is that we must understand that the constraints that limit the flow of finance to SMEs is sometimes beyond the scope of what financial institutions can do or outside the inherent adverse characteristics of SMEs. There are factors which exist outside the financial system and beyond SMEs which nonetheless affect resource flows. These might include poor infrastructure, bureaucracy which makes it difficult to carry out business, an unattractive tax regime and unclear or unfavourable government policies. Acquiring an appreciation of these factors and appropriately dealing with them can help to foster the efficient use of available financial resources by SMEs, increase their success in the application of credit and therefore give positive feedback to financing institutions which itself encourages them to lend more to the sector.

Let me conclude by wishing you all a fruitful three days of deliberations and to reiterate my challenge to you to attempt narrowing that undesirable gap between the identification of problems and the delivering of practical solutions that will enable the flow of appropriate and sustainable financial resources to SMEs to enable them to play their wealth creation and development role in Africa. For me, the SME sector can be a great engine for economic development in Africa. Meetings like this can help in making them become just that. But we must also go beyond just paying lip service to the sector and show true and real commitment to making the sector strong on our continent. I suspect that to go beyond lip service might, in some instances require a paradigm shift on the part of financiers, governments and the players in the SME sector itself.

I thank you for your attention!!!