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# **Small Businesses in Emerging Markets**

Presentation to IFC Conference on Measuring Development Results

IFC Auditorium

May 2nd, 2008

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## Agenda

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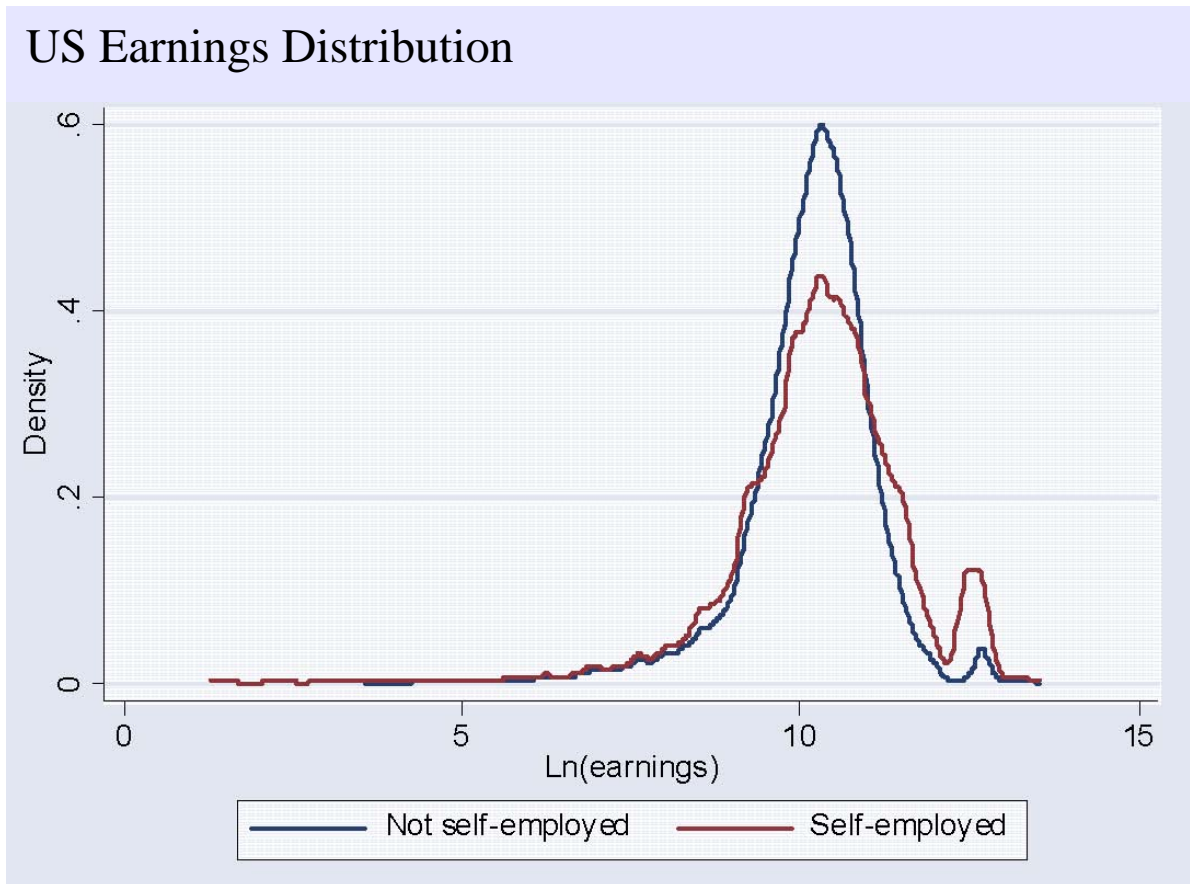
- A few facts about SMEs in developing countries
  - Growth constraints for entrepreneurial firms
  - Project Overviews
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# In developing countries SMEs play a big role in business



In the United States, bi-modal earnings distribution is most pronounced for self-employed

