

PHOTO: WILL BOASE

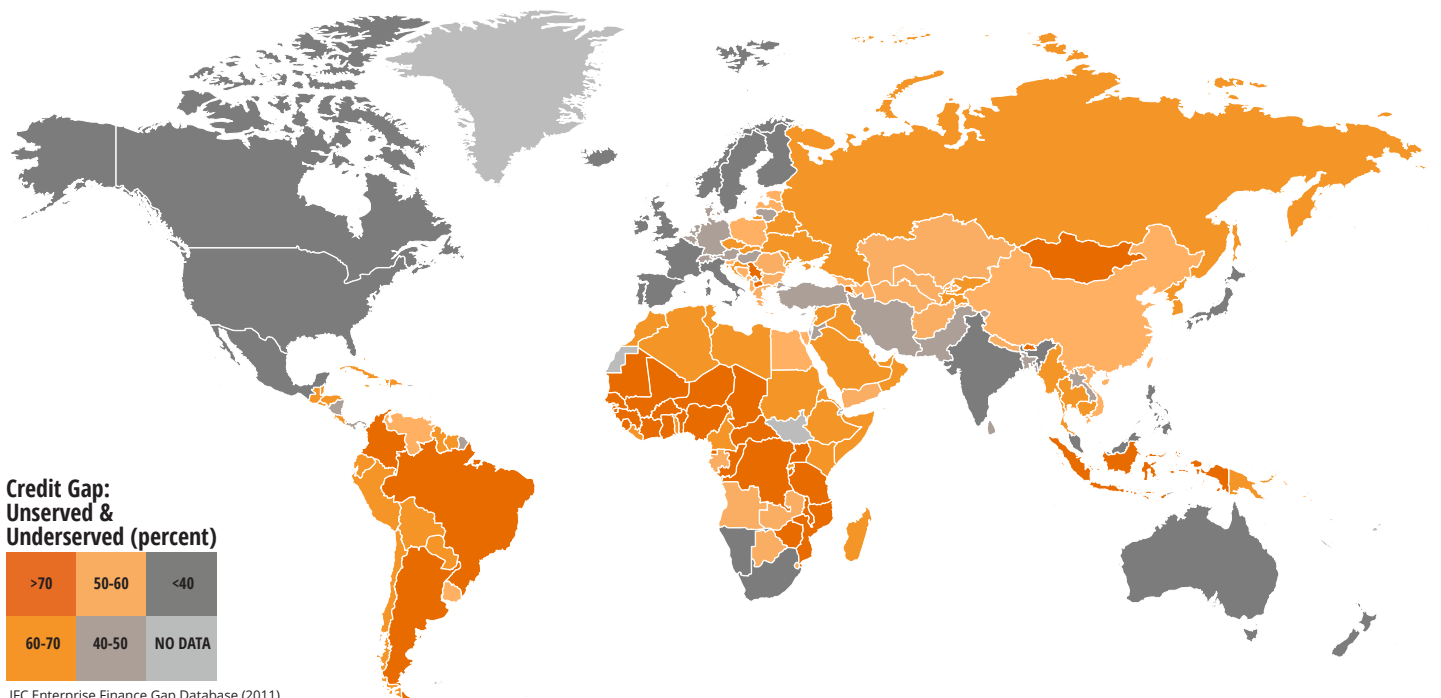
Access to Finance for Small and Medium Enterprises



Financial access is critical for the growth of small and medium-size enterprises (SMEs). It allows entrepreneurs to innovate, improve efficiency, expand to new markets, and provide millions of jobs. Yet, in developing countries, the majority of SMEs are unable to acquire the financing they need to reach their potential. Financing SMEs in the developing world can be risky and expensive for lenders, leading to an **estimated financing gap of one trillion USD** (International Finance Corporation, 2011).

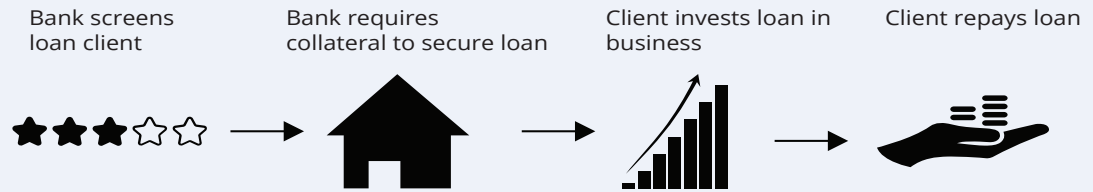
To reduce the credit gap, financial institutions, governments, and donors invest in lending products and policies designed to provide SMEs with the financing they need to grow and innovate. However, the extent to which such programs effectively reduce the barriers to SME financing has generally not been rigorously measured. **The SME Program at Innovations for Poverty Action (IPA) rigorously evaluates potential solutions and promotes the most efficient and cost-effective ways to expand access to finance for SMEs.**

