

DICHOTOMY OF INTEREST RATE DEREGULATION POLICY IMPLICATIONS TO SME PERFORMANCE IN NIGERIA

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ABSTRACT

The purpose of this study is to analyze the implications of interest rate deregulation policy on the performance of manufacturing small and medium size businesses in Nigeria. Shortly before the recent global financial crunch, the Nigerian Government embarked on a policy of interest rate deregulation with the assumption that deregulation of interest rate will increase the accessibility and productivity of the financial system through market driven competition of banks. While this may be true with large scale borrowers, the fate of small and medium scale borrowers remains doubtful. Based on the analysis of primary and secondary data, the result of this study reveals a high sensitivity of the return on investment (ROI) of SMEs to interest rate fluctuations and that the conventional wisdom which holds that deregulation of interest rate always improves efficiency maybe incorrect. It also revealed that the ROI of those SMEs without loan obligation were also affected by the changing interest rates that affect other production inputs.

JEL Code: D23, L25, L26, P20; O16; G21; G28; H27

Key words: Interest rates, financial market, return on investment, SMEs, liberalization, deregulation

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I. INTRODUCTION

This study investigates the impact of interest rate deregulation on the return on investment (ROI) performance of manufacturing small and medium sized enterprises (SMEs) following the liberalisation of the financial market in Nigeria. The policy was based on the assumption that deregulation of interest rate improves the accessibility of finance to potential investors, including SMEs and the efficiency of the financial system through bank competition on products, price, services and supply of investible funds to both small and large scale borrowers (Lovell, 2001; Henry, 2003; Ayadi and Hyman, 2006; Obokoh, 2008a). In other words, the competition will reduce the cost of access to finance for SMEs so as to improve their performance through greater access to funds. However, empirical evidence on the impact of the policy in Nigeria and elsewhere has been mixed (Ikhide and Alawode, 2001; Lovell, 2001). Some study reports improvement in availability and accessibility to funds for SMEs (Ajilore, 2004; Hübler, Menkhoff, and Suwanaporn, 2008), while others report the contrary in view of the difficulties of SMEs still accessing formal funds and the dwindling profit performance of businesses due to cost of funds and the inflationary effects of the policy (Akinlo, 1996; Olukoshi, 1996; Akinlo and Odusola, 2003; Obokoh, 2009).

These opposing views are captured in Berger and Humphrey (1997) study which revealed that the results of interest rate deregulation are different across countries and also depend on the industry conditions prior to deregulation. The industry condition can range from the existing excess loan demand, the desire to rapidly expand market share by the banks and competition to pay higher deposit interest rates without a corresponding reduction in either banking service cost or an offsetting decrease in deposit fees. How well this assumption hold true for manufacturing SMEs in Nigeria is doubtful in view of the recent bank consolidation and the subsequent sacking of the board and Managing Directors of some banks in Nigeria by the Central Bank Governor. It is on this premise that this study investigates the impact of interest rate deregulation on the ROI of manufacturing SMEs in Nigeria considering the sensitivity of SMEs to interest rate shock and the economic condition prior to the liberalization of the financial market in Nigeria (Gertler and Gilchrist, 1994; Ehrmann, 2000; Vickery, 2008; Obokoh, 2009). Nigeria experienced economic down turn in the early 1980s as a result of the fall in price of crude oil and other primary products in the international market. The fall in price led to a drastic fall in revenue to the governments and her inability to meet her import bills (Olukoshi, 1996). This resulted in balance of payment crises because of the government dependence on revenue from petroleum (Akinlo, 1996). In other to save the country from the economic crisis, the government then embarked on economic reforms programmes (Obokoh, 2008c).

Broadly, financial sector reform which was one of the various policies embarked upon by the Nigerian government, commenced against the backdrop of neo-liberal policy discourse and practices across Africa during the 1980s (Emeseh et al, 2010). Among other outcomes, the policy attempted to excise government from controlling the economy in favour of market forces (Prasad, Rogoff, Wei and Kose, 2003; Zhang, 2006). In the specific instance of the policy, the expectation was that financial liberalisation with flexible interest rates would ultimately encourage the mobilisation of investible funds from home and abroad towards vibrant economic opportunities, including towards SMEs. It has been argued by proponents of liberalisation that efficient financial market is only achievable by the government ceding control of the sector to the dictates of market forces (Noorbakhsh and Paloni, 2001; Henry, 2003). The outcome was the deregulation of interest rates in place of the administratively managed (adjustable peg) interest rate regime (Oduola and Akinlo, 2001).

