WHITE PAPER

SECURING AND ENRICHING NIGERIANS AT SCALE

PROSPERITY INCLUSION THROUGH FINANCIAL SECTOR INNOVATION

BY THE
NESG FINANCIAL MARKET AND FINANCIAL INCLUSION POLICY COMMISSION, IN COLLABORATION WITH ZEDCREST GROUP

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Executive Summary

Nigeria has maintained a positive economic growth trajectory since the economy exited the COVID-19-induced recession in Q4-2020 (National Bureau of Statistics (NBS), 2024a). However, the economy is still plagued by several macroeconomic challenges, including a high inflation rate, which rose to a record high of 33.69 percent in April 2024, external imbalances and exchange rate volatility. Besides, the economy continues to witness increasing unemployment and underemployment rates, rising poverty levels, inequality, and insecurity. These challenges have persisted over the years due to skewed and declining growth performance, with growth concentrated in a few sectors that cannot support the macroeconomy and generate inclusive social outcomes.

Resolving Nigeria's socio-economic issues depends on the ability of the different sectors of the economy to expand and contribute positively across board. Beyond developmental targets like the National Development Plan (2021-2025) target of lifting 35 million people out of poverty by creating 21 million full-time jobs by 2025, there is a need to drive improved productivity across major sectors of the economy. Also, due to the share of Micro, Small and Medium Enterprises (MSMEs) in the economy, there is a need to drive scale in MSMEs and expand their capacity to contribute to output growth, job creation and macroeconomic inflows in terms of revenue, export, and foreign exchange earnings.

In light of the current realities of constrained government finances, Nigeria needs to drive inclusive development and the mobilisation of private investments (domestic and foreign) to create expansion in economic opportunities and inclusive prosperity. Foreign Direct Investments (FDIs) in Nigeria have consistently been below $1.5 billion per annum since 2016 (NBS, 2024b), a meagre amount compared with countries like Egypt, Indonesia and Malaysia (World Investment Report, 2023). At the centre of investment mobilisation is the financial sector, which needs to be rejigged to take up this responsibility. While recognising the impacts of structural factors such as an unfavourable business environment, infrastructural deficit, policy inconsistency, and regulatory bottlenecks on Nigeria's investment growth, inefficiencies in the financial system also undermine the inflow of investments into the country.

Indeed, the government needs to tackle the problems of insecurity, exchange rate volatility, and infrastructure deficit, which impact investors' confidence. However, the financial sector needs to step up its role of mobilising resources from savers to investors to drive expansion in investment across the economy, especially for MSMEs. The Central Bank of Nigeria (CBN) has been contending with a system liquidity bulge for many years, with measures ranging from interest rate manipulation to direct debit on Deposit Money Banks' (DMB) reserve balance. The liquidity needs to be channelled to productive activities, which leaves a heavy responsibility on the financial sector.

1.0 Introduction

Financial Sector and Economic Expansion: Mobilising Domestic Resources for Inclusive Prosperity

Nigeria is currently confronted with myriad challenges, including rapidly stagnating development progress and the growth of its core productive and sensitive sectors. The unemployment rate has maintained its upward trajectory, coupled with an elevated inflation rate and continual loss of value in the naira, among many other challenges. Despite various poverty alleviation programmes targeted at reducing poverty, Nigeria's poverty profile has remained grim, with 63 percent of the population living in poverty, according to available statistics (NBS, 2022).

Macroeconomic instability and insecurity issues have resulted in businesses' cautious approach to pursuing expansionary plans. The effect is also negative for foreign investors as it depletes the confidence in Nigeria as an attractive investment destination. While the real sector depends on both fiscal and monetary discipline, the unconvincing macroeconomic backdrop has seen Deposit Money Banks remain cautious about increasing the flow of credit to the real sector, particularly the MSMEs. The unmet financing need of MSMEs was estimated at NGN13 trillion in 2022 (US$32.2 billion) (International Finance Corporation (IFC), 2022). Meanwhile, a survey report published by the Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) in 2022 showed that MSMEs contributed 46.31 percent to the GDP and accounted for more than 95 percent of the labour force (Kippa, 2022). Though credit to the private sector continues to expand, it has favoured the oil and gas industry and large manufacturing businesses (Dong et al., 2023).

