MSME Access to Finance

Miriam Bruhn
(Development Research Group, World Bank)

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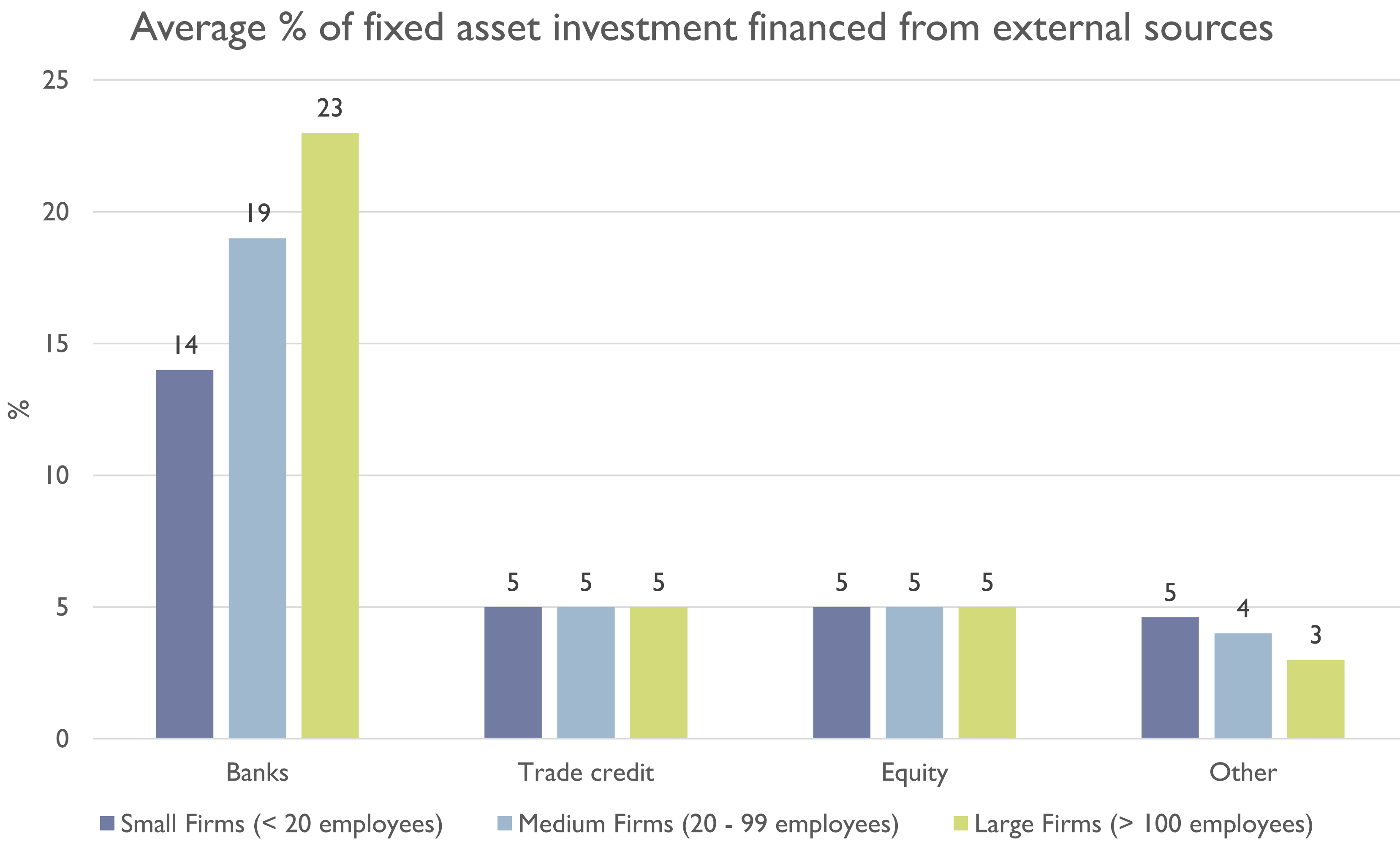
SMEs are less likely to use external finance than large firms (driven by bank lending)

