

# The Elephant in the Room: Financial Inclusion for the Missing Middle

## THE LIMITS OF FINANCIAL INCLUSION

Donor agencies, philanthropists, and social innovators are much enamored of financial inclusion these days. Their enthusiasm is matched by their expenditures: the Consultative Group to Assist the Poor (CGAP), in its 2013 Funders Survey, estimated that donors committed at least \$29 billion to advance financial inclusion in 2012 alone.<sup>1</sup> The Bill & Melinda Gates Foundation's Financial Services for the Poor program spent nearly \$90 million in 2013, almost exclusively to support digital payments, savings, and credit products for the poor in developing countries.

Partly as a result of this largesse, electronic payment platforms and other technological innovations have sprung up across the landscape of the Global South. Virtually no discussion on digital financial inclusion can avoid mentioning Safaricom's M-PESA, a mobile payments service that leveraged initial funding from the UK's Department for International Development to achieve phenomenal success in Kenya and, to a lesser extent, a few neighboring countries. Many other less famous initiatives have also sought to expand financial inclusion using mobile technology, including payment platforms like Zoono in Zambia and products aimed at expanding access to microcredit, like In-Venture and the SIMLab Credit Project.

Giving poor people direct access to basic financial services is a laudable goal in itself, one that can generate important benefits. Evaluations of microfinance programs

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have found, for example, that having access to credit and savings allows a household to accelerate consumption and absorb shocks, such as an illness.<sup>2</sup> Financial inclusion can also have a more personal impact: a survey of borrowers of Compartamos, a large Mexican microfinance bank, found that having greater access to credit results in people feeling less depressed and having more trust in others, and in women having greater household decision making power.<sup>3</sup> The impact of mobile payments is less clear, but recent studies of M-PESA suggest that they promote savings and increase the volume of financial transfers, which might reflect increased economic activity in rural areas.<sup>4</sup>

While financial inclusion can help the poor improve their lives in some important ways, there is one thing it apparently does not do, at least as far as the research suggests: financial inclusion does not make a significant difference in helping people escape poverty. A Poverty Action Lab review of seven randomized control trials of microfinance products around the world found that access to microcredit did not lead to a substantial increase in borrowers' household income.<sup>5</sup> A CGAP review similarly indicates that "most of the studies to date provide mixed evidence on the impact of microcredit on important measures of household welfare such as an increase in consumption or income."<sup>6</sup> Several studies indicate that savings, insurance, and payment services can help smooth income and improve resilience to external shocks, which perhaps prevents people from falling further into poverty.<sup>7</sup> To our knowledge, however, there is no evidence that increased access to savings, electronic payments, or other financial services produces a significant, sustained increase in household income or consumption.

## THE PROMISE OF FORMAL EMPLOYMENT

If financial inclusion does not help lift families out of poverty, what does? Experience suggests that the most reliable route out of poverty for low-income families in the developing world is access to formal employment. Granted, the relationship between job growth and poverty alleviation is complex, as not all sectors produce jobs that benefit the poor, and not all poor people are able to take advantage of the jobs that are available. However, one thing does seem certain: formal-sector employment is much more effective in reducing poverty than work in the informal sector. A 2010 UN study found that wages in the informal sector are on average 44 percent lower than wages in the formal sector.<sup>8</sup> A more recent report by the International Finance Corporation (IFC) states, "Although informal jobs help make ends meet, they tend to be suboptimal solutions that could further perpetuate rather than reduce poverty. Many of the 4 billion people estimated to be at the Base of Pyramid (BP) depend on informal sector activities, which can act as poverty traps."<sup>9</sup>