Indeed, the government needs to tackle the problems of insecurity, exchange rate volatility, and infrastructure deficit, which impact investors' confidence. However, it is very important for the financial sector to step up its role of mobilising resources from savers to investors to drive expansion in investment across the economy, especially for MSMEs. The Central Bank of Nigeria has been contending with a system liquidity bulge for many years, with measures ranging from interest rate manipulation to direct debit on DMB reserve balance. The liquidity needs to be channelled to productive activities, which leaves a heavy responsibility on the financial sector.

Attracting Foreign Capital to Nigeria

Generally, the financial sector in Africa is shallow. Still, Nigeria is among the four African countries with a relatively developed financial sector besides South Africa, Egypt and Kenya. Nevertheless, Nigeria has not leveraged this position to attract considerable investment inflow. Despite double-digit interest rates obtainable in Nigerian markets and potential opportunities for investment in the real sector, the flow of global excess liquidity eludes Nigeria. Also, Nigeria's capital importation composition has always favoured Foreign Portfolio Investments (FPI) (NBS, 2024b). This investment category is termed "hot money" due to the transient nature of such investments, which reflects the fragility of Nigeria's financial sector, the lack of confidence in the economy and the unsustainable nature of the foreign investments the country attracts.

Despite its size, Nigeria has lost its spot as the favourite Foreign Direct Investment (FDI) destination to countries such as South Africa and Egypt. Since 2016, Nigeria's FDI inflows have remained below US$1.5 billion per annum. It stood at US$468 million in 2022 (NBS, 2024b) compared with US$11,400 million in Egypt in the same period (World Investment Report, 2023). Nigeria's poor foreign investment inflows could be attributed to age-long structural factors, including the infrastructural deficit, policy inconsistency, insecurity, and lopsided foreign exchange management, constituting an unfriendly business and investment climate. Foreign capital, particularly FDI, benefits host countries because it helps enhance firm productivity, integrate domestic firms into global markets, and support the macroeconomy.

Striking a Balance Between Innovation, Regulation and Consumer Protection in the Financial Sector

Technological innovations have radically transformed the financial services sector, benefiting consumers and the economy. As a result of this digital transformation, customers—many of whom were financially excluded or underserved—can now carry out financial transactions such as payments, fund transfers, and investments, amongst other things, using their computer or mobile phone. Access to global markets can now be seamlessly made possible, offering customers access to a wider range of investment opportunities, from global equities to alternative investments.

However, as these digital financial services and related delivery channels become more widespread and commonplace, questions are being raised about whether the sector is well-regulated enough to ensure that consumers and investors are adequately protected. Hence, there must be a balance between encouraging innovation and effective and efficient regulation. Ultimately, it is incumbent on regulators to strike a balance and allow companies operating in this industry the space to continue operating at the cutting edge of innovation sensibly and safely.

2.0 Financial Sector and Economic Expansion: Mobilising Domestic Resources for Inclusive Prosperity

Inclusive prosperity is when everyone has the opportunity, resources, and education to take advantage of economic growth, technological advancements and globalisation, irrespective of financial status. Inclusive prosperity in Nigeria borders on three major factors; education, respect for the rule of law, and security.

Issues Identified

- **Poor Financial Literacy:** Despite financial institutions having the right products in the right areas, people do not take advantage of them due to a lack of informal or formal education. The absence of education or suboptimal education hampers inclusive prosperity, and as a result, the rich available resources do not get to the end-users. For instance, many interventional target funds in different government establishments remain untapped because information and knowledge gaps are existential.

- **Insecurity and Disregard for the rule of law:** Disregarding the rule of law results in influential people skewing available opportunities only to their favour, which leads to an increase in the number of the top echelon of society at the expense of the lower class. Hence, making access to credit facilities and funding one-sided. Also, the state of security in the country creates an unfavourable environment for doing business. In a society where insecurity is a significant issue, it is nearly impossible to achieve the objectives of financial inclusion.

- **Perceptions about MSMEs:** Lack of understanding of the demography of the MSMEs. About 74 percent of the MSMEs are in the Nano space and were only captured under the MSMEs' nomenclature in 2021 (SMEDAN, 2021). The major challenge is that the system excludes the Nano businesses by design, affecting their scalability. Financial institutions are more corporate-focused and prefer to give out loans to matured companies on the premise that larger companies are not likely to be defaulters.