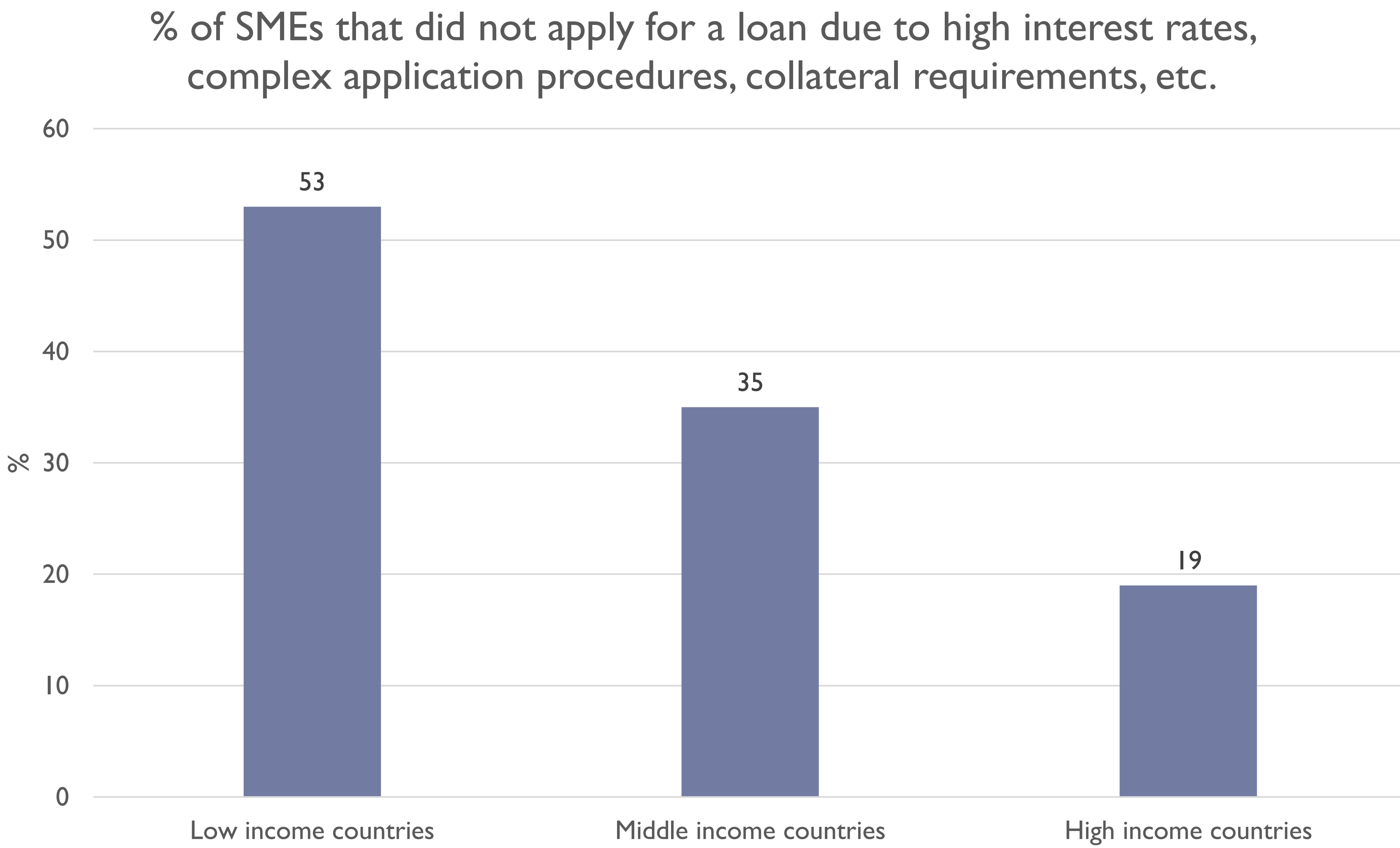


Source: Enterprise Surveys for 139 countries, covering the period 2006 to 2017.