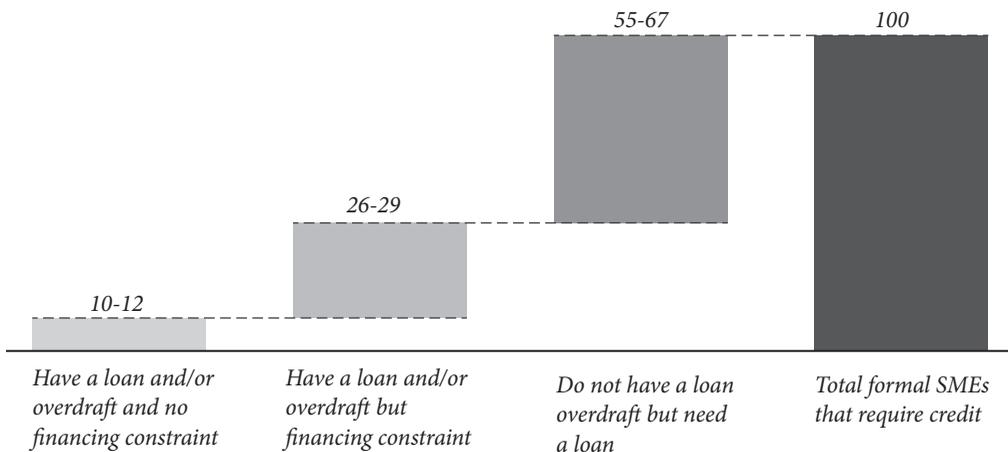
In light of these observations, the apparent failure to bring about meaningful improvements in household income or consumption through financial inclusion is not surprising. For the most part, microfinance is designed to make life easier for people who work in the informal sector, rather than to help them find or keep a job in the formal sector—let alone to increase the supply of formal jobs available to the poor. As



Notes: the data refer to employment in the formal, non agricultural private economy; firm size is based on the number of full-time employees; microenterprises are excluded; based on data from 98 countries.

Source: ILO/GIZ

**Figure 1.** Employment shares across countries from firms with 5-249 employees (percentage)



Source: IFC

**Figure 2.** Formal SMEs’ use of financial institution loans and financial constraints (percentage, emerging markets)

Anel Karnani writes in the *Stanford Social Innovation Review*, “Although some micro-credit clients have created visionary businesses, the vast majority are caught in subsistence activities...They would gladly take a factory job at reasonable wages if it were available.”<sup>10</sup> In fact, one of the few successful examples of microfinance the Poverty Action Lab researchers discovered was from South Africa, where giving loans to employed individuals increased their incomes by helping them absorb economic shocks, which in turn enabled them to keep their jobs.<sup>11</sup>

## SMES: THE ENGINE OF PRO-POOR JOB CREATION

If formal employment is the key to escaping poverty, how is that employment created? A large majority of the jobs in developing countries are in small and medium-sized enterprises (SMEs)—the businesses that occupy the vast middle ground between microenterprises and large corporations. As seen in Figure 1, firms with more than five but fewer than 250 employees account for nearly 80 percent of formal employment in low-income countries and about two-thirds of employment in lower-middle-income countries. As economies grow and new jobs are created, most of those jobs are with SMEs, rather than with large corporations or microenterprises. In a sample of 85 countries with net job creation, 75 percent of all new jobs were created by SMEs.<sup>12</sup>

Moreover, it is likely that the jobs created by SMEs are more accessible to poor people than jobs created by larger businesses. Larger companies in the developing world—especially multinationals—tend to be more sophisticated than their SME counterparts and require skills that low-income workers are not likely to have. Thus, supporting the growth of SMEs, especially those in labor-intensive industries that are most likely to hire low-income workers, should be an effective way to alleviate poverty.

