Misconceptions Surround High Interest Rates and Low Bank Credit to MSMEs in Zambia

By Joseph Simumba & Bernard Banda

"*Misconceptions held by both the Commercial Banks and Micro, Small and Medium Enterprises (MSMEs) could explain the high interest rates and inadequate flow of credit to MSMEs currently prevailing in Zambia*", observes a team of researchers from the Zambia Institute for Policy Analysis and Research and the Department of Economics at the University of Zambia. These sentiments come in light of a study that has just been concluded by the two institutions involving MSMEs in Lusaka, Livingstone, Choma, Ndola and Kitwe as well as 17 out of the 19 commercial banks registered in Zambia.

The important contribution made by MSMEs in the development of any economy cannot be overlooked. In Zambia, MSMEs contribute about 56% of the total number of jobs and account for over 80% of the number of businesses registered at the Patents and Companies Registration Agency. MSMEs also present an avenue for transforming the economy away from its dependence on mining to high value addition and other sectors which could enhance the economy's resilience and increase its sources of economic growth

Similarly, the role of commercial bank credit in the development of MSMEs in Zambia cannot be overemphasized. The opportunities for MSMEs to source adequate financing outside the commercial banking sector are limited. The only equity market, the Lusaka Stock Exchange, is still developing and does not cater to MSMEs at present. Venture capital initiatives are still rare. The public owned Citizen Economic Empowerment Fund that was established in 2007 to provide affordable finance has limited capacity to meet the demands of all the MSMEs in the country. In a way, microfinance credit offers some alternative but its disadvantage is that it is rarely available in bigger amounts and longer tenure like bank credit.

However, a key limitation to the growth of MSMEs in Zambia is the high cost of commercial bank credit which subsequently leads to the inadequate flow of commercial bank credit. While there are various reasons for this scenario, some specific to enterprises, banks and regulators that could explain this constraint, the widely held misconceptions by both MSMEs and the Commercial banks about each other stand out.

On the one hand, the commercial banks that participated in the study argued that MSMEs often lack good financial information and reasonable collateral to enable them gauge the capacity to pay back loans. They contend that the core business of a commercial bank is not to fund an entrepreneurial idea or business plan but their primary interest is to fund businesses on the basis of previous cash flow performance. "*Remember, we use depositors money and we have a duty to them to safeguard it", stated the bankers*. Despite the widely held view that commercial banks are pessimistic about the future of MSMEs, the commercial banks interviewed project a positive outlook for MSMEs in the next five years.

On the other hand, MSMEs lament with the view that commercial banks are not willing to deal with them. They perceive the requirements advanced by the commercial banks for accessing credit as barriers for their access to commercial bank credit. Particularly, the need to provide audited financial statements by a chartered accounting firm usually demanded by some commercial banks is viewed as a prohibitive factor, given that these services come at a huge cost.

The government together with other stakeholders has taken a number of steps aimed at addressing the financing obstacles MSMEs face. These include the capping of lending interest rates, compulsory credit registration at the Credit Reference Bureau and the introduction of credit guarantee schemes. Commercial banks are therefore expected to respond to these initiatives by increasing the flow of credit to MSMEs.

An assessment of information collected from both the banks and MSMEs indicates that long-term relationships between MSMEs and commercial banks barely exist. In the absence of these relationships, banks are not able to gather sufficient information about MSMEs. Particularly, information on aspects such as the financial culture of an enterprise, the character of its principal owners and management and broadly the business network of the enterprise are difficult to gather in the absence of long term relationships. This is clearly what underpins the two-fold problem of inadequate flow of commercial bank credit to MSMEs and the existence of high lending interest rates.

Ideally, it would be expected that commercial banks would draw much of their attention to building relationships with MSMEs in order to acquire sufficient information for assessing their credit worthiness. On the contrary, the tendency to deal with MSMEs at arms' length exhibited by most commercial banks in Zambia creates a platform for poor credit assessments and eventually culminates into high interest rates.

"The failure to factor these important attributes in the lending decision for an MSME application by commercial banks, reflects a lack of practical understanding of MSMEs business exposure and a clear tendency to upward mispricing of the true risks", observed the Researchers.

On the side of MSMEs, the absence of relationship banking impedes the flow of information to the commercial banks. Currently, estimates show that bank lending to MSMEs lingers around K2 billion which is about 10 percent of the nearly K20 billion worth of commercial bank total loans.

The study points to a very important policy matter based on the evidence gathered. There is urgent need to enhance or perhaps create additional institutions with a mandate to cement ties between banks and MSMEs. "*In mind, we're thinking of 'outside the box' interventions by the Zambia Development Agency, Citizens Economic Empowerment Commission, Development Bank of Zambia and the Zambia Chamber of Small and Medium Business Association*" stated the Researchers. MSMEs need a front office where they can seek expert guidance and match-making with suitable commercial banks. Such initiatives that are currently lacking or not effectively organized will help to build ties that can serve as conduits for enhancing the flow of bank credit to MSMEs in the future.

Equally important, it might be helpful for the government to reassess some of the regulations that seem to impair the ability of commercial banks to provide credit to MSMEs at lower interest rates. Specifically, regulation should aim at meeting a balance that encourages bank lending to MSMEs as well as creating an environment where commercial banks can borrow favorably to cover short term fluctuations once they tie up money in MSMEs loans.

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