

Informal Credit Markets and the Development of Micro and Small Scale Enterprises in Nigeria

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Abstract

This study analyzed the development in investment of Micro and Small Scale Enterprises Intermediated by the informal credit market in Nigeria. Primary data for this study were collected from 10 (ten) Local Government Areas of Oyo State, Nigeria using a multi-stage sampling technique. The result indicates that size of lending, experience in lending business have positive and significant impact on growth in investment of micro and small scale enterprises. Policy aimed at making fund increasingly available to small scale enterprises is recommend to boost growth in small and micro enterprises.

Keywords: micro and small scale markets, financial market, informal sources, finance

1. Introduction

Government direct intervention in the activities and provision of financial services by the financial institutions led to unprecedented development of informal money markets that became essential part of the financial intermediation process. In explaining the reasons for development of informal markets Abereijo & Fayomi (2005) affirm that banks in Nigeria prefer to lend to government and its agencies with less consideration for the financial needs of small scale enterprises. Earlier studies such as Beneivenga & Smith (1991) demonstrated keen interest in the relationship between financial development and economic growth. In their findings they emphasized the role of efficient financial intermediaries and markets in reducing transaction costs and improving accessibility of investors to credit as well as fostering efficient allocation of scarce economic resources.

Despite the rural banking policy of the financial regulatory authorities, markets and institutions providing credits to micro and small entrepreneurs are extremely limited. The thinness of formal financial markets in the rural communities as well as absence of more complicated interlinked contracts for credit and insurance has been confirmed in several studies by scholars such as Collier (1983) and Artyeetey (1996). In spite of the various government support programmes at developing and facilitating the growth of SMEs, the potentials of the SMEs have not been fully exploited (Egbuogu, 2003). Studies confirm that the informal finance sector has considerable experience and knowledge about dealing with small business borrowers and that their performance in relation to financing small business has been positive especially in Asia and Latin America, though there are significant limitations to what it can lend to growing micro businesses. This present study seeks to identify the micro and small investment activities financed by the informal credit markets and also determining the types of financing provided.

1.1 Informal Financial Market

The informal financial market has been described as unorganized money market and non-institutional financial market by Wai (1957) and Chandarvakar (1985) respectively. Aryeetey (1995) attempts an all-embracing working definition of informal finance as financial transactions outside the functional scope of various countries' banking and other financial regulations that include a wide range of financial activities whose scope of operations may differ from country to country". Thus, depending on the socio-economic goals of communities, informal arrangements are developed to meet the demand of specific financial services.

The multiplicity of arrangements defies simple classification, and it is very unusual to find substantial number of the arrangement that is identical, which is a confirmation of the flexibility and creativity involved in informal finance. In general, three broad classifications of informal finance are found in Africa. These include primary savings mobilization units with little or no lending; primary lending units that are hardly involved in savings mobilization; and units that mobilize deposits and do a considerable amount of lending albeit to members of distinct associations or groups such as: savings collectors and money keepers, commercial lenders (money lenders), friends, family and non-commercial lenders, self-help financial groups that include different levels of savings and credit rotating ones and licensed cooperative societies or unions.

These are “esusu” groups/clubs which are known in the literature of informal finance as Rotating Saving and Credit Association (ROSCAs). They are the most basic forms of “esusu”, which combines savings and credit arrangements including regular fixed amount of contribution to a common pool of funds by members in turn. Orders of receiving the amounts are decided by negotiation, lottery or any other agreed arrangements/modalities. Once each member has had access to the fund, the group disbands or starts over again. Therefore, the “esusu” cycle depends on the number of participants and the unit of collection (weekly, fortnightly or monthly). Schreider & Vas (1992) define informal finance as an organization wherein participants agree to save regularly on a contractual basis. Peculiar to non-rotating savings and credit association is the direct relationship between the contributed amounts; the individual’s saving capability and credit worthiness. Non-rotating financial institutions can be divided into three main groups as saving association, savings and credit associations, and credit associations.

In saving associations, members regularly contribute fixed or variable amounts to the group fund. This fund is either kept by the treasurer at home or deposited in a savings bank account, or a combination of both. At the end of a specified period, the group members received their deposits. While, in saving and credit group, the group fund is applied to grant loans to members and possibly to non-members. An emergency fund might complement the savings fund, and usually borrowers of the emergency fund must pay interest on their loans. In credit association, participants agree to contribute variable amounts for an unspecified time period. A money lending group uses fund exclusively for non-member loans, while interest is charged in advance, loan terms seldom exceed one month. The interest is re-invested in non-member loans until the end of the business year, then group members receive a dividend out of the interest revenues proportion to their subscriptions/accumulated savings or equally.

1.2 Historical Evolution of Informal Finance

Two schools of thoughts have engaged in the debate concerning the historical evolution of informal finance. These are the Financial Repression School (FRS) and the Neo-structural School (NSS). These schools of thought were developed from the seminar works of McKinnon (1973) and Shaw (1973). They theorized that the defining features of under-development are fragmentation, that is, situations in which financial agents face different prices and do not have access to the same technology. They found that the immediate cause of this fragmentation is government policy designed to favour certain activities or certain classes of agents at the expense of others. McKinnon (1973) perceives self-financing to be the rule in many low-income countries because financial intermediation is inadequate. This proposition implies that there is no one to intermediate between savers and those with profitable investment opportunities.

