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Small and Medium Enterprises Bank Credit Financing in Nigeria: Mudharabah Vs Usury

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Abstract

The high administrative or transaction cost of lending or investing small amounts that do not make SMEs financing profitable businesses has created a huge financing gap to business enterprises. Hence, this paper presents a comparative analysis of the conventional banks debt finance that is interest based (usury) and Islamic bank equity finance that is interest free (mudharabah) sources of SMEs financing in Nigeria. The study incorporates NPV technique to determine whether conventional banks usury is more viable than Islamic bank mudharabah financing for SMEs growth and innovation. Results based on the difference between the present value of loanable fund and the discounted actual loan from 2000 – 2017 sampled periods showed that mudharabah has a positive and higher NPV thus it is far better and more worthwhile for enterprises to grow and innovate than the usury source of finance. Hence, the study concludes that mudharabah is most reliable source of finance that promotes equity, income redistribution and enhances growth and innovation of SMEs in Nigeria. Therefore, the study suggests that SMEs should utilize Islamic bank mudharabah financing in order to raise profitable funds for investment, expand their businesses and acquire the latest technology that ensures their competitiveness and growth and that of the nation as a whole.

Keyword: *SMEs, Mudharabah, Usury, Bank Credit financing.*

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Background to the Study

Recently, small and medium enterprises (SMEs) financing has been one of the major interesting research subject for economists and policy makers working on financial and economic development. This interest is driven in part by the fact that SMEs are key drivers of growth and development of the economy through their positive effects on employment generation and poverty reduction (Sule, 1986; Takats, 2004; World Bank, 1995). In contributing meaningfully to economic development, access to finance by SME operators has become critical as it is often cited by firm owners as one of the key determinants of growth and expansion. SMEs depend on financial institutions to raise funds, undertake productive investment, expand their businesses and acquire the latest technology that ensure their competitiveness and that of the nation as a whole. Yet, in developing countries, the majority of SMEs are unable to acquire the financing they need to reach their potential (Beck, Demirgüç-Kunt & Maksimovic, 2005; World Bank Ghana Office, 2014).

In developing countries, traditional banks are often unable or unwilling to give term loan to SMEs. They prefer to lend to large, established businesses with well-developed balance sheets and credit histories of additional assets for the collateral required in conventional bank financing (Gallardo, 1997), which obstructs the access to external formal finance of SMEs. This situation can be attributed to insufficient asset and low capitalization, vulnerability to market fluctuations and high mortality rate of SMEs. Berger and Gregory (1998) and Binks et al (1992) added that information asymmetry arising from SMEs lack of accounting records, inadequate financial statement or business plans make it difficult for creditors and investors to assess credit worthiness of potential SMEs proposal. This creates a huge financing gap to SMEs. The implication is that young firms are put out of business or stunts growth of SMEs.

To reduce the financing gap, financial institutions, governments, and donors create various schemes and programs to support SMEs. Likewise, several scholarly studies have suggested many credit facilities to enhance SMEs growth and innovation. However, the extent to which such schemes, programs and facilities promote the most efficient and cost-effective ways to expand access to finance for SMEs has generally not been rigorously evaluated. Therefore, this study brings a unique addition to the various studies in the field by taking a holistic view of the more viable bank financing for SMEs as it classifies firms financing into mudharabah (Islamic bank equity finance) and usury (conventional bank debt finance). The study is motivated by the need to undertake an objective analysis of usury and mudharabah bank financings with a view to determine the more ideal bank financing for SMEs growth in Nigeria. The findings of this research are hoped to contribute to the existing body of literature, provide a better understanding of the subject matter to SMEs owners/managers, financial analysts and serve as a frame of future reference to researchers, academics and students.

