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LENDING MONEY

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LENDING MONEY

"Neither a lender nor a borrower be" Polonius

In this paper, I have put down some very tentative thoughts on loans, firstly as they are used in financing small-scale African enterprises, and secondly as a service African businessmen give to their customers. These remarks arise out of research in progress, and may well need to be revised when the findings are more complete, and have been analysed. Meanwhile, I hope what follows will suggest a few ideas for discussion, in a field of development where there are many problems, little previous experience and knowledge to go by, but already hopeful progress.

The development of Kenya depends much on lending money - by foreign governments to the Kenya Government; by the Kenya Government to farmers, co-operatives, settlers, businesses; and by these in turn, sometimes, to their customers. Few of these loans are strictly commercial, in the sense that the lender is looking for the most profitable return on his investment. They are part of a development strategy, where the lender's aim is to promote economic growth as efficiently as he can, rather than to make the safest or largest profit.

The need for these loans usually arises because the investment is too uncertain, or the profit too small, to attract commercial capital. The borrower may have little or no security to offer, his credit-worthiness may be impossible to assess, the viability of his enterprise may be speculative. The purpose of the loan is, therefore, to supply a need for capital where commercial safeguards against bad risks, and sanctions against default cannot easily be applied. And the lender is looking for a different kind of return: even if he loses money, he has achieved his essential aim if he has promoted a significant growth in the economy.

Such development loans cannot, then, be treated as if they were straightforward commercial loans. They involve a different kind of relationship between lender and borrower, where mutual trust and understanding are much more important. The lender cannot simply calculate the rate of profit that would justify the risk, and secure himself by legal contract against too severe a loss. He has to explain the kind of development he hopes to achieve, and find borrowers who want to achieve it, trusting very largely in the sincerity of their intentions.

His first problem, of course, is that his confidence may be abused. The borrower may not use the money for the purpose intended - a government builds a palace instead of irrigation works, a farmer gets a new wife instead of fertilizers and ploughs. But apart from such bad faith - as the lender sees it - there are, I think, great difficulties in working out the expectations and obligations of such a relationship between lender and borrower, even where the intentions of both are sincere.

Here I want to discuss a particular strategy of lending, which can be illustrated, for instance, by the Industrial and Commercial Development Corporation's small industries loan scheme. A limited amount of money is provided for a revolving fund, which is lent at a rate of interest high enough to cover the cost of administering the fund, and to service the debt which the government itself may have incurred in setting it up. The loans are to be repaid by instalment over about seven years, so that the fund can, in fact, revolve. Since the purpose of the scheme is to promote African enterprises in a field where as yet few are established, it has little experience to guide it in assessing the viability of projects put to it, or the competence of the applicants. Nor can it insist too much on adequate security, so long as the scheme hopes to encourage talent held back for lack of access to capital - since some of these talented people will have little by way of security to offer. At the outset, promising projects are examined, and the hopeful ones financed, without strict regard for guarantees.

Inevitably, there are disappointments. Ventures fail through mismanagement, technical difficulties, lack of a market. A new bakery attracts more determined competition from those already established, and cannot sustain a price-cutting war. A sawmill fails to obtain an allocation of forest timber. Machines do not turn out a satisfactory product. A partnership breaks up in recrimination, and when the books are gone through, a great deal of money has disappeared. Some of these misfortunes are bad luck, and could not have been foreseen, but meanwhile the revolving fund is being drained, and the whole operation endangered. The scheme has, then, to become tougher in self-protection. It begins to insist more strictly on security, and to control more closely the way the money is spent. So, for instance, the I.C.D.C. generally prefers to give loans for machinery, workshops, and other recoverable assets, rather than for working capital. And it pays for these itself, once the borrower has placed his orders, so that it can be sure that the loan is spent exactly as agreed. If the instalments are not repaid, it can then insist that the assets are sold up, and at least recover some of its money. It must, of course, be prepared for this, and has a responsibility to protect its resources. But the safeguards can have awkward consequences.

If an enterprise is chiefly dependent on government loans, then it needs government help as much, or more, for working capital as for machinery: otherwise there will not be enough money to keep the machines working. Once a business runs into difficulties, they quickly become cumulative. A machine breaks down: by the time it is repaired, the business has run out of money to fuel it or feed it supplies, so the business shuts down again. By then it is losing its customers, the I.C.D.C. is beginning to press for its instalments on the loan, and within a few months of starting, collapse may already be near. At the same time, since loan repayments begin usually six months after the granting of the loan - when the machinery bought with it may scarcely be installed and fully working - there is almost no margin to allow for unforeseen difficulties.

