Scaling up SME Loans: Products with Dynamic Incentives

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Motivation

• Last slide of Chris’ presentation in the IPA SME September 2011 conference:

High returns, heterogeneity, high variance

• What does this imply about optimal contracts for providing capital?
  – State-dependent?
  – Equity?
  – Identifying those with better prospects?
Questions

• Long term
  – How should financing products aimed at *scaling up high growth* SMEs look like?

• Immediate
  – Test empirically whether the necessary conditions for such a product to be feasible exist
Innovation Example: Dynamic Incentives

• Contract features that offer higher future payoffs to high growth entrepreneurs
  – Promise of higher future lending (growth)
  – Performance pricing (separation)

→ Theory: Self-selection
  (example: Manso-Strulovici-Tchistyi 2010)

→ Practice: Features exist in current small business credit card products
RCT Design Example

• Goal: measure effect of performance pricing on self-selection of high productivity borrowers
  – Design similar to Karlan-Zinman 2009
  – Suppose: SME/micro lender, max. credit of $1,000, rate r

• Treatments:
  T0. (25%) Offer nothing
  T1. (25%) Offer $500 loan (add.); rate r
  T2. (50%) Offer $500 loan (add.); rate r; missed repayments on additional loan increase rate to $r_1 > r$ on all balances
  T3. Remove perf. pricing to half of T2 sample after selection
Discussion

• Interpretation
  – T3 – T1: pure selection effect of perf. pricing (0, +)
  – T2 – (T3 – T1): pure repayment effect of perf. pricing (−, 0)
  – T2 – T1: overall effect of perf. pricing (?)

• Caveats in implementation
  – Corner solutions (0% or 100% take-up)
  – Power: extensive margin requires large samples
  – Relevant outcomes: repayment and return on investment
  – Partner: looking to scale up
  – Cost: expensive if capital must be funded externally
Necessary Conditions for Positive Selection Effect

- Low incentives to “take the money and run”
  - Default must lower SME returns (ex. some assets to seize)
- Entrepreneur cares about risky future payoffs
- Entrepreneurial success driven by permanent characteristics (not luck), observable by entrepreneur
  - Entrepreneurs know their own “type”: ?
- Entrepreneurs understand the product
Thanks!