Review of Related Literature

Financial access is critical for the growth of SMEs. Banks do grant loans and advances to individuals, business organizations as well as government in order to enable them embark on investment and development activities as a means of aiding their growth in particular or contributing toward the economic development of a country in general. Funds extended to businesses may either be in a manner where the seeker of funds becomes indebted to the institution, or by way of capital participation in a joint venture, where practicable (Umer, 1985). The former, commonly referred to as debt-financing (Usury) that is the practice of charging financial interest in excess of the principal amount of loan, where the process leads to the creation of a debt. In the latter mode, funds are provided as capital exposed to profit or loss, the liability remains with the provider to the extent of the capital, and no debt is created. This method, which could be called equity financing as it is based on contributing equity, comprises Islamic modes of financing such as profit-and-loss sharing (Mudharabah). This lending principle is based on the belief that providers of capital and the users of capital should equally share the risk of business ventures. Translated into banking, the depositor, the bank and the borrower should all share the risks and the rewards of financing business ventures. There exists a plethora of studies comparing and contrasting usury and mudharabah. According to the Institute of Islamic Banking and Insurance (1990), Islam encourages the economy of wealth redistribution; customers are encouraged to invest their money and to become partners in order to share profits and risks in the business. This is unlike the interest – based commercial banking system, where all the pressure is on the borrower. He must pay back his loan, with the agreed interest, regardless of the success or failure of his venture.

Muhammad (2002) explains that the instrument of interest has a constant tendency in favour of the rich and against the interests of the common people. The rich industrialists, by borrowing huge amounts from the bank, utilize the money of the depositors in their huge profitable projects. After they earn profits, they do not let the depositors share these profits except to the extent of a meagre rate of interest (compared to the amount of profit they earn when successful), and this is also taken back by them by adding it to the cost of their products. Therefore, looked at from a macro level, they pay nothing to the depositors. While in the extreme cases of losses which lead to their bankruptcy and the consequent bankruptcy of the bank itself, the whole loss is suffered by the depositors. This is how interest creates inequity and imbalance in the distribution of wealth. Siyanbola (2013) added that economic instability results from imposition of high interest rate on loan and since conventional banks impose high interest rates on customers, that rate is passed on to the cost of commodities which makes everything to be on the high side and unbearable to the small players, hence widening the gap between the rich and the poor, making the latter to be worse of as income inequality widens by the day.

In profit-and-loss sharing (PLS) arrangements, only shares of expected profit are determined at the outset, while the actual rate of return on investments is to be determined in the end, on the basis of realized profits. However, debt, on the other hand, requires predetermined interest payments, and business difficulties may create pressures on the firm's cash flow, forcing it to forgo lucrative business ventures, borrow further, or sell its existing assets. As Mudharabah does not create such mandatory payment, the cost of adjustment to any contingency is lower (Usamah, 1994). Therefore, proponents argue that in an advanced economy, PLS financing should be the rule and not the last resort. Profit sharing provides more flexibility in meeting contingencies. This is because of the balanced distribution of gains as well as the risks among the participants in equity financing, while debt is restrictive and unforgiving, hence less stable.

The main objection of Gesell (1904) to interest is that it is an endemic factor in the instability on interest based economy i.e. the cycles of boom and bust, recession and recovery. Even Keynes (1936) the campaigner for interest based monetary policy, admits the fact that "the rate of interest is not self-adjusting at the level best suited to the social advantage but constantly tends to rise too high", Kennedy (1995) was bolder, suggesting that the compound growth of interest may in fact cause inflation. She shows for instance, how in Germany, while government income, Gross National Product (GNP) and the salaries and wages of workers rose by about 400% between 1968 and 1989, the interest payments of the government rose only by 1.36%, which she claims to imply an inflationary effect.

Despite several criticisms levelled against usury, Fong maintains that usury has a complete control over the business. The lender charges a company interest for the use of a loan, but the lender does not have the right to say how a company should manage its business. The ownership of the business stays completely in the hands of the corporate directors and shareholders. This also means that lenders will not be entitled to any of the profits that companies make from the business; the borrowing company is merely required to repay the loan within the fixed time period.