- **Regulatory Constraints:** As a regulated entity, financial institutions cannot lend to an unregistered entity. Despite an established and well-regulated financial system, a hungry but unregistered productive sector exists amid excess liquidity. Hence, the financial institution can only transact with bankable MSMEs. While much of the focus is on commercial banks to solve MSMEs' access to finance problems, commercial banks are not designed to solve microfinance problems. Commercial banks are designed to serve specific categories of people called wholesale bankers, and any efforts of MSMEs to seek help from commercial banks could be frustrating.

- **Lack of well-structured policies on inclusive prosperity:** Policies around solving the problem of inclusive prosperity are not well structured. Pre-distribution policies that equalise opportunities by capturing people outside the prosperity net and ensuring they contribute to the productivity net are poorly developed.

Recommendations

Regulators and policies’ role in inclusive prosperity

- **Improve public education:** It is important to educate the public. Problems arise in society due to a lack of formal or informal education, which creates information gaps. Therefore, it is crucial to equip societies with the correct information to take advantage of opportunities and turn them into wealth creation. The public must also self-educate, acquire more knowledge, and keep track of global trends to maximise opportunities.
- **Ensure stakeholder engagement:** Everyone has a role to play. There is a need to define roles clearly to ensure that products are sustainable. For MSMEs, the obligations must be clearly defined. Regulators should not work in silos and develop measurable indices to facilitate market growth.
- **Implement enabling policies:** Regulating and developing the market, and connecting the dots in stakeholder identification and engagement is crucial. Strategic policies need to be implemented to include businesses in rural and underserved areas. Regulations should also allow for an accessible collection of loans to ensure a continuous flow of credit.

Financial Sector's role in inclusive prosperity: Adopt inclusive financial market strategies

- Agency banking strategies should be supported so that financial institutions continue offering valuable products that meet consumers' needs in rural areas.
- Financial institutions should adopt an investment banking market strategy that involves reaching out to people in the lower income bracket, e.g., the market man or woman, and grooming them through the banking process to ensure they become bankable.
- Financial institutions should leverage existing MSME clusters and mobilise resources using the clusters as gatekeepers to reach those needing funds to unlock potential in the space.
- Understanding the demography of MSMEs and domesticating solutions to solve peculiar problems is imperative. To foster inclusion among women, create women-led groups or clusters. Cooperations should partner with these clusters and act as gatekeepers in mobilising funds.
- Commercial banks should introduce an investment banking go-to strategy, including Nano and micro-businesses, instead of focusing only on the big corporate businesses.
- **Promote Financial Literacy:** Financial institutions should partner with traditional and religious leaders to teach the marginalised population the benefits of financial literacy.

SMEs’ role in inclusive prosperity

- Adopt financial record keeping, environmental and business study research to ensure business structure and access to credit and funding.
- Build a credible character regarding credit facilities and capital remittance.
- Small businesses should be structured because lenders are more comfortable with structured platforms. There is a need to catalyse business registration to migrate informal businesses to corporate businesses that are bankable and taxable. MSMEs should also keep financial records, enabling financial institutions to measure their creditworthiness.

3.0 Attracting Foreign Capital to Nigeria

Issues Identified

Foreign capital importation has dropped by approximately six-fold since 2019, from US$24 billion to US$3.9 billion in 2023 (NBS, 2024b). Nigeria's FDI inflow has also steadily declined despite different interventions in the last five years. Investors' perceptions remain a major bottleneck to FDI inflow. The negative perception and investors' lack of confidence contribute significantly to the decline in FDI inflow. Other factors include but are not limited to:

- **Macroeconomic Instability**: While efforts have been made to improve the business environment in Nigeria, the cost of doing business remains high. Persistent structural macroeconomic challenges such as an unstable power supply, infrastructure deficit, rising inflation, and exchange rate volatility have pushed up the cost of business operations in Nigeria, making other African countries the preferred destination for investors.

- **Policy inconsistency:** Political and regulatory risks are the most significant risks to any investor. Constantly changing policies remain a disincentive to both local and foreign investors.

- **Demography:** Nigeria has not taken advantage of its demography. It is not enough to have the population; it is important to be aware of the consumption pattern. In Nigeria, there exist structural gaps. Investors cannot afford to fund greenfield or brownfield because people who will drive consumption are not empowered, so the challenge is existential for investors.

- **Capital Control:** Investors like to put their money where there is a certainty of value. Foreign exchange (FX) instability is one of the major causes of the decline in foreign portfolio investment, which has plunged to approx. US$1.2 million in 2023 from US$16 million in 2019 (NBS, 2024b). The instability of the FX rate is a big challenge and discouragement to investors.

