Private Enterprise Development in Low-Income Countries

High Interest Rates and Low Bank Credit to MSMEs in Zambia: Do Switching Costs matter?

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Using data collected from a sample of small firms in urban Zambia, this project investigates the existence of switching costs among Micro, Small and Medium Enterprises (MSMEs) when borrowing from commercial banks, and finds no evidence of MSMEs getting 'locked in' by their main bank. While additional research is required to test their robustness further, these findings suggest that MSMEs' lack of collateral and banks' lack of adequate information, rather than switching costs, might be driving the high interest rates and low volume of formal credit offered to MSMEs in LICs.

The problem of high lending interest rates and low access to formal bank credit faced by Micro, Small and Medium Enterprises (MSMEs) in many low-income countries (LICs) has been a cause of concern to policy makers. MSMEs account for 56% of jobs in Zambia and represent over 80% of businesses registered at PACRA (Figure 1). For the vast majority of these MSMEs the high cost and low volume of commercial bank credit are major obstacles that affect their growth. While there are various reasons for this – some that are specific to enterprises, banks and regulators – the low level of competition among banks stands clear, which might well be due to the existence of 'switching costs'.

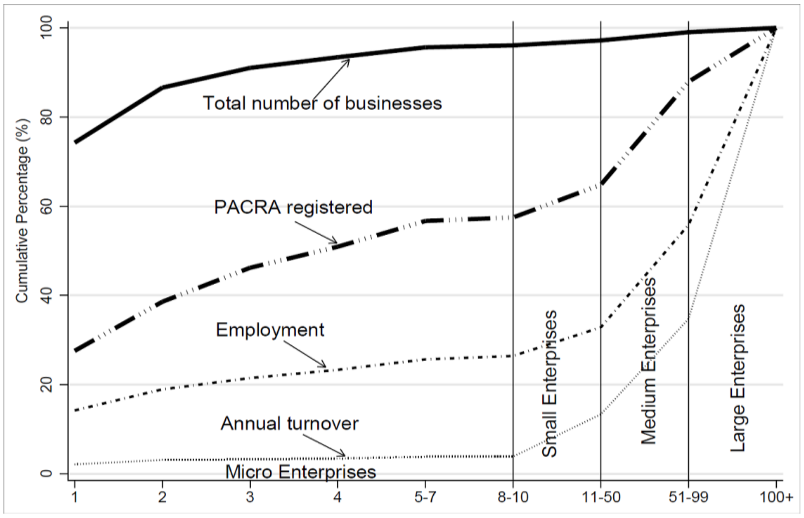

Figure 1 – Enterprise characteristics by number of full-time employees

Switching costs refer to the difficulty of leaving the current lender or main bank and joining another that offers more favourable credit terms. Among MSMEs, switching costs are likely to be crucial in developing countries like Zambia, where many MSMEs lack the adequate information and collateral required by banks for granting loans. As a result, bank lending to MSMEs is often based on a pre-existing relationship between a bank and a borrowing firm. Unfortunately, many small firms only establish a single relationship with one bank due to the substantial amount of time and other resources involved in building a relationship. This makes MSMEs vulnerable to 'capture' or 'lock-in' by their main bank, because it is only the main bank that has 'privileged' knowledge of the firms - i.e. information that is unknown or cannot easily be verified by competitor banks. The main bank can then harvest their locked-in MSME borrowers by charging them non-competitive high interest rates.

While switching costs have been shown to play a significant role in determining the level of competition in some developed countries, evidence on the existence and size of switching costs among MSMEs when borrowing formal bank credit in developing countries is currently sparse. One of the reasons for this lies in the difficulties in accessing or gathering the necessary data required to perform the investigation. Commercial banks are unwilling to provide the data on MSME borrowers, while central banks don't collect this information at all.

Evidence from Zambia

In order to investigate the existence of switching costs in Zambia, we first examined whether there is significant persistence in MSMEs' repeated choices of main bank by analysing the relationship between past and present choices of main bank by MSMEs. In order to account for the possible persistence in unobserved factors that influence both current and lagged choices and might confound the estimates on their relationship, we used an empirical framework that was capable of isolating the effect of switching costs from the spurious correlation in repeated choices. In another specification, we tested for the existence of 'locked in' banks using the interest rates that MSMEs report being charged on their loans by their main banks.