Debt financing is appropriate for companies which pursue an aggressive growth strategy, especially when they have access to low interest rates. Though a company may lose some of its assets if it is unable to repay its loans, the company won't lose corporate control or ownership to outsiders. Companies wishing to make use of debt financing are recommended to seek appropriate legal advice from the company's lawyers and accountants for better information on asset protection.

In addition, debt financing is related to loan repayment interest. Companies can deduct their interest payments (but not the principal repayments) as a business expense. The interest rate which a company pays is usually based on the prime interest rate, and the interest that the company has to pay on a company loan is tax-deductible. This means that debt financing covers up part of a company's business income from taxes and reduces the company's tax liability.

However, the study of Aisya and Shifa (2016) on challenges of PLS financing in Malaysian Islamic banking found that there were four major obstacles to PLS financing such as high risk of investment; difficulty in selecting appropriate partners; demand comes from low credit worthiness; and lack of capital security.

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or large corporate companies rather than servicing SMEs because they can be risky and expensive for lenders due to insufficient asset and low capitalization, vulnerability to market fluctuations and high mortality rate. In addition, the fragile economic environment and absence of requisite infrastructure have rendered SMEs practice costly and inefficient, thereby worsening their credit competitiveness (Berger et al., 1998; Binks et al., 1992; Gallardo, 1997; Luper, 2012)

Similarly, it could be observed from the available statistics that the conventional banks' lending rate in Nigeria grew to 17.69% in the third quarter of 2017 from 16.82% in 2016. Lending rate averaged 18.33% from 2000 until 2017 reaching an all-time high of 24% in 2002 and a low record of 15.48% in 2008. The mean lending rate (18.33%) is quite close to the median rate (17.26%) with small standard deviation (2.58%) suggesting that the distribution is symmetric. This observation is confirmed by the small positive skewness (1.43%) and kurtosis (0.53%), which shows that lending rate, has a short right tail. That is, the distribution is symmetric, with some distant values in a positive direction from the centre of the distribution (see appendix 2).

Analysis of Usury and Mudharabah SMEs Financing with NPV

Table 1: Analysis of Usury and Mudharabah SMEs Financing with NPV

Period	Actual Loan to SME (N million)	Usury Bench Mark Lending Rate for SMEs (%)	Present Value (PV) (N million)	Mudharabah Rate (50% of the Usury rate for SMEs)	Present Value (PV) (N million)
1	2	3	2 × 3 + 2	4	2 × 4 +/- 2
Loanable fund			579, 946.7 less		579, 946.7 less
2000	44,452.20	21.27	53,907.10	10.63	49,177.46
2001	52,428.40	23.44	64,717.61	(11.72)	46,283.79
2002	82,368.40	24.77	102,771.05	12.38	92,565.60
2003	90,176.50	20.71	108,852.05	(10.35)	80,843.23
2004	54,981.20	19.18	65,526.59	9.59	60,252.89
2005	50,672.60	17.95	59,768.33	(8.97)	46,127.26
2006	25,713.70	16.90	30,059.31	8.45	27,886.50
2007	41,100.40	16.94	48,062.28	(8.47)	37,619.19
2008	13,512.20	15.48	15,603.88	7.74	14,558.04
2009	16,366.50	18.36	19,371.38	(9.18)	14,864.05
2010	12,550.30	17.59	14,757.88	8.79	13,653.47
2011	15,511.70	16.02	17,996.67	(8.01)	14,268.21
2012	13,863.50	16.79	16,191.18	8.39	15,026.64
2013	15,353.00	16.72	17,920.02	(8.36)	14,069.48
2014	15,966.60	16.55	18,609.07	8.27	17,287.03
2015	10,155.90	16.90	11,872.24	(8.45)	9,297.72
2016	11,920.10	16.82	13,925.30	8.41	12,922.58
2017	12,853.50	17.69	15,127.20	(8.84)	1,717.25
	NPV (Usury) = (₦115,092.44)			NPV:Mudharabah = ₦1,526.31	

Source: Authors' Computation (2018)