McKinnon-Shaw school discovers that administratively imposed ceilings on interest rates and strict collateral requirements force formal financial institutions (banks) to concentrate their portfolios on safe, low-yielding assets. This school’s proposition also found that large reserve requirements imposed with the consequence to shift in the allocation of investible funds from the formal financial market to the government, thus reducing the flow of funds into banks while also creating excess demand for credit at official rates. Their summary is that the financial repression school acknowledges the emergence of informal financial markets to fill the credit gap and serve as an alternative vehicle for saving and sourcing of credit.

An alternative perspective of developing country financial market is provided by the Neo-Structuralists school. Though the existence of informal credit markets is acknowledged in the McKinnon Shaw analysis, they are perceived as inefficient, limited in scope, and not central to the transmission of shocks from the financial to the real sector. In Neo-Structuralists models, however, informal credit markets occupy a prominent place in any modern developing economy. Such markets play two important roles in these models. In commodity markets, they are taken to determine the marginal cost of funds relevant for private spending and saving decision. In financial markets, they represent an alternative mode of financial intermediation available to private saves. “The school proposes that the existence of informal finance is a product of forces other than economic forces”

(Soyibo, 1966). The neo-structuralists view the informal financial markets as subordinate and implementer to the formal financial markets. Following the relevance and the above mentioned gap in the study of informal market, this study employs an empirical method to answer the question on the effects of informal credit market on the development of small scale business.

2. Method

This study was carried out in Oyo State, Nigeria. Primary data was collected for this study with the aid of structured questionnaires. A multi-stage sampling technique was used to obtain information from 240 respondents in 10 (ten) Local Government Areas of Oyo State. The data collected were analyzed using descriptive and inferential statistical tools. Descriptive statistical tools such as frequency tables, tabulation and cross-tabulations were employed to examine the general characteristics of the informal financial markets (credit providers) while multiple regression analysis was also used.

3. Results

Four (4) major informal credit markets were mainly involved in investment financing of micro and small scale enterprises in the study area. In spite of the very high interest rate charged on loans, moneylenders dominated the providers of credit to Micro and Small Scale Entrepreneurs.

Table 1. Category of informal financial markets

Category	Frequency	percentage
Esusu/Daily collectors	17	18.9
Money lender	29	32.2
Cooperative	25	27.8
ROSCAs/ISACAs	19	21.1
Total	90	100.0

Source: field survey, 2011.

As shown in Table1, Moneylenders constituted 29 (32.2%) of the 90 providers surveyed. This was closely followed by cooperative societies with 25(27.8%) of the sample surveyed. 'Esusu'/daily collector and ROSCAs/ISCAs account for 17 (18.9%) and 19 (21.1%) of informal financial sources of micro and small scale entrepreneurs. Amount of take-off capital of the majority of informal financial markets surveyed ranges between N1,000 (1 N = \$153)and N100,00; representing about 38.9% of the surveyed informal lenders; while 16.8% started with a capital ranging from N400,000 to N500,000. About 7.7% had between N2, 000,000 and N15, 000,000 as their start-up lending capital.

Table 2. Source of initial capital for informal lending

Sources	Frequency	Percentage
Personal money	15	16.8
Rotational savings/ Contribution	22	24.4
Gratuities/Pension	30	33.3
Other occupation/economic activity	20	22.2
Monthly esusu	20	22.2
Total	90	100.0

Source: field Survey 2011

Table 2 shows the various sources of initial or start-up capital of the surveyed informal financial institutions. About 41% of the respondents obtained their start-up capital through personal accumulated savings, rotational and *Esusu* contributions. Money generated from other occupation or professional count for initial capital of informal lenders in their initial capital. Some of the respondents 24.4% utilized their rotational contribution funds for on-lending to micro and small entrepreneurs.

The importance of finance for establishment, restructuring and performance is one of the most consistent conclusions arrived at by studies conducted in transition economies. Unfortunately, available evidence suggests that enterprises in such transition economies like Nigeria have been subjected to acute financial constraints that have hindered their activities and development impacts expected of them on their economy (Cornelli et al, 1996: Commander et al, 1996, Bevan et al, 1999).

