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Policy Brief

A Future of Equitable Access to Credit for MSEs Supported by a Strong Credit Information (CIS) System in Ethiopia

Why is Access to Credit for MSEs Supported by CIS Important?

MSEs add considerable value to Ethiopia's overall economy and harness' colossal untapped potential to develop and grow the country astronomically. Despite their pro- found economic impact, they face a variety of hurdles that has limited their ability to grow and achieve economies of scale at a healthier and feasible speed.

In Ethiopia, lack of access to finance is one of the major problems MSEs are facing (CSA, WB). Other macroeconomic indicators also lead to a similar surmise. For example, at the end of June 2020, private sector credit from Ethiopia's banking system accounted for only 14.4 percent of GDP, compared to 24.3 percent in Sub-Saharan Africa.

Although lower access to credit by the private sector (MSEs) can be attributed to a variety of supply and demand side micro and macroeconomic factors, in Ethiopia the crowding out effect of higher credit for State Owned Enterprises (SOEs) and lack of a well-developed credit information system have their own contributions.

The government owned Commercial Bank of Ethiopia (CBE), which controls more than 60 percent of the banking system's outstanding credit, continues to channel funds mainly to SOEs, mostly via direct government instructions. This leaves limited pool of credit for the private sector and even less credit for MSEs to tap into.

Furthermore, in the absence of a good CIS, the Financial Institutions (FIs) relay on collateral to protect themselves from credit risk. The Ethiopian CIS is limited in its scope and depth, leaving the FIs with no choice but to adhere to a collateral-based credit system, which has negatively affected MSEs ability to qualify for credit.

A Closer Look: The Current Policy Landscape

Access to Credit

Ethiopia's economic growth has been fueled by large public sector investments, especially through the large-scale financing of SOEs. These investments were financed with domestic and foreign borrowings and with public banks like CBE, who is serving as the primary lender in the domestic market. Despite the fact that the CBE has over 30 million deposit account holders, the bulk of its credit is going to a small number of large-sized public enterprises. The bank's two largest borrowers are the government owned Ethiopian Electric Power Corporation (EEP) and Railway Corporation (RC).

CBE's credit exposure to EEP amounted to Birr 302.3 billion at the end of June 2020, which is equivalent to 47.7 percent and 29.3 percent of CBE's and the entire banking system's outstanding credit, respectively. More importantly, the bank's total credit exposure to public enterprises accounted for 85.6 percent of its total outstanding credit. Not only are public enterprises favored in terms of access, but they also benefit from the favorable loan-terms offered by the bank. Those public enterprises often receive loans from CBE through government guarantees, often without thorough financial feasibility review, as the loan is extended by corporate bonds issued by public enterprises.

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Additionally, the interest rate on these corporate bonds range from 9-11.5 percent per year, compared to the 14-15 percent annual interest rate charged by the pri-vate banks.

The National Bank of Ethiopia (NBE) also played a major role in the credit market by adopting some policies that adversely impacted the credit provision to the private sector in general and MSEs in particular. One of these policies was the NBE-Bill Purchase Directive, which compels private banks to buy NBE bills equivalent to 27 percent of their disbursement, but the bank ceased it in November 2019. Such policies had an effect on private banks lending to MSEs by forcing them to rely on the remaining limited loanable fund to extend credit services.

Moreover, as these banks have to make a profit on the remaining funds alone, they were inclined to allocate funds towards well-established corporate firms which left a limited pool for MSEs. On top of directing the credit allocation of financial institutions, NBE provides direct credit to the central government. As of June 30, 2020, NBE's net credit to the government constituted 17.6 percent of total domestic credit by the banking system.

Consequently, the share of public sector credit eventually overtook that of the private sector, owing in part to the credit policies discussed. In 2003/04, public sector credit accounted for 2.7 percent of GDP, while private sector credit accounted for 17.3 percent. By surpassing credit to the private sector, credit to the public sector rose to 16.2 percent in 2019/20, compared to only 14.4 percent for the private sector.

The situation in other countries showed that private sector credit is substantially higher than the case in Ethiopia. While the private sector receives close to four-fifth of the total domestic credit, SOEs receive less than 3 percent in Kenya,

Rwanda's credit distribution also showed that the private sector receives the bulk of the credit with public enterprises receiving only a small portion. Similarly, in the case of Malaysia, the proportion of the banking sector's assets in the public sector's claims have been less than 5 percent. A study also claimed that the historical involvement of state-owned companies in Malaysia was a major reason for the decrease in investments into the private sector development in the country over the past decade.

