FIRM UP PERFORMANCE

ATHENS, GREECE
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WORLD BANK GROUP
Improving Access to SME Finance

Bilal Zia
September 10, 2019
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

[Diagram showing frequency against size (number of employees)]

Size: no. of employees
Empirical Puzzle

Size: no. of employees

Frequency
Empirical Puzzle

Missing Middle?

Frequency

Size: no. of employees
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

• 55-68 % of formal SMEs underserved by financial institutions:
  – Credit gap of US$ 0.9-1.1 trillion (World Bank, 2014)

• Impact evaluations of grants to microenterprises 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?
  – Opaque
  – Risky
  – Lack of collateral
Solutions?

• 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

<table>
<thead>
<tr>
<th>Need</th>
<th>Input</th>
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<th>Outcome</th>
<th>Impact</th>
<th>LT Impact</th>
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<td>Improved HH income</td>
<td>Improved HH welfare (e.g. health, education, satisfaction)</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
First Order Question: Take-up?

Oversubscription
First Order Question: Take-up?

Over-optimistic
### 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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<tbody>
<tr>
<td>Business ownership</td>
<td>↑</td>
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<tr>
<td>Revenue</td>
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<td>↑</td>
<td>-</td>
<td>↑</td>
<td>-</td>
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<tr>
<td>Inventory/assets</td>
<td>↑</td>
<td>No data</td>
<td>↑</td>
<td>No data</td>
<td>↑</td>
<td>↑</td>
<td>-</td>
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<tr>
<td>Investment/costs</td>
<td>-</td>
<td>-</td>
<td>↑</td>
<td>↑</td>
<td>No data</td>
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<td>Profit</td>
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<td>Household income</td>
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<td>-</td>
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<td>↓</td>
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<td>-</td>
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<tr>
<td>Household spending/consumption</td>
<td>-</td>
<td>↓</td>
<td>-</td>
<td>↑</td>
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<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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- 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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Group Liability Structure

• Can increase tension among members
  – Leads to voluntary dropouts
  – Can harm social capital among members

• More costly for clients who are good risks, because they are more likely to pay off loans of their peers
  – Bad clients can “free ride” off good ones
  – Makes it more difficult to attract and retain good clients

• As groups mature, loan sizes typically diverge
  – Smaller clients may not want to guarantee larger loans of other group members
Group Liability Structure

• Carpena, et al (2011) look at shift from individual to group liability in an Indian MFI:
  – Group liability induces lower missed payments, greater mandatory savings deposits

• Gine and Karlan (2014) conduct an RCT to study shift from group to individual liability in the Phillipines
  – No differences in repayment rates
  – Greater # of borrowers
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.
CGSs: Principles and Research

• Potential downsides: distortions and capture.

• In 2015 the World Bank Group and FIRST (Financial Sector Reform and Strengthening) Initiative convened a global task force to develop “Principles for the Design, Implementation, and Evaluation of Public Partial Credit Guarantee Schemes for SMEs”:
  – (i) legal and regulatory framework
  – (ii) corporate governance and risk management
  – (iii) operational framework
  – (iv) monitoring and evaluation

• Research on impact of CGS is limited to immediate outputs rather than economic additionality. WBG Toolkit offers menu of options for rigorous evaluation.
Collateral Registries and Trade Finance

• 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 (stay tuned!)

• Alternative Scoring:
  – Psychometrics (stay tuned!)
  – 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!