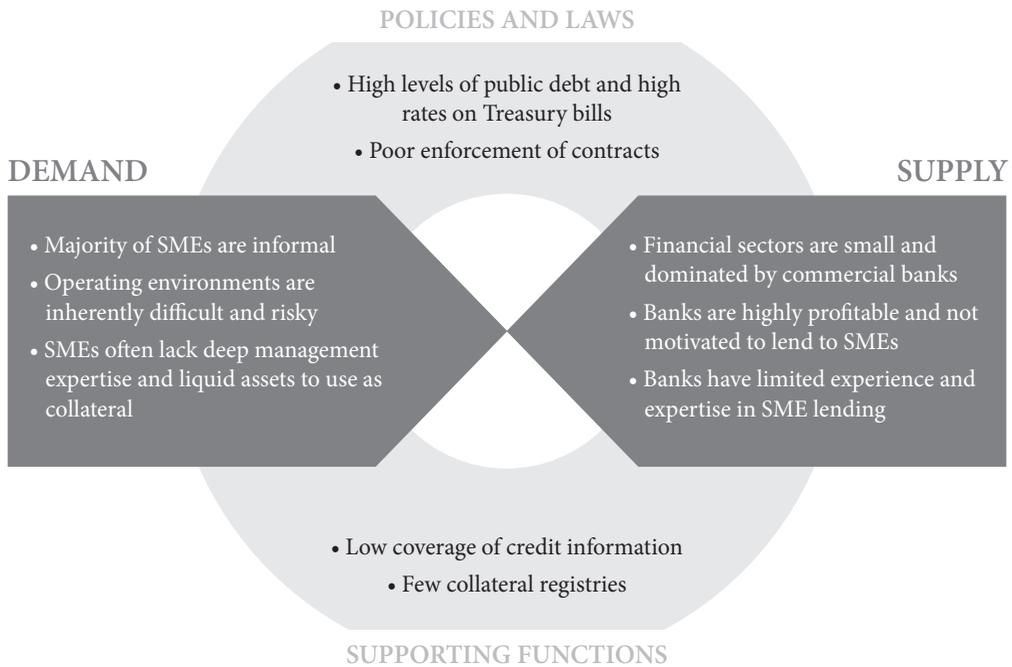
## THE SME FINANCING GAP

If SMEs are so effective at creating jobs, why are unemployment and poverty rates still so high in most developing countries? The answer to this question is largely that SMEs lack access to affordable capital—or, to use the lexicon of the financial inclusion community, SMEs are financially excluded.

The World Bank Enterprise Surveys reveal that SMEs around the world list financing constraints as their single greatest barrier to growth, while large firms place it only fourth.<sup>13</sup> A study by the IFC estimates that about 90 percent of formal SMEs in emerging markets have limited access to credit (see Figure 2).

To make matters worse, the IFC also estimates that only about one-quarter of all SMEs are formal; the remaining three-quarters operate without formal legal registration and thus, almost by definition, are financially excluded.<sup>14</sup> Informal SMEs typically have no verifiable financial statements, no formal ownership of assets that could be used as collateral for a loan, and sometimes not even a formal address. All of this makes it virtually impossible for banks to lend to them. If one assumes, then, that all informal SMEs lack access to credit, the share of all SMEs that have access to credit without any financing constraints is not more than 3 percent. In other words, up to 97 percent of all SMEs in the developing world face some degree of financial exclusion.

According to the IFC, the total financing gap for formal SMEs outside the high-income OECD countries could be as high as US \$700-\$850 billion.<sup>15</sup> If informal SMEs were included in that calculation, the financing gap would easily be twice that size.<sup>16</sup> Because of this massive financing gap, SMEs have become known as the missing middle—the proverbial elephant in the room. Governments, donors, and others who work



Source: Dalberg analysis. Basic market framework developed by The Springfield Centre

**Figure 3.** Barriers to SME finance

toward financial inclusion know that it's there and recognize that it's a problem, but few ever mention it because no one knows quite what to do about it.

### BARRIERS TO SMES' ACCESS TO FINANCE

The impact of addressing the SME financing gap in terms of alleviating poverty, which is a primary goal for most donor organizations, should be obvious. Formal employment is the most effective way to escape poverty, and most formal employment is created by SMEs, which are prevented from creating even more jobs by their very limited access to financing. Yet how to address the gap is far from obvious, as it involves a complex set of interrelated, mutually reinforcing factors. Figure 3 summarizes the key factors that contribute to the dearth of credit in the missing middle. Constraints exist on both sides of the market—demand and supply—as well as within the policies and laws that influence credit markets and the technical infrastructure functions that support them.

#### **Demand**

Put simply, many SMEs are not particularly creditworthy. As noted earlier, some 75 percent of all SMEs in the developing world operate informally, which makes them almost entirely “unbankable”—that is, banks cannot lend to an entity that does not legally exist. But even formal SMEs face three problems that make them unattractive

to lenders. First, most developing countries are difficult and risky places in which to do business; unpredictable electricity, poor roads, expensive and patchy Internet service, and a poorly educated workforce afflict nearly all lower-income countries to some degree. While large corporations face these same challenges, they often have the resources to overcome them by, for example, generating their own power or building their own access roads. SMEs typically do not have the resources to do the same, and thus find it difficult to generate consistent profits and predictable cash flows.