Table 3. Micro and small scale enterprises financed by informal credit market

Enterprises	Frequency	percentage
Market Trading	19	12.7
Bakery	10	6.7
Hair dressing	7	4.7
Fashion designing	12	8.05
Nylon Making	5	3.3
Artisans	14	9.3
Block Making	22	14.7
Soap making	21	14.0
Printing Press	8	5.3
GSM/Accessory Business	13	8.7
Carpentry	8	5.3
Shoe Making	11	7.3

Source: field Survey, 2011

Table 3 shows that block markets dominate (14.7%) the number of clients patronizing informal financial market for their investment financing; Soap making (14.0%) and fashion designing (8.05%). Entrepreneurs source their funding from the informal financial institution, while market women—(provision seller, supermarket owners) and artisans borrow to boost their store replenishment with 12.7% and 9.3% respectively in the surveyed respondents. The main source of start-up fund common to most entrepreneurs was personal savings, which is either through rotational savings (24.0%) or “*esusu*” contribution (34.7%), while money lenders (15.3%) and cooperative societies (11.3%) were other means by which entrepreneurs raised capital for the establishment of their enterprise. Further result reveals that most new assets acquired after establishment were financed through funding from informal finance institutions. Mostly accessed are money lenders 30%, Cooperative societies 21% and “*esusu*” or rotational collection 18%. About 15% of the entrepreneurs utilized their retirement benefits in adding more to their business assets.

Regression Results on development in Investment of Micro and Small Scale Enterprises Intermediated by the Informal Credit Market.

In order to measure the effect of each of the explanatory variables on the dependent variable (amount given out as loan by the informal finance providers), a regression estimation was carried out to seek how best the variability in the dependent variable has been captured by the explanatory variables. Three explanatory variables influencing informal finance granted by informal credit markets were estimated.

Table 4. Estimation of loan granted to small scale enterprises

Variables	coefficient	T-value	p-value
Constant	29191.88	1.96	0.055*
Experience in lending (yrs)	4764.654	0.647	0.520
Size of lending capital (N)	128	5.210	0.000***
Income from lending activitie	14.064	0.047	0.963
R ²	0.56		
F (3, 104)	9.233		
prob	0.000		

***, *, Means significant at 5% at 1% respectively

As shown in Table 4, revealed that only the size or magnitude of informal lending capital has a very significant influence at 5% level on the amount of credit loaned out to MSEs in 2001 ($t=5.210$; $p<0.05$). Other variables such as experience in lending business ($t=.647$; $p > 0.05$) and income from lending activities ($t=.047$; $p > 0.05$), contrary to our *a priori* expectation, did not show any significant effect on the size of loans given out to MSEs by the informal lenders. This may be due to the number of clients they deal with since the market is not a monopolistic market. Moreover, size of lending capital was better in explaining the amount of loans granted to SMEs in 2001 ($Beta=.485$; $p<0.05$). However the value of R^2 indicated that the explanatory variables jointly accounted for 56% of the change or variation in the level of loans granted. The F-statistic of 9.233 (0.000) indicated that the model was correctly specified and is capable of explaining the relationship between the variables of interest.

4. Discussion

Informal finance users surveyed included those entrepreneurs engaging in trading activities, (provision sellers, spare part dealers), technicians and artisans (welder, iron benders, mechanics), fashion designers, soap makers, block makers, bakers, cobblers, polythene bag makers. It was discovered that trading accounted for (12.7%), block making (14.7%) and Soap making (14.0%) of the total of 150 micro and small entrepreneurs surveyed, while GSM phone and accessories business accounted for 8.7% of the surveyed entrepreneurs.

Having initiated their enterprises, MSEs often later rely on informal financial markets for additional business loans, or to assist with safeguarding savings and regulating cash flow. On expansion cost sourced from informal credit markets, 14.0% and 16.7% of the 150 micro entrepreneurs sought for between N101, 000–N200, 000 and N201, 000–N300, 000. Following the same trend, 12% sought for expansion credit of between N301, 000–N400, 000. These compared more favorably than the percentage of micro and small entrepreneurs sourcing for the same credit range to start up their businesses. It was also discovered that the expansion credits obtained were utilized in further business assets acquisition to increase their physical asset base.

Informal sources of credit have been known to gain preference of micro and small scale entrepreneurs because of their accessibility and simple loan procedures. Informal financial markets, which are small scale finance providers have long been recognized as an engine of both rural and urban development. Though their capacity is limited, it is discovered that formal credit markets with much greater financial capacity rarely reach the rural areas, and in some instances, segments of urban communities because of the risks and transaction costs entailed. In spite of the various government financial sector reform programmes, the informal financial institutions have no tendency to outwit her; they should therefore be encouraged through appropriate policy guidelines for optimum contribution to the growth of the economy.

It can be concluded through the survey findings that a reasonable percentage of micro credit and savings are still being managed informally. Though to varying degrees, informal financial services are characterized by ease of access, flexibility in loan use, rapid processing and flexibility in interest rates. Collateral requirements still hold sway in performing the role of propeller and engine of economic development. However, the markets are restricted in the size and duration of lending and in their area of operations.

MSEs Operators depend largely on informal finance in order to finance their enterprises. For most of the micro entrepreneurs surveyed, it was gathered that after having approached formal financial market with little or no success, they have over the year depended on the informal financial markets either for their start-up capital or

expansion capital. The provision of intermediation of start-ups and expansion financing represent the most important means by which informal credit markets are of assistance to the MSEs operators. They provide operators flexibility in choosing activities that best suit them especially when gainfully paid employment does not exist. Having initiated their enterprise, operators often later rely on informal financial institutions for additional business loans. The flexibility that characterizes informal finance makes it especially well suited to serve the needs of micro and small entrepreneurs.

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