THE SME CREDIT GAP



The SME Program addresses challenges throughout the SME lending cycle

SME LOAN PROCESS:



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

★★★★☆ CLIENT SCREENING

In developed countries, financial institutions assess SME loan applicants using information supplied by credit bureaus. In emerging markets, however, strong credit bureaus and other financial infrastructure often do not exist. Instead, banks rely on time-consuming methods to obtain credit histories directly from loan applicants. Incomplete financial records and unverifiable client information further increase the cost of assessing SME loan applications, making banks reluctant or unable to lend to SMEs. However, the SME sector in many developing countries is large and represents a very promising frontier for lenders. To capitalize on this, some banks have begun implementing innovative screening mechanisms to reduce the cost of lending.

CREDIT SCORES CAN IMPROVE LENDING DECISIONS

Colombia | Daniel Paravisini and Antoinette Schoar

IPA partnered with Bancamía, a bank focused on SME lending, to evaluate whether a computer-generated credit scoring system reduced the cost and improved the quality of the bank's loan review process. Usually, Bancamía's credit committee approves or rejects loan applications, or refers them to a regional manager. Researchers tested whether the committee's behavior changed when the credit score was available during the decision process. They also tested whether the additional transparency provided by the score incentivized committee members to improve their performance.

Results

Existence of a credit score, whether it was included in the initial loan review or not, encouraged the committee to spend more effort on difficult-to-evaluate applications. The improvement even when the score was not used suggests that **the committee might already have had the necessary information to make decisions on difficult applications, but lacked the incentives to use the information efficiently.** The committee's enhanced decision-making lowered the number of loan applications referred to the regional managers, which in turn **reduced the overall cost of the decision-making process.** Additionally, when the credit score was included in the loan review, the committee was able to better allocate loans, extending larger loans to less risky borrowers and smaller loans to riskier borrowers.

CAN LOAN OFFICERS IDENTIFY CLIENTS CAPABLE OF GROWING THEIR FIRMS?

Egypt | Gharad Bryan, Dean Karlan, and Adam Osman

Many microfinance institutions (MFIs) aspire to "graduate" their clients to larger loans as their businesses grow, but often lack the ability to successfully screen SME-level loans. Harnessing MFI loan officers' knowledge of their clients' borrowing potential could provide an innovative and cost-effective screening mechanism. IPA researchers are partnering with the Alexandria Business Association to develop and test a model that combines quantitative data with loan officers' knowledge of their clients in order to identify the microenterprises most likely to succeed with larger loan amounts. By randomly assigning a portion of the qualified clients to receive an SME-sized loan, researchers will be able to evaluate whether loan officers can accurately identify high-potential clients. The study will also measure the impact of the significantly larger loans on job creation and firm growth.



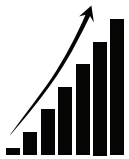
COLLATERAL

Banks traditionally require that clients provide collateral such as land or real estate to secure their loans. However, many creditworthy SMEs do not have the type of collateral required by commercial lenders and therefore have trouble accessing needed financing. To remove this barrier, some governments and financial institutions are relaxing collateral requirements or eliminating them altogether.

DO FLEXIBLE COLLATERAL REQUIREMENTS IMPROVE CREDIT ACCESS?

Colombia | Marcela Eslava and Antoinette Schoar

The Colombian government, with support from the International Finance Corporation, recently introduced a new Secured Transactions Reform that provides a legal framework for accepting movable collateral such as vehicles, machinery, accounts receivable, and inventory. The reform has two main pieces. First, it establishes a unified online registry for all movable assets used as collateral, so that potential creditors can verify whether assets offered as collateral are subject to other obligations. Second, the law improves enforcement in cases of default. By reducing banks' risk in accepting alternative forms of collateral, the reform is expected to increase access to credit for SMEs. IPA is measuring the impact of the reform on lenders' provision of credit to SMEs as well as business growth indicators such as employment and sales.



FINANCIAL CAPABILITIES

Entrepreneurs' financial management skills can determine their ability to access credit and grow their firms. In developing countries, business owners often have received no formal financial training. Financial literacy programs are a popular approach to improving financial management and decision-making, but the evidence on whether these training programs actually promote business growth is mixed.

