STUDY SUMMARY

Asset-based Finance for Microenterprises in Pakistan

Lack of access to finance constrains small business growth—a problem that is exacerbated for Muslim business-owners, many of whom do not take out traditional loans for religious reasons. Innovations for Poverty Action is supporting research in Pakistan on a lease-based product that features more flexible repayment schedules, allows businesses to share risk with a large microfinance institution, and complies with local Islamic financial norms. Researchers will evaluate whether this product boosts sales and profits for small businesses in Pakistan.

RESEARCHERS
Simon Quinn, Muhammad Meki, Kashif Zaheer Malik, Faisal Bari

COUNTRY
Pakistan

PARTNER
Akhuwat

PROGRAM AREAS
Financial Inclusion, Financial Services for the Poor

TOPICS
Product Design, Savings

TIMELINE
2016-2019

Policy Issue

Limited access to finance restricts the growth of small enterprises. Policymakers hoped that microfinance would overcome this problem, but research has shown that traditional microfinance products with high interest rates and immediate repayment requirements rarely increase business profits or have a significant effect on household income. However, loan products with increased flexibility (such as grace periods for missed payments) may improve business profits,[1] and grants have helped at least some types of microenterprises grow.[2] Lease-based contracts (in which a bank helps a client buy a fixed asset) fall between grants and traditional loans in terms of the burden they place on businesses; they provide access to capital without high interest rates or immediate repayment requirements.

Businesses also fail to grow when they avoid making riskier but potentially more profitable investments. Business owners may be more likely to take on these projects if they are able to share the risk with another entity, such as a microfinance institution (MFI), through lease-based finance. Shared risk may help in other ways, too. For example, when the MFI and the microenterprise take on such risk together, their incentives are better aligned, and the MFI has a clear motivation to consider the longer-term growth and survival of the microenterprise.

Evaluation Context

In Pakistan, as in many countries with large Muslim populations, social norms against interest-based borrowing mean that many Muslim poor reject traditional microloans.[3] This coincides with large and sometimes increasing incidences of poverty and financial exclusion among Muslims; financial exclusion rates are as high as 88 percent in Pakistan.[4] CGAP surveys suggest that, for Muslims with access to microloans, up to 40 percent reject such loans on religious grounds.[5]

Akhuwat is a large nonprofit microfinance institution based in Lahore with over 570,000 active borrowers and a loan portfolio of over 8 billion Pakistani Rupees (approximately US$77 million). It operates 500 branches in cities and towns across Pakistan. Akhuwat has identified a proportion of its clients who have successfully taken out and repaid loans and who own businesses with high-growth potential. These clients will be offered the chance to receive one of the asset-based finance products described below, which are both consistent with locally accepted Islamic financial norms

Details of the Intervention

Researchers are conducting a randomized evaluation in Pakistan to test the impact of asset-based loan products on business growth. Researchers will randomly assign 900 microenterprises to one of three groups:

> **Debt-based contract**: Akhuwat will offer to finance business owners' purchase of an asset that can significantly increase the businesses' productivity. Bank representatives will stipulate that lending is conditional on the purchase of the fixed asset, which will be collateral for the loan (this will be enforced by accompanying the client to purchase the asset). The contract will require the client to buy the asset from Akhuwat over a fixed period of time, and pay an intermediate rental fee for use of the asset. Apart from this, the contract will be conventional, with a fixed repayment schedule that the client must follow regardless of their business outcomes.
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> **Lease-based contract**: As in the debt-based contract group, Akhuwat will offer to finance business owners' purchase of an asset, and the clients will pay rent on the assets. The entrepreneur will contribute a small amount to the asset initially, and then will have the option of "buying back" more of the asset so as to reduce the rental cost. Unlike the debt-based contract, however, the borrower will be under no obligation to buy back the asset unless they want to. This will allow entrepreneurs who experience growth in their firms to buy back the asset more quickly in order to reduce rental payments, but clients with less successful businesses will not be penalized for not making payments.
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> **Comparison**: The comparison group will not be offered an asset-based loan product. However, they will be given the same information about the asset as the other two groups, including the price of each item and information on where the item may be purchased.

Both asset-based finance products require Akhuwat to have some way to repossess the assets of clients who do not fulfill the terms of their contracts. Senior members of the community will be witnesses to each contract; in the event that Akhuwat needs to repossess an asset, these witnesses will be used to facilitate repossession of the asset.

By comparing sales, profits, employment, use of other forms of finance, and investment behavior of the microenterprises in each group, researchers will evaluate whether a more flexible lease-based contract stimulates growth more successfully than a traditional fixed-repayment-requirement debt contract, and whether clients who have the more flexible contract make riskier and more profitable investments. They will also compare take-up of the product offers in each group, in order to evaluate the demand for the asset-based finance products. Finally, they will evaluate whether the client's gender, the type of enterprise, their business and managerial skills, as well as behavioral characteristics (such as time and risk preferences) affect the efficacy of these products.

Results and Policy Lessons

Results forthcoming.

Sources

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[3] El-Gamal, M, El-Komi, M, Karlan, D, and Osman, A, 2014, "Bank-insured RoSCA for microfinance: Experimental evidence in poor Egyptian villages," Journal of Economic Behavior & Organization.

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