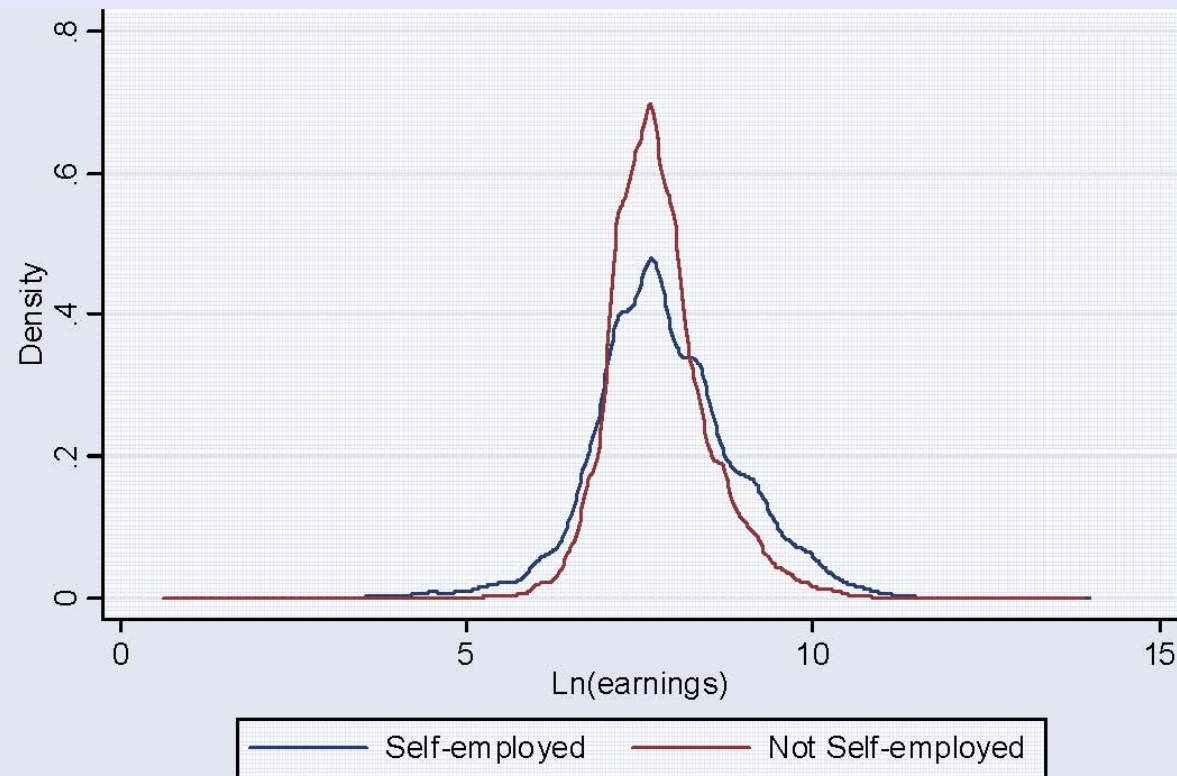
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In India, earnings distribution is centered around the mean

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India Earnings Distribution



## Comparison Developing Countries and United States

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- In developing economies entrepreneurial firms are centered at the low end of the firm size distribution, in the US the distribution is much more continuous
- In developing countries a much larger fraction of the population relies on earnings from **self-employment** than **wage** earnings, across all segments of the economy

→ Small firms face limitation to growth! Why?

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# Factors that can facilitate/hurt investment in small businesses

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**Screening: Identify the profitable firms**

- Use sector insights to create screening rules at the bank level
- Find existing information channels to extend finance, e.g. channel financing

**Business Environment: Aiding viable firms**

- Electricity
- Supply chain
- Create resale market for collateral
- Business Training

**Contract Enforcement: Ensure repayment**

- Credit Bureau
  - Monitoring and relationship building
  - Alternative financial instruments, e.g. micro equity and flexible loans
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# Reasons for Design Interventions

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Private incentives to innovate may be low

- Small business lending has social benefits that a single firm/bank will not internalize
- Banks may not have *some* of the necessary human capital

Private capacity to innovate may be limited

- Best practices spread slowly
- Knowledge and application are not always matched optimally
- Banks may not have scale to innovate