Figure 2 – Small construction firm surveyed for the study

Following the refusal by commercial banks and the credit reference bureau to provide data on MSME borrowers, data was collected from a sample of MSMEs located in urban areas of Lusaka, Ndola, Kitwe, Choma and Livingstone. Each research assistant canvassed a delineated geographical area – usually a street, avenue or section. Every MSME defined as an enterprise with sales below K10 million per annum and which had borrowed at least one loan product between 2008 and 2013, was interviewed. 57% of the 350 MSMEs that operated over the period 2008-2013 and provided information on all variables that we needed, conducted their businesses in the retail and wholesale trade sectors. 10% had switched their main bank at least once.

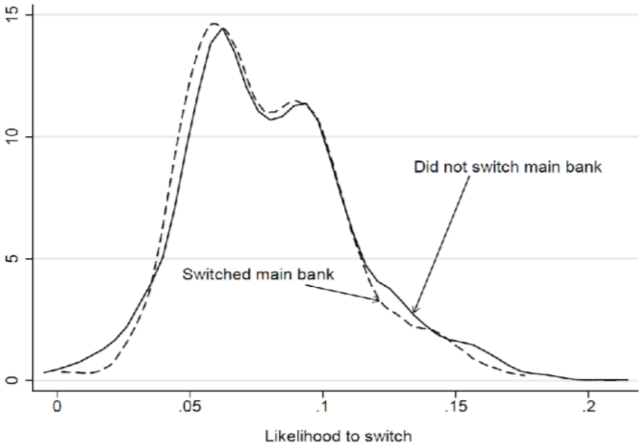

Figure 3 – Distribution of the MSMEs' propensity scores for switching main banks

The costs and effects of switching

Results from our dynamic probit model show that MSMEs' choices of main bank do not persist over time, signaling the absence of switching costs. Based on results from the average treatment effect on the treated and propensity score weighted regressions, we also found that switching main banks has no effect on lending interest rates. This also constitutes evidence against the existence of switching costs, as it suggests that MSME borrowers are not 'locked in' to their main bank – if they were, our analysis of interest rates would have likely yielded evidence that main banks abuse their 'incumbent position' by charging their MSME borrowers higher than competitive interest rates.

These results are among the first to document the absence of switching costs among MSMEs and investigate their existence in a developing country like Zambia. However, while the results are informative, they are not persuasive and require caution. Specifically, they do not show the mechanism through which switching costs are absent, despite the compelling argument that MSMEs are vulnerable to bank harvest due to their informational opaqueness and lack of collateral. Further, we do not completely rule out the bias due to sampling and the use of a small sample.

Nevertheless, the results suggest that MSMEs are not 'locked in' or captured by their earlier choice of main bank and long-term relationships between banks and MSMEs hardly exist. They also suggest that banks don't use discounts on lending interest rates to attract enterprises from competitor banks.

Policy Implications

If there are no long-term commitments from MSMEs towards their early choice of main bank, it is likely that relationship building between commercial banks and MSMEs is neglected and weak. While the absence of switching costs is a good stimulus for competition, it is also likely that this contributes to explaining the prevalence of high interest rates and low volume of credit available to MSMEs in Zambia.

It is also plausible that the uncompetitive structure of formal credit markets in developing countries is rooted in the broader issue of asymmetric information between lenders and borrowers. In other words, banks might be lacking the practical knowledge of how MSMEs conduct their business necessary to properly determine MSME business risks. There is, therefore, a need to bridge the gap and to ensure that more stable and sustainable relationships are built between banks and MSMEs. One option would be to consider creating an institution that can provide business development services to MSMEs by intermediating between banks and MSMEs.

The major ramification of our results is that MSMEs don't commit to their early choice of main bank for a long time. It is therefore likely that relationship building between commercial banks and MSMEs is very weak. It also means that the likelihood of MSMEs to borrow based on soft 'proprietary' information quite is low. As a result, commercial bank lending to MSMEs is likely to be practiced at 'arm's length' interaction that require 'hard' credit information. However, the informational opaqueness of MSMEs suggests that 'relationship lending' might be the optimal lending technology in the shorter term.

Moving Forward…

One important focus for future research that is relevant to policy makers would be to explore the types of interventions that can lead to long-term relationships between banks and MSMEs. These mechanisms should be designed and evaluated on how well they can resolve information asymmetry and promote risk-sensitive pricing in bank lending to MSMEs.