In view of the fact that the outcomes of interest rates deregulation are peculiar to a country's economic circumstance before implementation, necessitates the need to take a more critical look at how the policy has impacted on the ROI of manufacturing SMEs in Nigeria. A further reason why the impact of interest rate deregulation on the investment performance of SMEs has stimulated research interest is that earlier studies neglected to look at how high interest rates impinges on the demand side of the financial market. This is the space where public policy, past and present have not been clearly and sufficiently articulated.

To this end, how has the policy made accessibility of funds at competitive interest rates to manufacturing SMEs possible as was envisaged before the implementation? To what extent has the policy helped to resolve the liquidity problems of SMEs which has been a major obstacle to their operations in Nigeria prior to implementation? Furthermore, how has the deregulation of interest rates affected other manufacturing inputs of SMEs? And how has it affected SMEs return on investment in Nigeria?

Hypothesis was formulated based on the literature that high interest rates affect working capital and output of firms which invariably also affect profits (Wijnbergen, 1985). It has also been argued that SMEs are more sensitive to interest rates shocks compared to big businesses because of their small resources (Vickery, 2008).

Hypothesis: There is no significant relationship between high interest rates and operational costs of SMEs after financial market liberalization.

This hypothesis would help us understand if manufacturing SMEs in Nigeria are insulated from interest rates shocks considering the fact that financial liberalisation led to the replacement of the administratively pegged interest rate policy with the market determined interest rates. As this was argued would eliminate or discourage investments in none profitable ventures (Kasekende and Atingi-Ego, 2003).

This study applied return on investment (ROI) on the micro level data of manufacturing SMEs to explore the impact of interest rate deregulation on manufacturing SMEs in order to provide answers to the above questions. The study focuses on manufacturing SMEs in Lagos State and covers the period 1980 to 2006, while data analysed in order to the achieve the study objectives were from 1994 to 2006. The remaining part of the study is organised into four sections commencing with the exploratory review of related literature, section three gives the methodology of the study. The results and discussion is contained in section four while the concluding remarks and implications of the policy are provided in the last section.

II. EXPLORATORY REVIEW OF RELATED LITERATURE

The common ground for the deregulation of interest rates was based on the McKinnon and Shaw (1973) models of financial repression. They believed that financial repression in the form of selective interest rate ceilings, high reserve requirements and capital controls prevent the outflow of domestic savings and compounds economic instability. It has been argued that in developing economies like Nigeria⁴, distortions of financial prices in the form of interest rates ceiling reduces the real rate of growth and the size of the financial system in relation to the nonfinancial system. And that increasing the real deposit rate would increase savings and ration out low-yielding investments since these will no longer be profitable at higher interest rates (Kasekende and Atingi-Ego, 2003). This presupposes that the real rate of deposit is the key to higher levels of investment and greater investment efficiency to the savers.

In the same vein, Harris, Schiantarelli and Siregar (1994) stated that the objectives of deregulation were to provide higher returns to depositors and lower the cost of borrowing through raising the degree of competition in the financial markets as a result of the increased number of participants. This would in turn increase savings mobilization through the banking system, efficient allocation of resources through market mechanism and the increased use of capital instruments in raising equity capital.

Reports suggest that some countries experienced higher savings and investments when they relaxed the control on capital flow and interest rates regulation following the implementation of liberalisation policy (Khatkhate, 1988; Henry, 2003). Hübler, et al, (2008) assert that liberalization of the financial market made borrowing cheaper and easier because it reduced interest rate spreads, decrease collateral requirements as well as revise the financial system by enlarging the power of market forces, although at the expense of traditional institutions.

⁴ See Obokoh (2008b) for detail report on the reform process in Nigeria

On the other hand, other studies reported failures for some economies that undertook financial liberalization (Larrain, 1989; Hellmann, Murdock and Stiglitz, 2000). The countries in this category suffered considerable macroeconomic instability, massive capital flight and widespread bank failures following the implementation of the liberalisation policy (Hellmann et al, 2000; Stiglitz, 2000, 2004).

