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Financial sector policies for enterprise development in Africa

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Abstract

This paper explores the key issues relating to financial sector policies for enterprise development, with special implications for Africa. The role of the formal financial sector – ranging from microfinance institutions, banks, the capital market, and regulatory agencies – is discussed with respect to enterprise development at all levels, including start-ups, small and medium firms, and large corporates. Specific policy choices for African countries are highlighted, including exploiting the current communications and information technology (CIT) revolution.

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1. Introduction

If there was full information about the creditworthiness of enterprises, banks would probably not exist. All finance would be ‘direct finance’, in the sense that lenders would finance enterprises directly without the need for banks (Diamond, 1991). Similarly, there would probably be no need to use money for transactions, since borrowing and financing would involve transfers of assets between wealth portfolios. Moreover, the vision of a world without banks (and money) may be contemplated in the context of the on-going communications and information technology (CIT) revolution. Electronic funds transfer is already replacing cheques and giro-based transactions. It is anticipated that electronic or digital wallets will replace physical wallets and purses containing bank notes and coins. Indeed, the process is well advanced in Kenya, where the M-Pesa system facilities transfer of money using mobile phones, and elsewhere in Africa (Napier, 2011).

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However, in most African countries rural enterprises are small, such that rural credit is problematic, given the challenge of delivering financial services to dispersed farming communities in remote areas. Small urban enterprises also suffer from ‘financial exclusion’ or credit rationing problems. Unlicensed money lenders exploit the opportunity to fill the gap and charge high interest rates.

To deal with the rural ‘financial exclusion’ problem, special initiatives such as mobile banking units and microfinance institutions (MFIs) have been invoked (Napier, 2011). The most famous example is the Grameen Bank set up by Yunus (2007). MFIs, along with other mutual financial institutions (e.g. Credit Unions and Community Development Finance Institutions, or CDFIs), have used state-backed loan guarantee schemes to resolve rural as well as urban ‘financial exclusion’ problems (Mayo et al., 1998). The schemes provide government subsidised loan guarantees to reduce banks’ exposure to credit risk, thereby encouraging greater bank lending to SMEs. It should be noted that loan guarantees can be targeted, with different levels of risk cover and subsidy, on different sectors of the economy in pursuit of industrial policy (e.g. encouraging lending to start-up and ‘growth’ enterprises in high-technology sectors) and social policy (e.g. lending to businesses led by women or particular ethnic groups and lending in deprived urban areas).

This paper explores financial sector policies for enterprise development, with reference to Africa. In what follows, the paper is structured into three sections. Section 2 discusses the role of the formal financial sector in enterprise development. The policy

implications for Africa are highlighted in Section 3, while the concluding remarks are presented in Section 4.

2. The role of the formal financial sector in enterprise development[1]

According to corporate finance theory, enterprises finance their investment and growth using a combination of internal finance (retained earnings) and external finance (new equity issues, and bank loans or funds raised by issuing debt instruments including bonds).[1] Hence, the capital structure of most enterprises includes retained earnings (internal finance), debt and equity (Brealey and Myers, 2002). As enterprises develop, external finance is eventually required to foster faster growth. Internal finance, however, normally remains the major source of funding for on-going investment in all firms. Much less commonly, because of fear of loss of control; small private enterprises also accept investment from venture capitalists. This typically takes the form of equity investment by individuals ('business angels') or through a private equity fund, which pools the personal wealth of investors. In general, however, as explained in Mullineux et al. (2011), enterprises tend to have a 'pecking order' of financing choices; they prefer using internal finance before they resort to external finance and prefer debt finance to equity finance.

The overall goal should be to establish a financial system that allocates capital efficiently on a dynamic basis. To achieve this, effective bankruptcy laws are required (Kowalski et al., 2005) and the use of capital allocated by the financial sector should be continuously and efficiently monitored. An appropriate balance between the rights of creditors and debtors must be struck, so that entrepreneurship is not stifled and banks remain willing to lend.