Second, many SMEs are not especially well managed and, for obvious reasons, few have much experience handling loans or lines of credit. Even some of the most professionally managed SMEs do not communicate in terms that bankers understand; for example, they cannot produce detailed cash flow forecasts or accurately assess the value of their physical property.

Third, many SME owners do not have much excess capital—cash or other liquid assets—to secure a loan. As the old adage says, “Banks only want to lend money to people who don’t need it.” While that might overstate the situation a little, most lenders do prefer to work with borrowers who have access to liquid assets and/or multiple sources of income. Because of these three factors—an inherently risky business environment, relatively weak or opaque management, and a lack of liquid assets—when banks offer financing to SMEs they generally do so only with restrictive loan terms and high interest rates, which makes borrowing uneconomic for SMEs and thus reinforces the vicious cycle that perpetuates the SME financing gap.

## **Supply**

The most direct constraint relative to the supply of credit for SMEs is that there simply is not enough of it. In most developing countries, the financial sector is small relative to the size of the overall economy. The most common way to measure the relative size of a country’s financial sector is the amount of credit outstanding to the private sector as a percentage of GDP. According to the World Bank’s 2013 Global Financial Development report, this ratio averages 103 percent in high-income countries, while the average ratio for low-income countries is around 25 percent.<sup>17</sup> To offer a few examples, credit to the private sector is 51 percent of GDP in India, 38 percent in Indonesia, and a dismal 14 percent in Tanzania. As basic economic theory explains, when the supply of a product (in this case, credit) is far below demand, the product will be scarce and expensive—as seen in the onerous procedures and high interest rates involved with accessing credit in many developing countries. Competitive pressure is weak, which lessens suppliers’ incentive to innovate or improve services. With plenty of safer and more profitable large companies to lend to, most banks in the developing world are in no hurry to serve SMEs.

Moreover, most developing countries’ financial sectors are dominated by commercial banks. In Nigeria, for example, commercial banks make up about 90 percent of financial sector assets, while the average for sub-Saharan Africa is around 80 percent.<sup>18</sup>

Non-bank financial institutions (NBFIs), many of which specifically serve SMEs, are tiny in comparison to banks in the developing world. In contrast, NBFIs in the United States hold nearly twice the assets of commercial banks.<sup>19</sup>

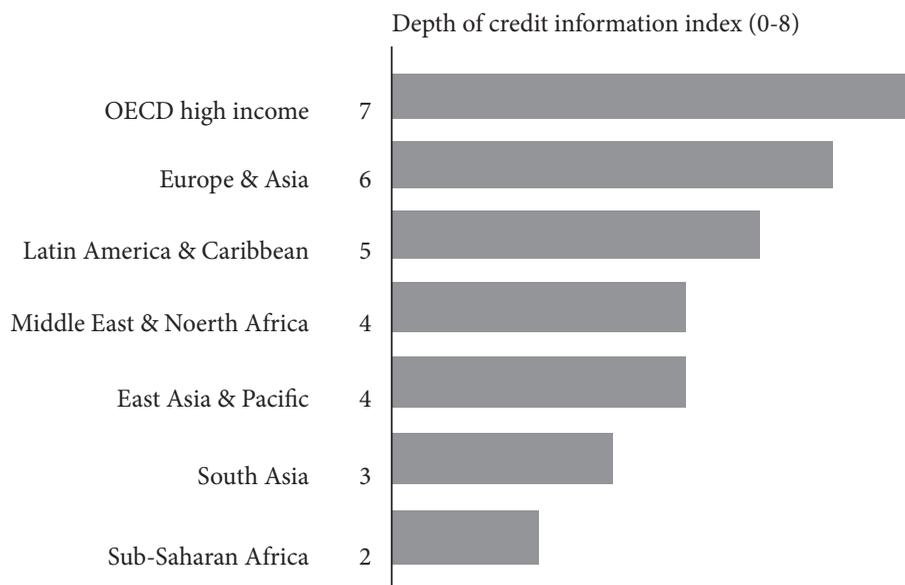
The dominance of commercial banks creates several problems, all of which are rooted in the fact that bank loans are funded primarily by deposits. First, as guardians of the public's savings, banks are strictly regulated in ways that protect depositors but make it difficult for them to take on riskier SME loans. For example, regulators require banks to set aside a substantial amount of capital against loans that are not highly collateralized, and commercial banks in many countries are prohibited from holding equity stakes in companies they lend to, which prevents them from deploying hybrid debt-equity instruments and other innovative financing mechanisms that could address the needs of SMEs. NBFIs, because they do not take deposits, are not subject to these restrictions.