Credit Information System

In principle, a strong CIS improves credit access by combating an adverse selection problem, reducing bank's potential ability to extract information rent, improving the borrower's discipline over default, and removing the incentives to over borrow from different sources (Jappelli and Pagano, 2000).

Ethiopia has only one Public Credit Reference Bureau (PCRB) established within the NBE but its value addition is minimal and not well developed. The CIS of Ethiopia is classified as one of the lowest or almost non-existent levels (WB Depth of Credit Information Index). This global index measures the rule that affects the scope, accessibility, and quality of credit information obtained from the credit bureaus worldwide. The performance of selected peer countries also indicated that the CIS in Ethiopia has lagged far behind.

In Kenya, Credit Reference Bureaus (CRBs) are owned privately by Transunion, Metropol and Creditinfo. In terms of service and product delivery, the increase in the numbers of CRBs has improved the depth and quality of services provided through enhanced competitions. The number of credit information recorded by private credit bureaus as a proportion of the adult population increased from 3.3 percent in 2010 to 36.4 percent in 2019. Moreover, Kenya scored eight out of eight for the WB Depth of Credit Information Index.

Correspondingly, in Rwanda, there are both public credit registry and privately-owned credit reference bureaus. Rwanda also scored eight out of eight for depth of credit information index while the figure is 3.9 for sub-Saharan average and 6.8 for OECD high-income countries. The coverage of the public credit registry was 1.4 percent of the total Rwandan adult population in 2012 which increased to 10.4 percent in 2019. Likewise, the private credit bureaus coverage also grew from 2.2 percent of adults in 2012 to 15.8 percent in 2019.

Another example is Malaysia, which has 7 private credit bureaus (PCBs) and 1 public Credit Reference Bureau. Malaysia's private credit bureau coverage (% of adults) reached 89.1 percent in 2019. According to Doing Business Reports, Malaysia ranked 37 in terms of getting credit rank. It is important to note that while the PCBs provide services that add value, including credit scores and rating the PCR does not.

The Way Forward: A Promising Policy Framework

Given the government's focus on the private sector in its Homegrown Economic Reform Program and its Ten-Year Development Plan, we advise the government to adjust its credit policy that favored SOEs and create a leveled playing field for the private sector with a focus on MSEs in particular. Additionally, a comprehensive and systemic approach that include a broad variety of policies and strategies are needed to address the MSE credit access problem.

The following policies and measures are recommended that could play a significant role in increasing credit access and improving the CIS in Ethiopia:

To increase access to credit for MSEs

- Introduce a well-designed partial public credit guarantee scheme to improve credit access in general,
- Introduce a regulatory sandbox to reap the benefit of digital technology,
- Use factoring to ease over reliance on traditional sources of financing instruments,
- Allow Purchase Order Financing so that MSE's get the funds they need to buy inputs and complete their customer orders,
- Strengthen the Warehouse Receipts financing scheme,

To improve CIS

- Gradually expand the CIS information to encompass full positive and negative credit data from micro-finance, capital goods financing companies, insurance companies, SACCOs, utility companies, and public records such as court records and tax authorities,
- Introduce a digital biometric unique national identity card,
- Allow the operation of Private Credit Bureaus (PCBs) to diversify products and services delivery and enhance its quality through competition,
- Digitize and automate CIS processes which will enable real-time credit information sharing through an online portal,
- Strengthen the existing Public Credit Registry's capacity in terms of both human resources and technology,
- Formulate a comprehensive national CIS policy roadmap,
- Ensure borrower's legal right and access to their credit data from the credit bureaus,

Note:

This document is an extraction and summary of key findings from a formal study conducted by Precise Consult International. Both primary and secondary data were used. While the former were collected via key informant interviews and focus group discussions, the latter were collected from different organizations as well as from internet resources. In addition, the study employed descriptive data analysis techniques and benchmarking of best-practice lessons for Ethiopia.

All data that were used in this brief are referred in detail in the full research document which can be found by visiting www.preciseethiopia.com or by email request to info@preciseethiopia.com.

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