The financial market should not be assumed or treated like the goods market where excess supply brings down prices, since financial liberalization do not automatically generate greater efficiency in resource allocation nor does it attract long term capital flow to countries facing economic crisis (Stiglitz, 2000). Instead it attracts speculative money flows from abroad and increases the likelihood of financial crises with no positive effects on investment, output, or economic growth without heavy welfare costs (Rodrik, 1998; Stiglitz, 2002; Singh, 2002; Charlton and Stiglitz; 2004). Harris, Schiantarelli and Siregar (1994) observed that the immediate effects of deregulation was the substantial increase in interest rate paid on deposits and rates charged on loans, while the anticipated changes in competitive behaviour of banks was slow.

Research have it that high interest rates resulting from financial liberalisation increases the risk of lending to firms as well as business distress due to foreign exchange exposure and inflation contrary to the assumptions of high inflow of foreign funds from abroad (Stiglitz and Weiss, 1981; Prasad et al, 2003). Agénor (2004), reports that the magnitude of capital inflows and outflows recorded by developing countries after the implementation of financial liberalisation policy was linked to deep financial instability, economic crises and sharp increases in poverty rates – especially in countries with irresponsible sovereign debt management, improper sequence of the policy, and poorly regulated domestic financial systems.

According to Stiglitz (2002), in a country where many firms are highly leveraged, high interest rate do not only weaken the banking system and induce corporate distress, it also reduces the ability and willingness of lenders/ financial institutions to lend. His report affirms Van Wijnbergen's (1985) argument that higher lending rate is contractionary because it prompts tightening credit conditions which increases the cost of financing working capital resulting in a decrease in output that pushes up inflation. Kasekende and Atingi-Ego (2003) argued that the only way a country can harness the gains of positive real interest rates to mobilize savings requires reforming the financial sector. This is because the capability of the formal financial system to increase the share of total financial savings, in addition to improving the average return on investment they finance is predicated on good financial system. They went further to state that a well functioning financial sector stimulates investment and raises the average rate of return on investment projects receiving the loans, as the financial sector is positively related to economic growth. How well deregulated interest rate is able to ensure

efficiency in resource allocation is questionable considering its effects on other economic variable such as inflation and exchange rates.

III. METHODOLOGY

This study used questionnaire and semi-structured interview methods to obtain data from manufacturing SMEs operating in Lagos State. The two stage data collection method was motivated by the in-depth results of the findings of Akinlo (1996) and Ekpenyong (2002) that used either method for their independent studies of the effects of SAP on manufacturing businesses in Nigeria. The study then applied ROI model on the financial data collected from the semi-structured interview of 69 SMEs from a sample size of 100 manufacturing SMEs operating in Lagos State that were part of the 500 SMEs earlier sampled using questionnaires. The total number of valid response from the questionnaire survey was 369 from which the respondents for the semi-structured interviews were randomly selected. The semi-structure interview which is the main focus of our analysis followed the questionnaires survey that was used to obtain general information about the entire sample population. Of the 69 participants in the semi-structured interview, only the transaction data of 50 participating SMEs were used to arrive at our conclusion because the data were complete and met the two criteria (leveraged and unleveraged SMEs) the study set out to explore using return on investment (ROI). The semi-structured interviews enabled us gain detailed and specific transaction data from the 69 SMEs that volunteered to present their transaction data for the research.

In addition, panel data from the Central Bank of Nigeria (CBN) covering the period 1994 to 2006 were used to complement the primary data obtained through the survey. The questionnaire survey and semi-structured interviews took a period of three months, between June and August 2007.

The decision to apply ROI on the data obtained was because of the different level of the capital base of the SMEs that participated in the semi-structured interview. ROI is one of the methods of investment appraisal methods used to arrive at future investment decisions for investment with unequal capital outlay and cash inflow by calculating profitability ratios of the investment and also the measure of evaluating the performance of managers in a decentralised organisation (Lucey, 2003). The decision rule for ROI is to accept investment that yield ROI greater that cost of capital (COC) [within the context of this study, COC is interest rates] and to reject investment that yield ROI less than COC. The COC is determined by market forces in line with liberalisation with inflation rate floating freely according to market conditions (Lucey, 2003; Lipsey and Chrystal, 2007).