Second, most deposits in developing countries are short term, which means they can only be used to fund relatively short-term loans. In the U.S. and other developed economies, companies of all sizes routinely take out a five-year loan to pay for a new truck or other large piece of capital equipment or acquire a long-term mortgage to pay for a factory or office space. In many developing countries, however, it is virtually impossible for an SME to obtain a loan with a term of more than two or three years.

Third, and most fundamentally, the dominance of deposit-taking banks limits the financial sector's potential for growth. Regulators enforce a maximum loan-to-deposit ratio (LDR) for banks, so the amount of credit available in countries with a bank-dominated financial sector is limited by the amount of savings individuals and enterprises put in banks. Once a bank meets its maximum LDR, its loans can never grow faster than its deposits. Deposits in low-income countries tend to be much lower, relative to GDP, than those in high-income countries, which mirrors the trend in credit as a percentage of GDP. In Nigeria, for example, bank deposits are just 13 percent of GDP and in Ghana they are 23 percent, which compares with 153 percent in the UK and 136 percent in Japan.<sup>20</sup>

One obvious reason why savings rates are so low in poor countries is that most people have relatively little money to save. A less obvious reason is that people who do have money to save often choose not to put it in a bank because bank accounts are not a particularly good deal for most savers. A study by the FinMark Trust found that \$100 deposited in a typical bank account in Zambia would be reduced to nothing in less than two years—drained by bank fees that significantly exceed the interest paid on the account.<sup>21</sup> In some countries with high inflation, the interest one can earn on a savings account is actually negative in real terms. Depositors in Angola and the Democratic Republic of Congo, for example, have been losing about 5 percent of their savings each year in real terms, not including the amount they pay in bank fees.<sup>22</sup>

Because of the huge gap between supply and demand and the resulting lack of competition, banks in developing countries boast profits that American or European



**Figure 4.** Availability of information on potential borrowers

bankers can only dream of. World Bank data indicate that average bank return on equity for low-income countries is 21.4 percent, while banks in high-income countries average only 8.8 percent return on equity.<sup>23</sup> With profits so high, commercial banks have little incentive to explore new market segments or take on unfamiliar risks, so the vast missing middle remains financially excluded.

### Policies and Laws

Another factor that makes it easy for banks in low-income countries to earn such impressive profits is a high level of government borrowing. Banks are able to invest their deposits in high-yielding government debt instruments and thus earn a healthy return while taking on virtually no risk. Three-month treasury bill rates that pay less than 1 percent in the UK and the U.S. offer around 24 percent in Ghana and 14 percent in Uganda. In fact, using data from 60 developing countries, Emran and Farazi described a “lazy bank” model in which access to safe government assets discourages the banks from lending to the private sector.<sup>24</sup>

Poor enforcement of contracts—caused by a combination of inappropriate or outdated laws, clogged court systems, poorly trained and sometimes corrupt judiciaries—makes it even harder for banks or NBFIs to lend to SMEs. The World Bank’s Doing Business Indicators show that the average time to enforce a contract is nearly four years in India and almost three years in Angola, but just over a year in the U.S. or the UK. In the typical sub-Saharan African country, the expenses associated with enforcing a contract represent 45 percent of the original claim value. It is little wonder, then, that banks in developing countries often require borrowers to put up collateral that is worth from 150 percent to 200 percent of the value of their loan.<sup>25</sup>

### **Supporting Functions**

In most of the developing world, the technical infrastructure that underpins a well-functioning financial market is either barely effective or missing altogether. One example is credit information: in the U.S. and other developed economies, banks turn to credit-rating agencies and other sources to find out if an SME owner is credit-worthy, but no such resources exist in most low-income countries. As seen in Figure 4, sub-Saharan Africa and South Asia score particularly poorly on the World Bank's depth of credit information index, which measures the scope, accessibility, and quality of credit information available.