Lending to MSMEs may be inhibited by information problems and transaction costs

- MSMEs often do not have adequate records and accounts to document firm performance when applying for a loan
- To compensate for missing information, lenders may ask for collateral, but MSMEs often lack adequate collateral
- High fixed costs of financial transactions render lending to small borrowers unprofitable
- Higher lending costs and greater risks are reflected in higher interest rates and fees for MSMEs than larger firms

Percentage of credit constrained SMEs is greater in developing countries



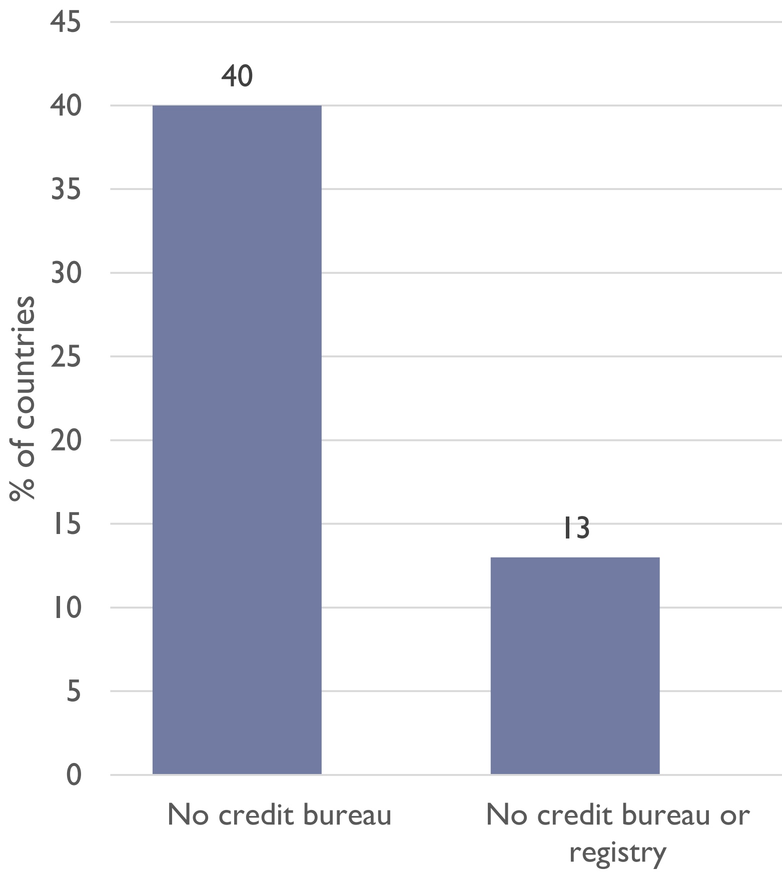
Source: Enterprise Surveys for 139 countries, covering the period 2006 to 2017.

Summary of research findings on policies for improving MSME access to finance

- Direct government interventions, such as government banks and credit guarantees, are difficult to implement since design matters a lot and they may be subject to political capture
  - Additionality – do these interventions support firms that would otherwise not have received credit?

- Market-oriented policies, such as collateral registries or credit bureaus, tend to be more successful

Credit information sharing can promote MSME lending



Source: World Bank Doing Business (2018)

- Introduction of a credit bureau has been shown to increase SMEs' use of credit
  - Stronger effects when coverage and scope of information is greater
  - Governments can put in place the legal framework and/or help lenders overcome coordination failures
- Credit registries don't have the same effect
  - Focus on larger loans and supervisory purposes