I do not mean to suggest that this is what happens to most of the enterprises supported by the I.C.D.C., or that the I.C.D.C. is wrong to guard its fund carefully. But there are some, I think, whose chances of success would be greater but for the conditions under which the loan is granted. That is, the regulations needed to protect the loan fund from depletion tend to inhibit the flexibility needed to give every enterprise supported the best chance. A lending institution like the I.C.D.C. has therefore to make an uncomfortable choice. If it insists on its regulations, it may have to wind up enterprises which with more time, more advice, and perhaps more money could succeed: and it will still lose a part of its investment. If it relaxes its regulations, then it is likely to lose even more. The choice depends in part on what it takes as its criterion of success. If, fundamentally, the purpose is to promote viable new enterprises, then so long as this happens, it is less important that the loan fund may become exhausted in time through default. But, naturally enough, a public institution accountable for its management tends to become preoccupied with the protection of the fund.

It can happen, for instance, that an enterprise which could afford to repay its loan instalments instead uses the money for further development - hiring overseas advice, installing electricity, replacing unsatisfactory machines with more efficient ones. The managers of the business may well be right that the investment is crucial to their progress, and the returns will justify it. But the lending institution cannot look at it this way. The fund depends on regular repayment of a fixed sum on a fixed day. It does not stand to gain anything by deferring payment, though the business itself may become much more profitable. A loan scheme cannot compensate for its support of businesses which fail by a higher return from those which succeed. Considered simply as a financing organization, the scheme is not concerned with the development it has promoted, but only with getting its money back.

In general terms, this is the paradox. The government wants to promote economic enterprise, and enable people with talent and initiative to exploit it. Government only needs to provide capital itself, where commercial capital is not willing to invest - that is, where the risks are high. So, to fulfill their purpose, the loans must go where little security can be offered, where there is little previous experience, and a great many unknowns. Inevitably, there are losses, and in reaction, government is likely to take one of two courses. It may restrict its loans to those who have experience and adequate security, or impose tight regulations. If it does the first, it may become redundant, lending where private capital would be equally willing to invest. And if it does the second, it may create conditions which many potentially viable enterprises cannot meet. It may also go so far in control that the borrower feels he has lost the initiative, and leaves the lending organization to run his affairs. When things go wrong, he looks to the lending body to tell him what to do next, while they expect him to assume the responsibility. Between the two, the situation may deteriorate irrevocably - the lender threatening to sue for his money, while the borrower is still petitioning for help and further funds. There is sometimes genuine confusion over the legal responsibilities the borrower has entailed. He tends to see the loan as part of a mutual co-operation in development - as indeed it is. But the lending institution tends to repudiate any responsibility for success or failure, insisting on the contractual commitment to repay, regardless of circumstances.

The relationship is, therefore, very difficult to establish on a basis of mutual understanding. Both lender and borrower share the belief that men with the initiative to start new enterprises deserve to be encouraged, and that this will create employment and a larger African share in the money economy. It is probably the African businessmen and progressive farmers who are doing most to pioneer the social changes in values and working habits on which development depends. But, though they share the same aims, the interests of lender and borrower tend to diverge as soon as problems arise. The first becomes preoccupied with saving his capital, the second with saving his enterprise. So, for instance, while the I.C.D.C. may be pressing for the repayment of its loan, the business is still talking of further loans, replacing obsolete machinery with more modern, diversifying its activities, or opening new branches to increase its market. And it seems that sometimes, to limit its risks, the I.C.D.C. may have been reluctant to grant enough for efficient machinery, and especially for working capital, to ensure the most promising start. And being short staffed, it cannot give much time to supervision and advice. By the time a business is in serious difficulties, it may be reluctant to approach the I.C.D.C. frankly, fearing that if it reveals the extent of its problems, it will only remind the I.C.D.C. of its indebtedness.

Given these difficulties, I wonder whether a loan represents most appropriately the kind of relationship the I.C.D.C. is trying to establish with the small industries it supports. From its own point of view, loans have the disadvantage that the return is the same, irrespective of the success of the enterprise. It loses on failures which cannot repay, but cannot balance the loss by sharing in the profits of its successes. Having no part in the management, it cannot easily influence the operation of the business, once it has agreed the loan. From the point of view of the business, the conditions under which the loan is granted leave very little margin for unforeseen difficulties, and may even inhibit the proper use of the new assets for lack of uncommitted resources, while the obligation of the loan instalments easily makes the I.C.D.C. seem - through no fault of its own - less a partner in development than an intimidating creditor.

Would it make more sense to replace loans by the investment of equity capital in these businesses? This represents more nearly, I think, the kind of co-operation which government is trying to establish, and meets most of the problems discussed above. When an enterprise is well-established, government should be able to recover its investment at a profit; it has a right to be represented in the management; the capital it has invested does not have to be repaid on pre-determined dates, irrespective of the needs of the business; it could be less specific about the particular use of its contribution; and it would be much more continuously in touch with the progress of the enterprise. There should probably be, also, a central auditing service to supervise the book-keeping. No doubt there are disadvantages to such a scheme, too. There would no longer, for instance, be a strictly revolving fund - though I doubt whether it is very realistic to suppose that any such fund can be self-sustaining for long, given the high risks of promoting small businesses in new fields. So the alternative of investment seems at least worth considering.