IV. ANALYSIS OF RESULTS AND DISCUSSION

This section presents part of the questionnaire results analysed with the aid of Statistical Packages for Social Science (SPSS) 16.0., and the semi-structured interview which is the main source of data for this study. The first two tables present some aspect of the questionnaire survey and discussions.

The questionnaire results for the distribution of sampled SMEs (table 1) gives a clear picture of the trend that shows that 59.1% majority of sampled SMEs have been in operation for less than 10 years. While less than 9% of the sampled SMEs have been in operation for over 26 years and above. This gives an idea of the mortality rates of SMEs and the number of SMEs that are profitable enough to remain in operation and who subsequently were able to survive through the pre-liberalisation era to post-liberalisation era. This age issue affected the number of SMEs with sufficient data for our analysis that participated in the semi-structured interview as will be seen later in section 4.1.

Table 1. Age Distribution of Sampled SMEs

Item Consideration	No. of Firms	Percentage
Age of Company (in years)	115	31.2
01-05	103	27.9
06-10	62	16.8
11-15	38	10.3
16-20	25	6.8
21-25	17	4.6
26-30	9	2.4
Above 30	369	100
Total		

Source: Field Survey 2007

Table 2. Effect of Interest Rate Deregulation on SMEs

Item under Consideration	No. of Firms	Percentage
The source of external loan before Liberalisation		
Informal money Lender	24	14.5
Commercial Banks	107	64.8
Cooperative Society	26	15.8
Family/ Friends	8	4.8
Total	165	100
The source of external loan after Liberalisation		
Informal money Lender	18	10.91
Commercial Banks	94	56.97
Cooperative Society	28	16.97
Family/ Friends	13	7.88
Missing	12	7.27
Total	165	100

Source: Field Survey 2007

From the analysis of the effects of deregulation on the source of external funds for SMEs operations as can be seen in table 2, the percentage of SMEs that had access or took external loans from both informal money lenders and the commercial banks reduced from 14.5 and 64.8 to 10.91 and 56.97 respectively. This trend is contrary to the assumption that with high interest rates, more funds would be mobilised from informal sector to the formal sector to bring down the rates, thereby making more investors to access formal sector funds. It is obvious that the high interest rates which averaged about 20% throughout the period considered constituted the barrier as most of the sampled SMEs had to seek other means of finance such as friends and family for funds. The percentage of those that sought funds from cooperative societies also increased because cooperative societies charge far less interest rates on loans from their members compared to the formal or informal sector sources of finance.

Table 3. Showing Aggregate Assets, Profits, Computed ROI of 50 Sampled SMEs, Interest Rates, and Inflation Rates

Year	Asset in Naira (N'000)	Profit in Naira (N'000)	Return on Investment (ROI) (in %) of the 50 SMEs	Interest Rate (COC)	(ROI)-(COC)= MOS (in %)	Inflation Rate	ROI of the 25 Debt free SMEs*	(ROI)-(COC)= MOS (in %)	ROI of the 25 indebted SMEs**	(ROI)-(COC)= MOS (in %)
1994	Nil	Nil	Nil	21.00	Nil	57.00	Nil	Nil	Nil	Nil
1995	112292	20212.56	18.0	20.18	(2.18)	73.10	20	(0.18)	15	(5.18)
1996	168438	37056.36	22.0	19.74	2.26	29.10	23.5	3.76	19.55	(0.74)
1997	286345	71586.25	25.0	13.54	11.75	8.50	27	13.46	21.44	7.90
1998	314665	61359.68	19.5	18.29	1.21	10.00	21	2.71	17.15	(1.14)
1999	349628	82512.21	23.6	21.32	2.28	6.60	24	2.68	22.95	1.63
2000	371945	76620.67	20.6	17.98	2.62	6.90	21.6	3.62	18.97	0.99
2001	383449	71704.96	18.7	18.29	0.41	18.90	20	1.71	15.46	(2.83)
2002	473394	79056.80	16.7	20.48	(3.78)	12.90	18.2	(2.28)	14.45	(6.03)
2003	537948	123728.04	23.0	21.16	1.81	14.00	25	3.84	19.44	(1.66)
2004	645537	116196.66	18.0	19.47	(1.47)	19.40	21	1.53	12.67	(6.80)
2005	694755	154930.37	22.3	20.00	2.30	17.90	24	4.00	19.41	(0.59)
2006	771951	186040.19	24.1	18.70	5.40	12.60	26	7.3	20.57	1.87