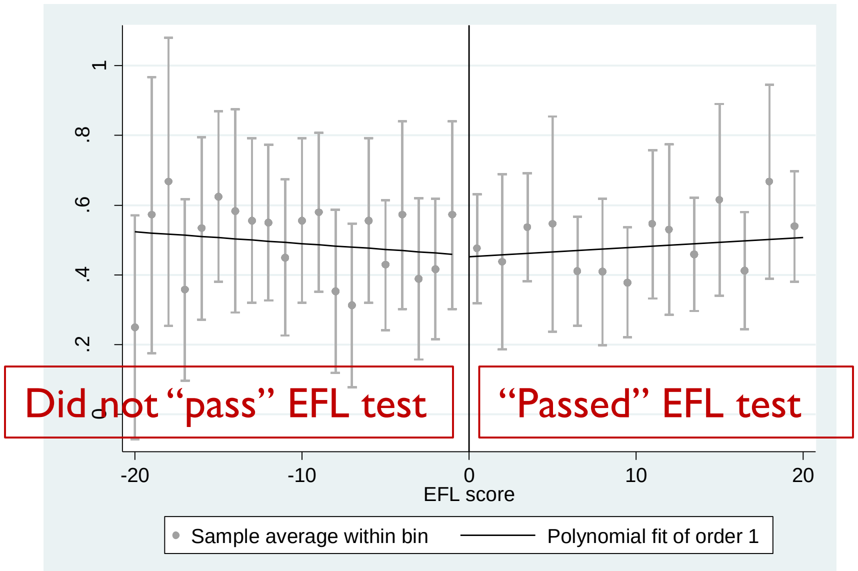
Can psychometric credit scoring provide valuable credit information on MSMEs?

- MSME owner takes a "personality" test as part of the loan application that measures
  - Potential for business success
  - Integrity or intention to pay back a loan

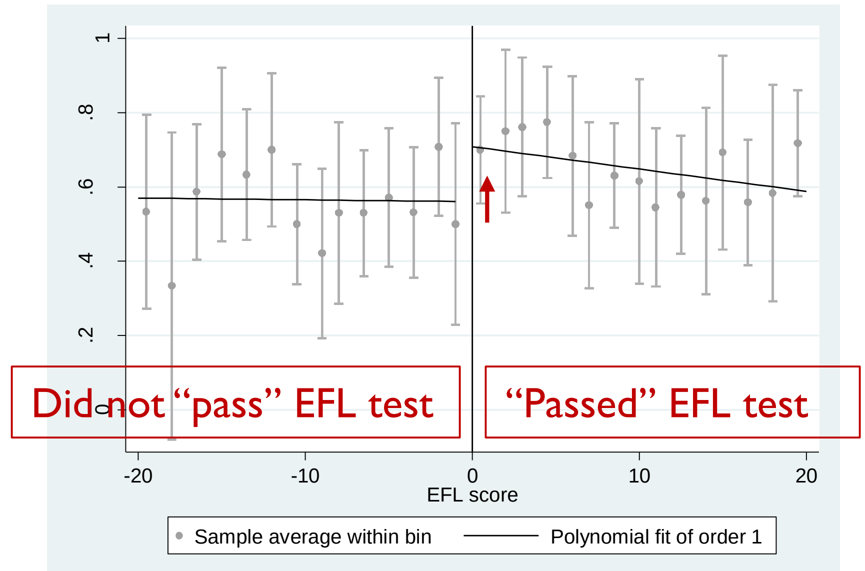
- The Entrepreneurial Finance Lab (EFL) developed such a test based on work in Africa and then also piloted it in Latin America, in collaboration with the IDB
  - Arráiz, Bruhn, Ruiz, and Stucchi study the viability of the EFL test in a sample of about 1,900 MSME owners who applied for business loans with a bank in Peru