- **Negative real return on Investment:** With inflation at 33.69 percent in April 2024 despite the hike in the monetary policy rate to 26.25 percent in May 2024 (CBN, 2024), a 750 basis points increase from 18.75 percent in December 2023, the real interest rate in Nigeria is negative at 7.44 percent. Meanwhile, in South Africa, it is positive at 3 percent (South African Reserve Bank, 2024), and in Kenya, it is positive at 7.9 percent (Central Bank of Kenya, 2024). Therefore, for investors, Nigeria is not a desirable destination.

- **Irregular Tariffs:** Irregularities in tariffs pose as a disincentive for foreign investors considering Nigeria as a destination of choice. Nigeria ranks 145 of 180 countries on the global corruption perceptions index (Transparency International, 2023).

- **Negative publicity:** The media houses and the public at large paint a negative picture of happenings in the country to investors with the way narratives are being pushed. On average, Nigerians easily de-market themselves to investors.

Recommendations

According to the latest Ease of Doing Business Report by the World Bank, Nigeria ranked 131 in the Ease of Doing Business index in 2020, a position formally occupied by Egypt in 2016. In 2020, Egypt was ranked 114 after undergoing several reforms (World Bank, 2020). Nigeria can learn and domesticate the Egyptian reforms to achieve similar success. Since 2016, Nigeria's FDI inflows have remained below US$1.5 billion per annum. It stood at US$468 million in 2022 (NBS, 2024b) compared with US$11,400 million in Egypt in the same period (World Investment Report, 2023). What have the Egyptians done differently?

- In 2017, Egypt passed a business-friendly investment law that allows foreign and domestic investors to operate equitably.
- There was also a tax reduction for foreign investors investing in Egypt as long as the investment was channelled to health care, Corporate Social Responsibility (CSR) and environmental protection to achieve sustainable financing.
- The country improved its fiscal position by introducing Value Added Tax (VAT) and allowing the exchange rate to be flexible. However, it was a tough reform because the currency was devalued but later stabilised.
- Investment in infrastructure: In Egypt, much investment has been channelled into road construction to reduce the cost associated with logistics. Also, there was a deliberate investment in power generation, making the country an over-supplier of power at a surplus of 25 percent. Egypt supplies power to Sudan.

Regulators and policies’ role in attracting foreign capital

- There is a need for strategic synergy between the regulators and the private sector. The private sector and the regulators need to work together more effectively. Stakeholders need to have a vested interest in regulations from a patriotic standpoint, not a nationalistic standpoint.
- The system in Nigeria is not designed to encourage export. It is designed to consume rather than produce. Therefore, there is a need to be deliberate about enacting laws and policies that can break these barriers. Like other African countries, e.g. Ghana and Egypt, Nigeria needs to take a tougher stand in policy direction.
- Regulations are needed to stimulate innovation in the fintech space. Nigeria's Fintech industry has been thriving in the last few years. The sector attracted FDI of approx. US$1.2 billion in 2022 (EnterpriseNGR, 2023). Nigeria is doing something interesting in the Fintech space. The country has derived an alternative way of doing business with a long-term goal and a reasonable market size, making the Fintech space attractive to investors. Nigeria has a bright spot in the Fintech space, and regulations must continue to stimulate innovation in the space. Also, other sectors should leverage and domesticate Fintech's approaches to attract investors.
- Movement of Capital: Although different agencies have made efforts to make the movement of capital efficient, predictable, and seamless, the action needs to be fast-tracked, and the processes involved need to be simplified.
- Self-sufficiency is long-term, but Nigeria should use short-term solutions while waiting for the long term. Foreign Portfolio Investment is an efficient solution for the country's short-term needs. However, the government must continue to find ways to solve long-term problems to be self-sufficient.

Financial sector's role in attracting foreign capital

- Advocacy: Financial institutions must advocate the importance of attracting foreign investment to regulators. They need to make the regulators know the implications of policies on investors. Financial institutions should also advocate for tax incentives for investors.
- Economic intelligence needs to be provided to prospective foreign investors by giving them the necessary information and guiding them in navigating the regulatory terrain. In addition, prospective investors are willing to work with financial institutions with good credit ratings. Therefore, financial institutions should ensure they position themselves in a way that makes investors feel safe.

Citizens and SME's role in attracting foreign capital

- Nigerians need to change their orientation to solution-driven minds. Every citizen should contribute to solving the problems in the country instead of complaining and blaming the government for everything. Citizens need to be patriotic.