Source: CBN Statistical Bulletin 2006 and computation from interview data

*25 from the 50 SMEs that finance their operation from owners' funds and retained profits

**25 from the 50 SMEs that their operations are partly financed by loan

A. Analysis and discussion of Semi-Structured Interviews

Table 3 presents the extracted figures of assets, profit, and operating cost from the 12 years transaction data of the 50 out of the 69 SMEs interviewed from the 100 that were selected from the valid 369 sampled SMEs. And the figure of the 50 SMEs split into two groups of indebted and debt free SMEs. The asset and profit figures of the 50 SMEs were aggregated and used to compute ROI for the purpose of this study.

The computation in table 3 reveals a small margin between ROI and COC. [Within the context of this study, is called margin of safety (MOS)] throughout the 12 years under consideration, only the ROI for 1997 and 2006 slightly yielded an impressive ROI. The

ROI for 1995, 2002 and 2004 were negative which corresponds to the years that either interest rate (COC) or inflation were very high. All other year's computation though produced positive ROI, the positive ROI this study reckons are too marginal to persuade any rational investor to invest or buy these businesses assuming they were put up for sale. This is consistent with Van Wijnbergen (1985) who argued that private investment would fall given high lending rates due to decreased profit from higher cost of financing working capital.

The assets and profits of the sampled SMEs were split into two groups of debt free SMEs and indebted SMEs. The analysis revealed a very high sensitivity of the ROI of SMEs to interest rate fluctuation. The result further revealed that the ROI of those SMEs without loan obligation were also affected by the changing interest rates, while those with loan obligation were worst hit by high interest rates.

It was revealed by those SMEs not having loan obligation that they had to pay off their loan and rely on their profits and other source of finance as interest on borrowed funds was seriously affecting their profits. According to one of them: "It is better to rely on retained profits for our operations as a means of cutting down cost instead of paying out substantial part of our profits as finance charges [interest rates] to our creditors"

In addition, they also had access to and utilise credit facilities provided by some of their suppliers, who in turn source the raw materials locally. They are of the view that: "Instead of the liberalisation of the financial market to bring the interest rates down, it increased the interest rates charged by banks. This seriously affected our profits because it was as if we were working for the bank considering the amount we pay on the overdraft we took to purchase raw materials. This prompted our relying on our supplier's credit which cost us nothing".

It is clear from the findings of the semi-structured interviews that the high interest rates affected both groups of SMEs because interests also affect other economic variables as would be seen in the hypothesis tested in this study.

Hypothesis: There is no significant relationship between high interest rates and operational costs of SMEs after financial market liberalization.

Chi-Square test was used to test the significance or otherwise of the relationship between the respondents' view of high interest rates and the operational costs of SMEs after financial market liberalisation. This hypothesis test is necessary because in the body of literature, opinions are divided as to the effects of high interest rates on the cost of working capital and on the cost of access to funds for business operations. Fry (1988) believed that high interest rates would encourage prudent investments that would yield better returns and hence reduce the overall interest rates from the proceeds of investments. van Wijnbergen (1985) argued that high interest rates negatively affect operational costs and hence the output of businesses.

It is on this premise that Stiglitz (2002) asserts that only investors taking high risk ventures are the ones willing to take loans at high interest rates. The high risk venture argument by Stiglitz confirms the theoretical base of the argument that an increase in the real deposit rate above the market clearing rate would increase savings and ration out low-yielding investments since these investments will no longer be profitable at higher interest rates (Kasekende and Atingi-Ego, 2003). This means when these high risk investments fails, their loans becomes difficult to pay and subsequently bad debt to the banks involved. These different views necessitated the test of hypothesis on the sampled SMEs to find out if the high interest rates in Nigeria significantly affect the operational cost of SMEs in Nigeria.