Passing a psychometric test leads to increased loan access for MSMEs in Peru

Fraction who took out a loan within 6 months BEFORE loan application



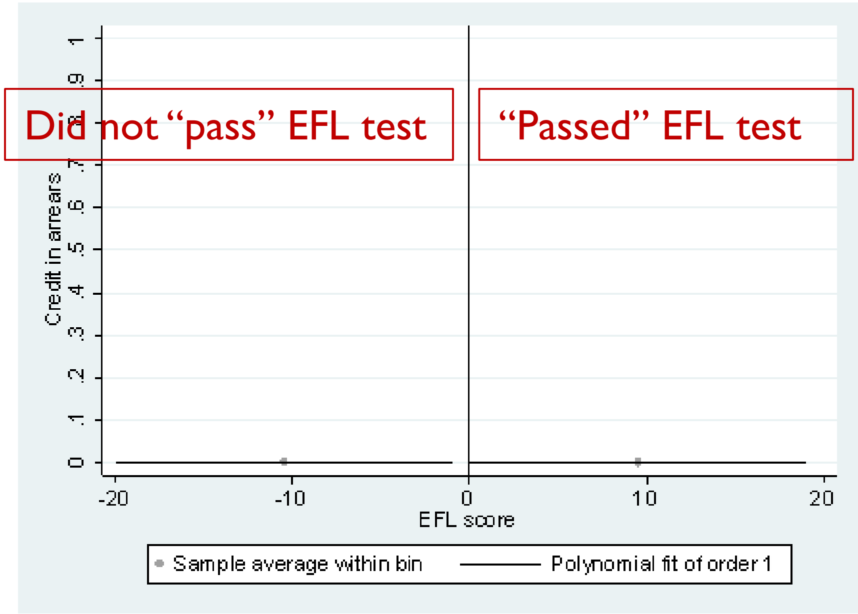
Fraction who took out a loan within 6 months AFTER loan application



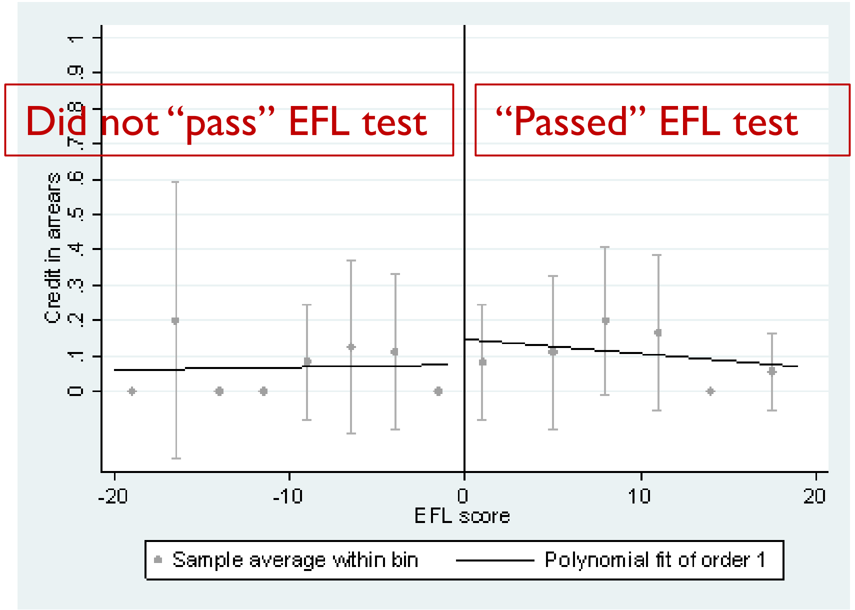
Probability of taking out a new loan within 6 months of the application increased from about 55 to 75% at EFL score cutoff (MSME owners with scores above the cutoff were offered a loan as part of the study)