Also, the financial sector plays a key role in corporate governance. As the allocator of debt and equity finance, the financial sector is a key stakeholder in enterprise development. It also has fiduciary duties to other stakeholders, namely those that have saved and invested their personal wealth in financial institutions. The infrastructure required for the efficient operation of a financial sector includes an effective corporate governance system, including financial regulation, to ensure that financial institutions manage their risk exposures and discharge their fiduciary duties appropriately. As the financial sector develops, the importance of institutional investors (pension and mutual funds and insurance companies) tends to increase relative to that of banks (Mullineux, 2011).

In most African economies, banks remain the major source of external capital for both large businesses as well as small enterprises, and indeed for the private sector and the economy as a whole. Debt finance thus tends to dominate equity finance, and bank debt (loan) finance dominates bond finance because it takes time to develop capital markets. Hence, it is important to ensure that the banking sector operates efficiently. The potential for banking sector instability and its damaging effects have been illustrated by an ever expanding catalogue of financial crises, including the Global Financial Crisis (Reinhart and Rogoff, 2011). Hence, banks should monitor borrowing firms to ensure that the firms use capital efficiently and banking firms should themselves be monitored to ensure that they use their capital and the deposits they collect, and thus other peoples' monetary and savings balances, efficiently, non-fraudulently, and without taking excessive risks (Murinde and Mullineux, 1999). There is accumulating evidence that banking instability and subsequent recapitalisation of banks are expensive in terms of charges on state budgets and lost growth (Reinhart and Rogoff, 2011). Furthermore, fluctuations in growth and inflation have an impact on the balance sheets of firms and the asset quality of banks. Bank supervisors must take this into account (Murinde et al., 2011).

Also discouraging MSME lending, especially to smaller enterprises, is the 'fixed cost problem' (Mayo et al., 1998) that results from the fact that the costs of making a loan rise less than proportionately to the size of the loan and so, to control costs, bankers prefer to make a smaller number of larger loans, than a larger number of smaller loans. Smaller enterprises also commonly find it difficult to provide 'collateral', or security, against loans in order to gain cheaper borrowing rates. Those with little or no wealth essentially face 'financial exclusion' from banks and must consider instead the prohibitive borrowing rates charged by 'informal lenders'.

Where credit market imperfections exist, credit rationing faced by MSMEs is commonly addressed using government sponsored loan guarantee schemes, sometimes with supporting business skills training programmes. Financial inclusion, or access to finance, is addressed through the promotion of Community Development Financial Institutions (www.cdfa.org.uk); which provide microfinance in urban areas in the US and the UK (Mayo et al., 1998). Loan guarantee schemes are used to resolve the risk exposure problem faced by banks. Government backed funds. Schemes vary in the extent of the guarantee and the degree of state subsidy and which types of business (classified by size or nature area of business) qualify. Subsidised insurance premiums are commonly paid by firms in the form of a supplement to the interest rate charged by the lending banks, which normally manage the loans. The accumulated premiums rarely cover the disbursements from the fund resulting from defaults on loans, and hence government funding is required. By reducing banks' risk exposure, it is hoped that banks will be induced to lend more than they otherwise would to MSMEs and rely less on 'collateral' and other loan securities.

Schemes such as the UK's 'Small Firms Loan Guarantee Scheme' (SFLG) were introduced on an experimental basis with the objective of encouraging banks to engage in and learn the business of lending to small firms on the basis of projected cash flows; rather than providing overdrafts and relying on collateral to secure loans (Cowling, 2010). The amount of bank lending to SMEs under the SFLG Scheme was sensitive to the extent of the guarantee, and the take-up by SMEs, not surprisingly, seemed to be related to the size of the risk premiums charged and hence the degree of subsidy (Mullineux, 1994; Cowling, 2010). Failure rates amongst SMEs, especially

[1] We ignore informal financial sector 'money lenders' and the 'shadow' banking sector' (Pozsar and Singh, 2011).

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