TRAINING WITH 'RULES OF THUMB' IS MORE EFFECTIVE THAN TRADITIONAL FINANCIAL TRAINING

Dominican Republic | Alejandro Drexler, Greg Fischer, and Antoinette Schoar

IPA researchers partnered with ADOPEM, a bank serving small businesses, to compare two methods of financial literacy training: one which emphasized classic accounting principles and another which focused on simple "rules of thumb." The more complex training covered topics such as inventory management and daily record keeping. The "rules of thumb" training focused on simple guidelines for financial decision-making, such as separating business and personal expenditures, paying oneself a fixed salary, and estimating profits from changes in cash on hand.

Results

The "rules of thumb" training resulted in significant improvements in firms' financial practices and revenues, while the standard accounting program had no effect. Relative to those who received no training, "rules of thumb" trainees were 6 to 12 percentage points more likely to separate business and personal cash and accounts, keep accounting records, and formally calculate revenues. "Rules of thumb" trainees also reported higher revenues overall but particularly in bad weeks, suggesting that the simplified training content equipped them to better cope with slower periods. The impact of the "rules of thumb" training was particularly positive for clients with poor management practices before the training.

CAN FINANCIAL "RULES OF THUMB" BE TAUGHT THROUGH SMS MESSAGES?

India | Shawn Cole and Antoinette Schoar

Mobile platforms have the potential to affordably reach thousands of small business owners. In this study, IPA researchers evaluate whether the success of a "rules of thumb" training program using a simple, heuristics-based financial education curriculum can be replicated when the training is delivered via SMS messages. Carefully designed messages containing basic rules that are easy to implement will be sent to a randomly selected group of small businesses. The study will measure the impact of this training approach on the financial management and growth of small firms.



LOAN REPAYMENT

SMEs tend to have higher default rates than larger firms, making SME lending riskier. Better screening mechanisms can identify creditworthy SME clients, but innovations to banks' client management practices and contract terms can improve portfolio performance even after loans have been disbursed. The SME Program assesses a range of programs aimed at improving SME loan performance.

PERSONAL RELATIONSHIPS CAN IMPROVE REPAYMENT

India | Antoinette Schoar

This study evaluates whether personalized attention from bank officers improves loan repayment. SME loan clients of ICICI Bank were randomly assigned to one of four groups that involved different levels of interaction with the bank. The first group received phone calls every two weeks from the same relationship manager; the second received calls but from rotating relationship managers; the third group received only reminder calls for upcoming payments due; and the fourth group followed the usual bank protocol of receiving only SMS reminders before payment due dates.

Results

Building a relationship between bank officers and clients reduced late loan payments and, in particular, reduced the likelihood of repeated late payments. Borrowers in groups one and two had on average about 0.1 fewer late payments than those in group four, a significant reduction. Among borrowers who had at least one late payment, those in groups one and two were more than 20 percentage points less likely to have a second late payment relative to those who only received SMS reminders. **The reduction in late payments for groups one and two outweighed the additional cost of the phone calls and bank staff time,** making the program cost effective for the bank. Better repayment among borrowers also helped small business owners secure more favorable terms with the bank for subsequent loans.

ALTERING THE TRADITIONAL REPAYMENT TIMEFRAME BENEFITS CLIENTS

India | Erica Field, Rohini Pande, and Natalia Rigol

Traditional microfinance contracts require clients to repay loans in weekly installments beginning shortly after disbursement. In a 2007 study, a randomly selected group of business owners received a grace period of two months before starting to repay their loans. The goal was to test whether the grace period would allow businesses to invest more of the loan in their business and thereby promote growth.

Results

Clients who received the loans with grace period invested approximately six percent more in their businesses, were more than twice as likely to start a new business, and had 41 percent higher profits after nearly three years. In addition, **13 percent of businesses receiving the grace period grew from microenterprises into SMEs** within five years of obtaining the loan. However, grace period clients were also more than three times as likely to default on their loans. IPA researchers are currently conducting follow-up surveys to determine the long-term effects of the contract modification on business growth.

The SME Program discovers and promotes effective solutions to the constraints affecting SME growth and entrepreneurship in developing countries.



Build the body of evidence

The SME Program brings together **leading researchers** and **innovative organizations** to test new ideas and evaluate existing SME development approaches. Relying on IPA's **research management expertise**, these partnerships lead to high-quality, cutting-edge research that informs SME policy design. The SME Program also directly supports new studies through its Competitive Research Fund on Entrepreneurship and SME Growth.



Promote evidence-based decision-making

Producing evidence is not enough to achieve policy impact: results must reach those with the power to enact change. The SME Program works closely with its partner organizations to ensure that **research findings inform programmatic and operational decisions.** The Program also shares evidence with multilateral organizations, nonprofits, governments, donors, and the private sector through international events.