MSME Access to Finance

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

<table>
<thead>
<tr>
<th>Source: Enterprise Surveys for 139 countries, covering the period 2006 to 2017.</th>
<th>Banks</th>
<th>Trade credit</th>
<th>Equity</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Firms (&lt; 20 employees)</td>
<td>14</td>
<td>5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Medium Firms (20 - 99 employees)</td>
<td>23</td>
<td>5</td>
<td>5</td>
<td>4</td>
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<tr>
<td>Large Firms (&gt; 100 employees)</td>
<td>19</td>
<td>5</td>
<td>5</td>
<td>3</td>
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</tbody>
</table>
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

% of SMEs that did not apply for a loan due to high interest rates, complex application procedures, collateral requirements, etc.

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

- 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

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

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

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