4.0 Striking a Balance Between Innovation, Regulation and Consumer Protection in the Financial Sector

Issues Identified

Financial innovation is fundamentally driven by technology, and many businesses have thrived in Nigeria by leveraging this technology. However, striking a balance between financial innovation, regulation, and consumer protection is crucial. There are bottlenecks that need to be addressed to achieve an innovation-driven financial sector. Some of these include:

- **Ethical Issues**
  - **Bundling of products for customers who don't understand the product:** Customers are not well informed about the need for the products; therefore, they do not value them when imposed on them.
  - **The use of information:** The unauthorised use of people's information remains a significant bottleneck. Collecting people's data without informing them about how the information will be used is one of the leading causes of distrust between operators and customers.
  - **Pricing issues:** Most customers are ignorant of the things embedded in the product pricing they buy; therefore, operators use this to their advantage.
  - **Collection Management:** Collecting money back from borrowers has changed over the years. Some providers go the extra mile by sending embarrassing and discrediting SMS to people they presumed to be closer to the borrowers.

- **Regulatory Issues**
  - In a bid to ensure that everyone has access to banking services, regulators are constrained to perform essential duties. For instance, Fintechs are not regulated because regulators do not want to hinder growth in the sector. Also, some micro-lenders collect money lender licenses from the state government and remain unaccountable and unsupervised by regulators.
  - Issues around the usage of enabling technology, e.g. P2P lending and blockchain distributing technology, among others.
  - The issue of speed and agility: The regulatory innovation system is not future-proof, and many regulators work in silos, leading to the lag time involved in accessing products.

- **Financial sector-related issues**
  - The existence of a large power distance: Most financial service providers do not have the duty of care for lower-status consumers.
  - A trust deficit exists: The consumers and the financial service providers do not trust themselves. They have different perceptions, which makes it difficult for trust to exist.

Recommendations

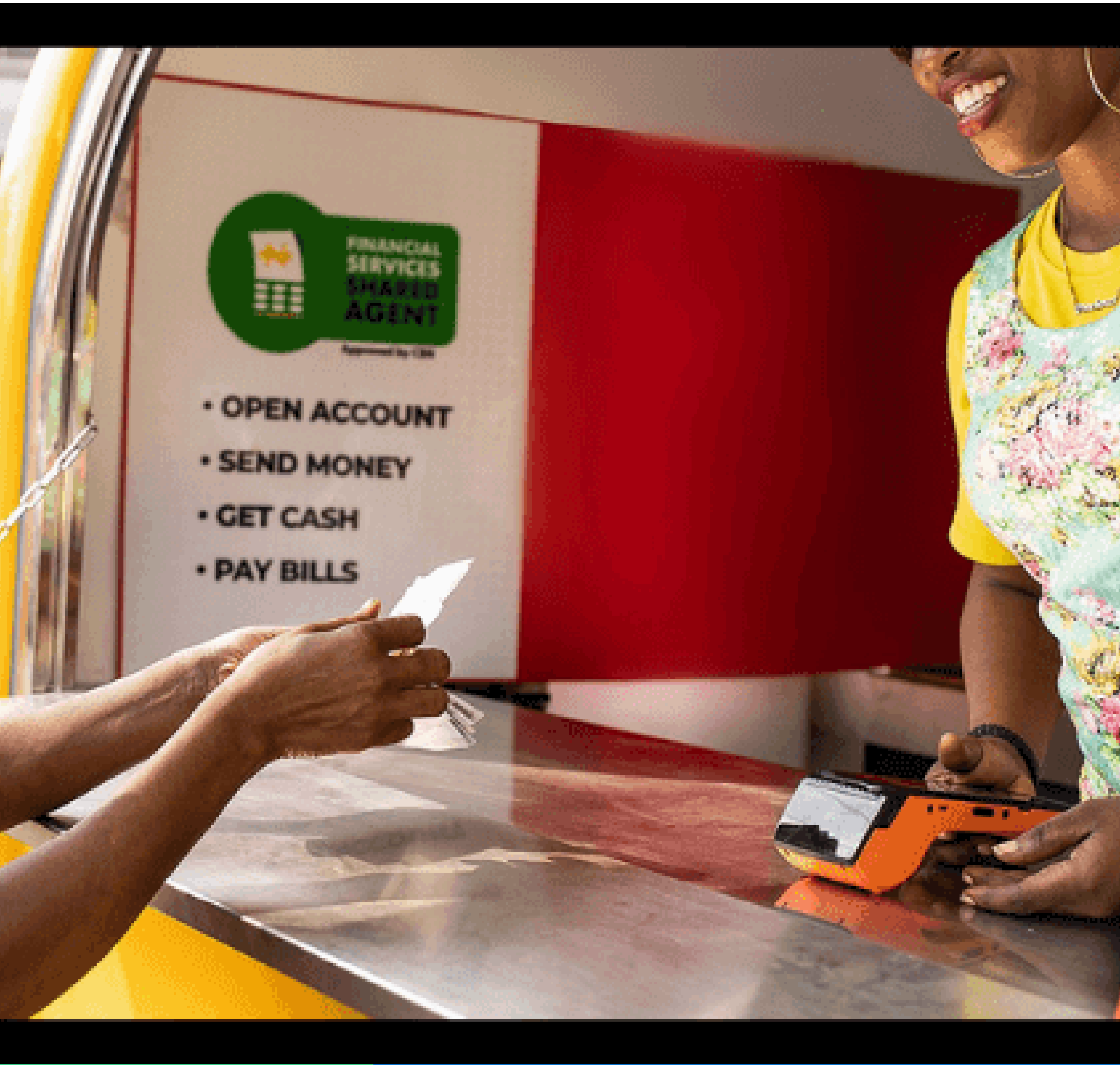
Regulators and policies' role in striking a balance