If it is not practicable, then I wonder whether there might be more emphasis on advice and training, rather than loans alone. Fewer or smaller loans, backed by an advisory service, would, I think, in the long run contribute more to development. Advisory services are expensive - especially as they can be worse than useless, unless the advice is really competent and imaginative, and so need well-qualified personnel. But part of the cost might be saved by inviting businessmen already established to volunteer their services as occasional consultants in their field, organized through the advisory service. Already some of the businesses get very useful advice in this way, learning from each other's experience. And I have never heard of anyone refusing advice, for fear of giving a competitor an advantage: African businessmen seem very ready to help each other in this way, with little sense of rivalry.

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I turn now to another kind of lender-borrower relationship.

The granting of credit to customers is one of the most widely acknowledged reasons for the failure of African businesses. African shopkeepers themselves list credit amongst their outstanding difficulties, and they would advise a newcomer to business to give little or no credit at the outset. Yet it seems that nearly all of them do give credit, and often lose money by it. In one market centre near Nairobi, for instance, about 90% of the businesses give substantial credit, and more than four fifths of these have incurred bad debts. The amounts are not large - from less than a hundred shillings to five thousand, with about half of the businesses owed more than four hundred shillings which they are unlikely to recover. But since many of these businesses probably do not realize more than two hundred shillings profit in a month, the loss is serious.

These businesses do not give credit indiscriminately to all their customers, except for a very few. They give to regular and reliable customers, as they say, people they know, those with regular salaries, teachers and government employees, friends or prosperous farmers. But their judgement of who can be trusted is evidently not very sure, since they lose money just the same. And it is not always easy to take effective action against those who do not pay. Although most say they are prepared to take defaulters to court, only a minority have ever done so, and the outcome sometimes hardly justifies it. Each individual debt may be too small to justify the expense, especially as the debt may still not be paid, inspite of the court order. And many of the businessmen fear to make themselves unpopular by initiating prosecutions, when it comes to the point.

At the same time, only half the businessmen in this market believed that they needed to give credit to retain customers. About two fifths give credit, lose money by it, and yet maintain that they need not do so to run a successful business. It is hard to say exactly why: they are influenced, I think, by prevailing custom, and by a sense of obligation to help people who could not otherwise afford to buy. But it seems clear that credit is not generally given simply to secure a commercial advantage. Most businessmen, if they set the loss of customers through refusing credit against the loss through bad debts of giving it, would almost certainly decide against credit. This is the advice they give, but do not follow. Credit seems at least in part a response to expectations in the community which they do not like to repudiate.

The relationship between a shopkeeper and his credit customers has, then, this in common with the relationship between government and the enterprises it lends to: in neither case is the money lent primarily for commercial reasons, but rather because the lender sympathizes with the borrower's needs, and believes that by helping him, he will be helping the progress of the community. And in both cases, it is hard to pursue defaulters ruthlessly without contradicting these altruistic aims. At the same time, the lender is open to exploitation, because he has few sanctions he can apply, is reluctant to make himself unpopular or cause hardship by applying them, and cannot easily judge who will prove trustworthy. With the shopkeepers as with government loans, part of the trouble lies in the different circumstances of lender and borrower, which make their interests hard to adjust.

The shopkeeper is buying his stock, usually for cash, and if he can get credit at all from his suppliers, it seldom runs for more than a month. So he works to a monthly cycle, while his customers are chiefly farmers, whose economic cycle is seasonal. It seems, once you think of it, odd that credit in an agricultural country should be tied to the monthly wage packet, when most people are not wage earners at all, but must wait for the harvest. But there is nothing the African shopkeeper can do about this, since his own access to credit is very restricted, if he has any at all - far more restricted than for the Indian shopkeeper with whom he competes, or the Indian wholesaler from whom he typically gets his stock, but who seldom trusts him with an advance.

At the same time, the farmer's attitude to credit may be influenced by a tradition of mutual help which is not governed by a strict timetable, especially where farming has not yet been greatly influenced by cash crops and government loans. A plough contractor in the coastal region, for instance, failed because his customers treated the service as they were used to treat help from a member of their community - as an obligation to be repaid as and when they could. But meanwhile, fuel had to be bought for the tractors, repairs paid for, loan instalments repaid. He was reluctant to take anyone to court, because he was genuinely concerned to promote the agricultural progress of his district, and did not want to discourage people from adopting modern techniques by associating them with legal prosecutions. The business failed, but he did succeed in demonstrating the value of using tractor driven ploughs, and he believes that if such a business were started again, people would now be more willing to pay promptly. Someone else will probably gain the advantage of his pioneering.