Psychometric testing "works" for applicants WITHOUT a credit history

Fraction with loan in default
at time of application



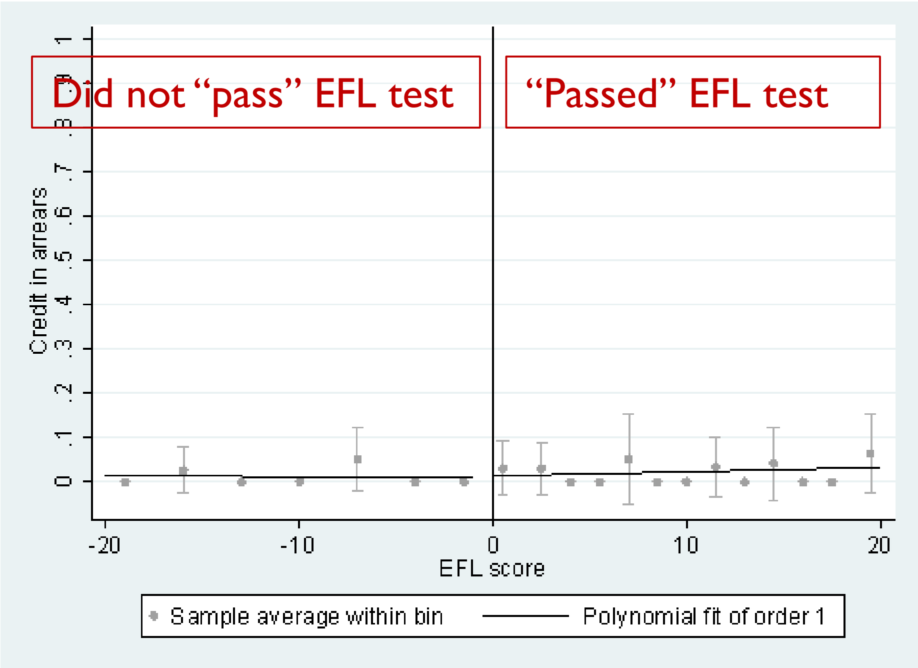
Fraction with loan in default
24 months after application



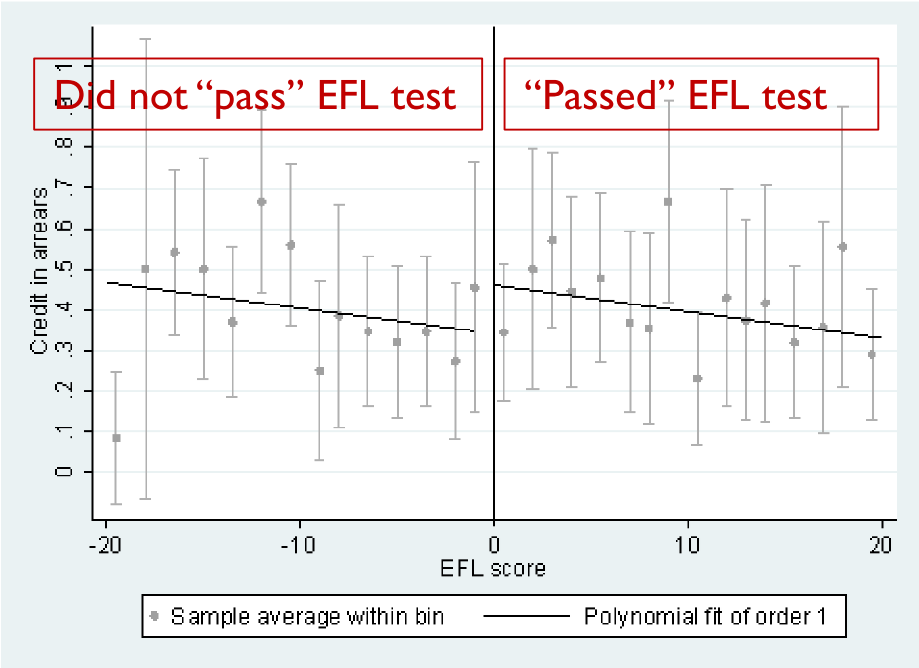
Applicants WITHOUT a credit history who were offered a loan based on the psychometric tool were NOT more likely to default on a loan within the following 24 months as those who received a loan based on conventional screening

BUT psychometric credit scoring does not replace credit bureau information

Fraction with loan in default
at time of application



Fraction with loan in default
24 months after application



Applicants WITH a credit history who were offered a loan based on the psychometric tool were more likely to default on a loan within the following 24 months as those who received a loan based on conventional screening. Why?

- Loans were offered even to applicants with a bad credit history
- Loans were covered by a credit guarantee, possibly reducing monitoring efforts