- Create ways to prevent systemic risk, that is, the prevention of the financial system's collapse. Protect the financial market from the anti-money laundry and counter-terrorism financing schemes.
- Regulation must be such that it protects the consumers. Regulations must ensure discipline in market conduct; that is, the operators in the market must operate responsibly.
- Tackle the unknown factors. Regulators must be current regarding global trends and be able to shape policies in a way that factors in the operating environment and global happenings.
- Regulators should have an evidence-based understanding of what needs to be regulated, who needs to be regulated, and how to regulate, and distinguish between them.
- Partnership between both regulators and operators: Regulators should not work in silos. They need to come together and understand that there is a thin line between commercial banking, investment banking, capital markets, and others.
- Harmonisation of consumer protection departments: Consumer protection departments should be harmonised and headed at the federal level.
- Efficient response time and operation management: The government should provide the necessary tools for operators to work effectively and efficiently, ensuring the reliability of the existing system.

Financial sectors' role in striking a balance

- **Financial Education:** To make more informed decisions, all stakeholders need to be educated on crypto assets and P2P lending, among other topics. Many consumers of financial services are financially illiterate. It is important to help people understand the product, process, and pricing to bridge the trust gap.
- **There is a need for a unique identifier:** Financial institutions face the challenges of trust and adverse selection. To prevent loans from being made to the wrong people, there is a need for a unique identifier. This will help fight poverty and enhance access to credit facilities.
- There is a need to collaborate and co-compete. Competitors can also be collaborators. Effective collaboration reduces the unit cost of a product; hence, it is logical to collaborate.
- **Leverage credit bureau for support:** Players in financial services, especially those involved in lending, should engage with the credit bureau to develop products for those captured by the system and those not captured. For instance, the bureau generates scores only for those taking credit while excluding those that do not. Other institutions have also developed different algorithms that can be fused into the credit bureau system. This will facilitate the design of a framework that is nationalistic in outlook and driven by necessity.
- **Financial service operators need to self-regulate and change their mindsets:** Financial service providers should understand that they operate in a market where more than 60 percent live below the poverty line. Therefore, they should inculcate the duty of care in their activities and treat consumers with the equity, fairness, and respect they deserve without reporting them to regulators.

- **Research and development:** Research and development are needed to understand the behaviour of consumers. The financial sector should partner with universities to conduct market research to make appropriate product designs that meet consumer needs.
- **Understanding consumer behaviour:** Regulators and operators can seek the help of the Policy Innovation Center (PIC) of the NESG to gain collective intelligence about consumers' behaviour. Also, Nigerian consumers are unique. Operators must domesticate practices and processes to suit Nigerian consumers' needs.



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About the NESG

The NESG is an independent, non-partisan, non-sectarian organisation committed to fostering open and continuous dialogue on Nigeria's economic development. The NESG strives to forge a mutual understanding between leaders of thought so as to explore, discover and support initiatives directed at improving Nigeria's economic policies, institutions, and management.

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