His experience can be compared with another plough contractor on a settlement scheme on the coast, who did very well, and now has several lorries and tractors bought with his own money, besides the equipment acquired through a government loan. Both men, as it happens, gained new ideas partly from their army experience, and while the one who failed had a few years primary education, the successful had no formal education at all. The different fate of their enterprises was not, I think, determined by differences in their competence or purposefulness, but rather by the difference between the communities in which they were living. The farmers on the settlement scheme were more familiar with the demands of a money economy, and they formed a more impersonal community from different regions, recently promoted by government action. So they were already conditioned to understand the need for prompt payment of the tractor's hire, and for sanctions against default.

As the country makes progress, I think successful businesses will give less and less credit, and more selectively. The businesses supported by the I.C.D.C. which I have met, who represent the more ambitious enterprises growing out of communities and market centres, are much less ready to give credit: about a third none at all, and the rest only cautiously. They have learned by experience. About a third have accumulated bad debts in the past, sometimes running into thousands of shillings. A few have begun to use hire purchase agreements, or ask for security. So it seems that as businesses grow more sophisticated, and larger in scale, the prevailing practice of credit begins to disappear. There is a popular picture, which you may find in shops up and down the country - printed I think in America early in this century. On the left, a harassed man, head in hand, sits despairingly amongst a pile of papers. On the right, a prosperous looking gentleman with a comfortably round waist stands in front of his safe, smiling complacently. The caption on the left reads 'I have given credit' and on the right 'for credit come tomorrow'. (And when tomorrow comes, of course, the customer will get the same answer). The future seems to lie with a philosophy of strictly cash transactions.

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Both these examples of a relationship between lender and borrower show how difficult it is to establish a pattern of obligation which is workable from both points of view, when the concern is not merely with a mutual calculation of financial advantage. The lender's desire to promote the well-being of the community makes strictly commercial terms inapplicable, but no other really satisfactory control takes its place. The outcome tends to be an uneasy hesitation between legal enforcement and a desire to maintain goodwill and co-operation for the future. In the end, businessmen are seeking to extricate themselves from a kind of relationship which causes more trouble than it is worth, while government may be wise to do the same, and look for other terms on which to co-operate in the development of private enterprise. (And it may be that the same is true of international loans to developing countries: the relationship is certainly uneasy, and fraught with a good deal of mutual disappointment). We need, I think, to search more imaginatively for ways of distributing capital for development, which can embody more effectively the mutual purpose, and establish a pattern of expectation which both parties can meet. In the promotion of enterprises, the solution may lie in a scheme of government participation through equity capital; for retail businesses, in offering, perhaps, discounts to customers who deposit money in advance. But whatever the solution, it will have to be worked out in terms of social controls which people can abide by, and represent values and interests which they share.

The notion of 'security' sums up the whole problem. For security in the sense of attachable assets is only a means of achieving security in the wider sense of protection against risk. But in the circumstances of a developing country, like Kenya, ambitious to for rapid progress and new forms of economic activity, the risks are bound to be high. The question is not, I think, how to avoid risk, but how the risk can be most fairly distributed. The security which most people can offer is their land. But given the deep attachment to land, and the ultimate dependence on it for livelihood and protection against hardship, how many people can really afford to hazard their land for business ventures? When it comes to the point, will government be ruthless enough to demand this sacrifice as the price of failure? Is it after all fair that those who pioneer new enterprises should take so great a risk? I would guess that most businessmen, when they give their land as security, do not seriously consider the possibility that they will lose it. Nor, so far as I know, has anyone yet been forced to sell his farm through his business failure. The common practice of securing loans against land may well not be an equitable way of sharing risk, and recognising this, it may not be enforced.

In practice, the government is generally seen as the carrier of risk - not only by those who seek loans, but by banks which, it seems, seldom accept any responsibility to venture their capital in the promotion of the African economy. The government can take it all. But, of course, if the government did, indeed, shoulder all the risks, there would be little incentive to those who receive loans to make every effort to justify the privilege of a share in scarce development capital. So, on the one hand, the insistence on security from the borrower tends to force him, in principle, to risk his whole livelihood; while reliance on the government's ability to spread its risks, leaves the borrower too little committed. What is needed, I think, is a system which ensures that both government and businessmen, or business-man and customer, distribute the risks equitably, in terms of their own resources. That is, each undertakes a risk which, given his circumstances, is neither ruinous nor trivial. He will then carry a manageable share of the burden of insecurity which is the inevitable counterpart of progress. But in seeking to share this burden fairly, we need, I think, often to look for other ways to express it than the form of a commercial loan.