Table 4. The Relationship between High Interest Rates and Operational Cost after financial market liberalisation

		Operational Costs	High Interest Rates
Operational Cost	Pearson’s R	1	0.216**
	Sig. (2-tailed)	.	0.000
	Chi-Square Value	1	37.076
	Degree of freedom	1	8
	N	369	367
High Interest Rates	Pearson’s R	0.216**	1
	Sig. (2-tailed)	0.000	.
	Chi-Square Value	37.076	1
	Degree of freedom	8	1
	N	367	367

**Correlation is significant at 0.01level (2-tailed)⁵

The Chi-Square test in table 4 is based on respondents’ views of the effects of the interest rates on their operating cost after financial market liberalisation. The test reveals a statistically significant positive relationship between high interest rates and operational cost of manufacturing SMEs after financial market liberalisation $\chi^2(8) = 37.076$, $P < 0.001$. This means that there is less than 0.001 probability that a correlation coefficient of 0.216 with a mean score of 37.076 and 8 degrees of freedom will occur by chance in a sample size of 367 respondents. This significant value of $P < 0.001$ indicates that the probability of this correlation being a ‘fluke’ is zero. Hence, the confidence placed on the relationship between high interest rate and operational costs after financial market liberalisation are genuine. Therefore, the positive relationship can be

⁵ The 0.01 level of significance was chosen by the SPSS 16.0 software. The explanation for this is to avoid type I error. This is a situation when the null hypothesis is rejected where in fact there is actually no relationship between the two variables being tested. So the 0.01 level of significance gives the study more confidence that the result of the test is 90% correct that it has not rejected the null hypothesis by error.

interpreted as, 'the higher the interest rates after financial market liberalisation, the higher the operational cost of manufacturing SMEs and vice versa'.

To measure the amount of change/increase in interest rate that accounts for the changes/increase in operational cost, the correlation coefficient 'r' was squared (coefficient of determination, R^2). This is the measure of the amount of variability in one variable that is explained by the other variable (Field, 2005:128). The interest rate and the operational cost produced a correlation of 0.216 and so the value of R^2 will then be $(0.216)^2 = 0.0467$. This tells us how much of the variability in operational costs can be explained by the increase in interest rate after financial market liberalisation. This 0.0467 value was then converted into percentage by multiplying by 100 to give 4.67%. This means that a change as small as 4.67% accounts for the increase in operational cost of manufacturing SMEs in Nigeria.

It should be noted that there are other factors that also account for or influence the increase in operational cost of manufacturing SMEs in Nigeria after financial market liberalisation. The value of 4.67% leaves us with as much as 95.33% of other factors to account for the increase in operational costs. This result reveals the high sensitivity rate of operational costs to changes in interest rates after financial market liberalisation. This is because any increase in interest rates affects all other economic variables which are directly or indirectly related to the operations of manufacturing SMEs in Nigeria. This phenomenon refreshes our mind to income or price elasticity, which defines the responsiveness of demand to changes in income or price.

Therefore, the null hypothesis of 'there is no significant relationship between interest rate and operational cost' is rejected, while the alternative hypothesis that there is a significant relationship between high interest rates and operational costs after financial market liberalisation in Nigeria is accepted.

V. CONCLUSION AND IMPLICATION

The potentials for positive real interest rates to mobilise savings (supply side) for investments as a result of deregulation and the ability of potential investors to borrow (demand side) and invest these funds in high yielding investments in order to be able to repay the loans are two sides of the same coin. There is no denying the fact that high interest rates attract savings for investment, which is the common area of concentration of most research in measuring the effects of financial market deregulation-interest rate deregulation. What most proponents of high interest rates for higher savings fail to put into consideration is that savings is a function of income and no amount of interest rate would entice individuals that spend substantial portion of their income on basic necessities to save. Furthermore, that the ability of the potential investor to repay the high interest rates charged on loans is predicated on his investment to yield return far above the interest rates charged on the loans. For instance, a deposit that attracts 20%

interest rate for the owner must be able to yield 30% or more return in the hands of an investor to be able to accommodate the bank's share of profit and the investor's profit as well. The question now is what type of investment would yield returns above 30% under a competitive business environment? From basic economics supernormal profits are always eroded under perfect competition.

Therefore the conventional wisdom which holds that deregulation of interest rate always improved efficiency and productivity may be incorrect. This is because the results of the policy differ for different countries depending on the economic and industry condition of the country. It is true that the liberalization of the financial market increased availability of funds in the financial system, but this did not translate into easy access to funds for SMEs. The recent shake up of the financial sector by the Central Bank of Nigeria revealed that most of the funds were in the hands of few big time burrowers who in some cases are not servicing their loans.

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