Improving Access to SME Finance

Evidence Dialogue on SME Development in Kenya

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World Bank
Performance of Emerging Market Firms Matters

Self employment rates 40%, as high as 75% (7% in the US)

Economic Rationale
- Labor is more productive in firms (Gollin et al, 2014)

Globalization
- Small firms are customers, suppliers, distributors

Question: How to help small firms grow?
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Empirical Puzzle

Size: no. of employees

Frequency
Empirical Puzzle

Frequency

Size: no. of employees

0 50 100 150 200 250 300 350 400
Possible Solutions?

Institutions (e.g. property rights)

Formalization (e.g. registration)

Managerial Capital (e.g. business skills)

Financial Capital (e.g. credit)
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Access to Finance Challenge

• Globally, 55-68% of SMEs underserved by financial institutions (IFC):
  • SME credit gap of US$0.24 trillion in Sub-Saharan-Africa; US $18 billion in Kenya.
  • MSME gap of US $0.33 trillion and US$19 billion, respectively.

• Impact evaluations of grants to small firms show severe credit constraints (e.g. McKenzie and Woodruff, 2008):
  • Estimated returns to capital 3-5 times higher than market interest rates
Why Credit Constrained?

SME LOAN PROCESS:
- Bank screens loan client
- Bank requires collateral to secure loan
- Client invests loan in business
- Client repays loan

KEY CHALLENGES IN SME LENDING CYCLE:
- Reliable historical data on SMEs is unavailable or expensive to collect
- Loan applicant lacks qualified collateral
- Client does not have the financial and managerial knowledge to successfully invest loan
- High default rates on SME loans increase risk, resulting in reduced SME lending

Source: IPA SME Brief, 2015
What has been tried:

• Cash Grants
• Microcredit

Promising new/under-researched avenues:

• Credit Guarantee Schemes
• Collateral Registries
• Trade Finance
• Psychometrics
• Digital Credit
• Alternative Credit Scoring
Cash Grants

Strong effects for male-owned enterprises, but not for female-owned enterprises in both short- and long-run.

• de Mel, McKenzie, and Woodruff, 2008 and 2012

Why?

• Sector selection
• Women are less entrepreneurial (!?)
• Spousal capture

→ Worth exploring household rather than enterprise-level outcomes (Bernhardt et al, 2019)
# Microcredit: Theory of Change

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<th>Need</th>
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<td>Business Investment</td>
<td>Increased sales/profits</td>
<td>Improved HH income</td>
<td>Improved HH welfare (e.g. health, education, satisfaction)</td>
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<td>(start/improve business)</td>
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Microcredit: Audacious to Humble

- Magic bullet against poverty
- Lifts millions out of poverty
- Raises income and consumption of the poor
- Helps poor cope with poverty
- Not about income or consumption, but rather about freedom and empowerment
### JPAL Policy Bulletin (2015) Summary

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Bosnia &amp; Herzegovina</th>
<th>Ethiopia</th>
<th>India</th>
<th>Mexico</th>
<th>Mongolia</th>
<th>Morocco</th>
<th>Philippines</th>
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<tr>
<td>Business ownership</td>
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<td>Revenue</td>
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<tr>
<td>Inventory/assets</td>
<td>↑</td>
<td>No data</td>
<td>↑</td>
<td>No data</td>
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<tr>
<td>Investment/costs</td>
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<td>↑</td>
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<td>Profit</td>
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<td>Household income</td>
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<tr>
<td>Household spending/consumption</td>
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<tr>
<td>Social well-being</td>
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Contract Structure

- MFI loans require repayment to begin immediately
- Contract structure not conducive for investment
- Possible explanation why money is spent elsewhere
- Rigol, Field, and Pande (2013) experimentally allow for a longer term loan with a 2-month initial grace period
Contract Structure

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- Contract structure not conducive for investment
- Possible explanation why money is spent elsewhere
- Rigol, Field, and Pande (2013) experimentally allow for a longer term loan with a 2-month initial grace period
- They find:
  - Business investment goes up
  - Profitability and variance also go up (borrowers are making risky investments)
Dynamic Incentives

Dynamic incentives allow lenders to reward good borrowers while punishing defaulters.

But without a national ID system, dynamic incentives cannot be used:

- Loan defaulters can avoid sanctions by using different identities
- Easier when multiple lenders operate in same area
- Lenders respond by limiting the supply of credit
Biometrics for Borrowing

Gine, Goldberg and Yang (2012): biometric fingerprint collected from all farmers as part of loan application
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Credit Guarantee Schemes

- Governments pledge to repay loan amount in case of SME default.
- This reduces the lender’s expected credit losses, acting as a form of insurance against default.
- CGSs can help improve information available on SME borrowers in coordination with credit registries and bureaus.
- Can help build the credit origination and risk management capacity of participating lenders.
- Important countercyclical role, providing support to small businesses during a downward economic cycle.
Collateral Registries and Trade Finance

Movable Collateral Registries:

- Easier to pledge and collect collateral → improved access to finance
- Relatively new tool and rigorous research is lacking

Trade Finance:

- Suppliers act as financial intermediaries
- More research needed on impacts (e.g. Jaza Duka in Kenya)
Digital Credit and Alternative Scoring

- Digital savings, credit, payments, and education platforms are widespread (e.g. M-Pesa, Arifu)
- Large number of studies are ongoing to study impact of digital credit on firms and HH outcomes
- Alternative Scoring:
  - Psychometrics
  - Using mobile call records to generate scores
  - Using digital education platform engagement to predict credit worthiness
Conclusion

• Access to finance for firms is an important avenue for alleviating credit constraints and improving SME growth.
• Recent advances and innovations have made products and services widely available.
• Research is fast catching up to industry in terms of identifying key impacts of various new credit tools and products.
Thank you