Governments may under-innovate policy

- Research on optimal policy as public good
  - Government can be very (sometimes the most!) important actor
  - Can catalyze private action
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*My question is: Are we making an impact?*

## Examples: Projects at Different Levels of Intervention

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- ***Borrower level intervention:*** Business training programs
    - Testing accounting and bookkeeping training with ADOPEM clients in the DR
  - ***Bank level intervention:*** Monitoring and relationship building between the bank and its clients
    - ICICI SBL facility
  - ***Market level intervention:*** Impact of liquidity provision on product market pricing and bidding of firms
    - Ebay and ICICI: Market for second hand vehicles
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## Example I: Business Training facilities for ADOPEM clients

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- **Idea:** SMEs often do not have needed business skills prior to starting their business. This could be a function of cash constraints or missing training opportunities.
  - Can a bank profitably provide these skills?
  - What are the adequate training interventions?



**ADOPEM**  
Asociación Dominicana para  
el Desarrollo de la Mujer  
*Filial del Banco Mundial de la Mujer*

## Example I: Training Interventions

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- **Group A:** Account separation training: relies on the idea that SMEs mix personal and business finances
  - **Group B:** Full accounting training: Provides in-depth accounting skills
  - **Group C:** On the job follow-up training versus in class training: Test the intensity of training needed
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## Early Insights

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- Clients all rank training offering very high
    - But highest satisfaction from the high end classes. Surprising since bank thought that clients would not be able to understand those
  - Clients have difficulty leaving their business for short amounts for training since they cannot trust anyone else to run the business
  - Clients face great uncertainty about business decisions; enjoy community of classes to exchange investment ideas
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## Example II: Small Business Loan Facility of ICICI

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- **Idea:** Many SMEs do not have sufficient collateral to get a bank loan even if they have cash flow to pay. Set up a collateral free loan and use score card to mitigate risk.



**i ICICI Bank SME Online**

**I got big success with just one smart move.**

**Get SME Loan up to Rs. 10 crore**

The advertisement features a man in a dark suit and light blue shirt, smiling and making an 'OK' gesture with his right hand. The background is a gradient of orange and red with a subtle grid pattern. The text is in white and yellow, with the ICICI logo in white on a dark red background.

## Example II: Small Business Loan Facility of ICICI

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- ***Problem:*** Credit bureau information are very important in setting up reliable credit scores, but India does not have a well functioning credit bureau.
    - SBL had initially high default rates, above 7%
  - ***Challenge:*** Design/test monitoring and incentive schemes to improve repayment rates and increase client loyalty
    - Can the incentives that bank provides substitute for the lack of financial infrastructure in the market?
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## Different Hypotheses for Effectiveness of Monitoring

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- How should ICICI set up its division to monitor and follow SME loan clients?
  - Depends on the reasons behind defaults, which are not known and need to be tested.
    - Strategic default: Reduction of asymmetric information for the bank?
    - Loyalty: Build personal relationship between loan officer and clients?
    - Behavioral factors: SMEs have poor planning skills
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# Monitoring Experiment Example

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## **Group A: No monitoring treatment**

Control Group

## **Group B: Reminder treatment**

Send SMS with interest and principal due every month. Follow up with phone call if clients have outstanding balances

## **Group C: Medium touch treatment**

Random loan officers follow up with clients regularly to solve problems, understand the nature of the business

## **Group D: Personal touch treatment**

Assign individual loan officer to create “ongoing relationship” with client. Treatment as in Group C.

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## Early Insights

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- Clients are developing relationship with bank officers; feel responsible to loan officer not bank
  - Seem to enjoy the additional attention by the bank
  - But might also create ratchet effect for high service level expectations which are expensive to maintain
  - Could potentially lead to problems in an environment with high turnover
    - Overall impact still to be seen!
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# Summary

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- Large need and opportunities for innovation and new designs in access to finance
  - New ideas will focus on the borrower level or the level of the banks or the market
  - Donor organizations and careful research can facilitate testing and diffusion of new ideas
- For-profit sector and banking sector can serve as a very scalable diffusion channel
  - Once products have been proven and tested banks will adopt and imitate new ideas