The above computation assumed that the bench mark lending rate by commercial bank for SMEs is the same as the value of profit-and-loss-sharing ratio to be shared equally between the Islamic banks and the enterprises since the research lacked privilege to get the data because of the sensitivity of the information. In addition, it is also assumed that the profit-and-loss-sharing ratios are distributed equally for all sampled periods (2000 – 2017) where some percentage discount rates are taken as profit (positive rate) some rates are regarded as loss (negative rate). Based on the analysis, NPV was ₦1,526.31 for Islamic mudharabah SMEs financing and (₦115,092.44) for conventional banks debt-financing. Mudharabah had a positive NPV indicating profitable for SMEs while usury had a negative NPV indicating a loss. The result implies that the mudharabah is far better and worthwhile for enterprises to grow and innovate than the usury source of finance.

Results and Conclusion

In this study, comparative analysis of the conventional bank debt finance (usury) and Islamic bank equity finance (mudharabah) sources of SMEs financing in Nigeria was carried to accomplish the objectives of the study and contribute significant to the body of the literature. It is aimed to establish whether conventional banks usury is more viable than Islamic PLS bank financing for SMEs growth and innovation using NPV technique. Since the research is a mutual exclusive loan decision problem, the decision rule for this method is to select loan option with higher positive NPV. Therefore, the finding revealed that SMEs under usury financing still owe the sum of ₦115,092.44 having paid ₦579,946.70 originally borrowed from the conventional banks representing 19.84% of the total amount borrowed. This inhibits growth and development of enterprises and worsen debt burden. Whereas SMEs had a net balance of ₦1,526.31 under mudharabah financing after ₦579,946.70 had been paid.

The result of this study confirmed the findings of previous studies carried out in this area. Siyanbola (2013) established that economic instability results from imposition of high interest rate on loan. As conventional banks impose high interest rates on customers, that rate is passed on to the cost of commodities which makes everything to be on the high side and unbearable to the small players, hence widening the gap between the rich and the poor, making the latter to be worse of as income inequality widen by the day.

In Islam and Christianity, the prohibition of usury is stated in very strong terms. The prohibition of interest has integrated into the Islamic economic system on or before the time of Caliph Umar. Similarly, the Biblical provision states that anyone who "hath given forth upon usury and hath taken increase -- shall he then live? He shall not live. He hath done all these abominations: he shall surely die. His blood shall be upon him" (Ezekiel Chapter 18, verse 13). Therefore, mudharabah is the only viable source of finance that promotes equity, income redistribution and enhances growth of SMEs in Nigeria.

Recommendation

Hence, the study recommends that SMEs should utilize Islamic bank mudharabah financing in order to raise profitable funds for investment, expand their businesses and acquire the latest technology that ensures their competitiveness and growth and that of the nation as a whole.

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Appendix 1

Table 2: Commercial Bank Loan and Lending Rate for SMEs in Nigeria.

Period	Actual Loan to SME (N million)	Bench Mark Conventional banks' Lending Rate for SMEs (Usury- %)
2000	44452.20	21.27
2001	52428.40	23.44
2002	82368.40	24.77
2003	90176.50	20.71
2004	54981.20	19.18
2005	50672.60	17.95
2006	25713.70	16.90
2007	41100.40	16.94
2008	13512.20	15.48
2009	16366.50	18.36
2010	12550.30	17.59
2011	15511.70	16.02
2012	13863.50	16.79
2013	15353.00	16.72
2014	15966.60	16.55
2015	10155.90	16.90
2016	11920.10	16.82
2017	12853.50	17.69

Source: Central Bank of Nigeria: Money & Credit Statistics (2017)

Appendix 2

Table 3: Descriptive Statistics

Lending Rate

N	Valid	18
	Missing	0
Mean		18.3378
Median		17.2650
Std. Deviation		2.58514
Skewness		1.439
Std. Error of Skewness		.536
Kurtosis		1.328
Std. Error of Kurtosis		1.038
Minimum		15.48
Maximum		24.77

Source: Authors' Computation (2018)