Finally, in developed countries it is common for an SME to use a tractor, truck, or other piece of movable equipment as collateral for a loan. A bank can easily verify that the SME legally owns the equipment and has not already posted it as collateral for a loan with another bank. The bank can also lodge its claim to the equipment with a central registry, knowing that the claim will be recognized—and ownership transferred—if the borrower fails to repay the loan. In most developing countries, the lack of a movable collateral registry makes this process impossible and creates yet another obstacle to SME finance. Removing this obstacle can make a real difference in unlocking credit for SMEs: the World Bank finds that introducing or expanding movable collateral registries increases access to finance by seven to eight percentage points.<sup>26</sup>

All of these conditions—demand, supply, policies and laws, and supporting functions—interact in complex and mutually reinforcing ways. For example, banks do not lend to SMEs in part because they can earn more money with less risk by lending to the government, and in part because so many SMEs are informal. Governments borrow so much from banks because they collect so little in taxes, which in turn is largely because so many SMEs are informal and thus do not pay taxes. One reason SMEs choose to remain informal is because tax rates are so high, and because banks do not offer affordable finance even to formal SMEs, there is little incentive to formalize. So the vicious cycle of financial exclusion continues.

### **WHY MOST INTERVENTIONS HAVE NOT WORKED**

Donor agencies and the governments of developing countries have tried to address the SME financing gap in many ways over the years, but their efforts have rarely been successful—as evidenced by the fact that the gap remains so large and has not declined significantly on a global scale. In many countries, governments and donor agencies have provided lines of credit to banks to compensate for the lack of funds with which to make loans to SMEs. These lines of credit often remain unutilized, or they are used to fund larger enterprises and existing bank clients rather than financially excluded SMEs.<sup>27</sup>

USAID, IFC, and other agencies have also funded various capacity-building programs to train bankers how to lend profitably to SMEs and to teach SMEs how to manage their finances more effectively, or they offer both services simultaneously. In some cases, capacity-building has been combined with a market facilitation or brokering

role, in which the program “matches” SMEs that need funds with institutions prepared to finance them. While these programs have met with some success, they have largely failed to bring about substantial or sustainable increases in lending to SMEs. Moreover, the World Bank and IFC have found that advisory services tend to lose traction through excessive standardization, so capacity-building programs can be difficult to scale up.<sup>28</sup>

Another popular approach has been to issue partial guarantees for loans to SMEs, such as those offered by USAID’s Development Credit Authority. These credit guarantees can help overcome SMEs’ lack of collateral and the perceived risk of lending to these enterprises. However, an evaluation of 12 sample guarantees issued by the Development Credit Authority between 2008 and 2013 found that the guarantees only led to improved access to credit in three cases. Nearly half of the banks in the sample continued to rely on other guarantees after the USAID guarantee expired so they could continue lending to target sectors.<sup>29</sup> Evaluations of other credit guarantee programs have found that they do not always serve the intended population.<sup>30</sup>

These efforts have failed to achieve lasting large-scale improvement because they all focus on just one simple element of a multidimensional problem. They implicitly assume that the particular barrier they aim to address (e.g., limited liquidity, insufficient collateral, or bankers’ poor understanding of SME lending) is the primary or binding constraint on SMEs’ access to finance, and that addressing that single constraint will make a meaningful difference even if other constraints remain unaddressed. A second reason why most donor-funded programs to expand SMEs’ access to finance have failed is that they rely on commercial banks to implement them—the very institutions at the center of the problem—without addressing the fundamental incentives and structures that drive banks’ behavior or recognizing that commercial banks, as deposit-taking institutions, are inherently limited in their ability to lend to undercapitalized, relatively risky SMEs. Experience has shown time and again that single-solution approaches that rely on commercial banks to carry them out simply do not work.

## HOW TO CLOSE THE SME FINANCING GAP

In light of these failures, the obvious question is, what might work better? There are two ways that donor agencies might achieve better results. The first is to apply systems thinking to the problem of the missing middle, and the second is to bypass the system altogether.

Systems thinking begins with the premise that most social or economic problems, like the missing middle, emerge as the result of a complex, circular system rather than as a linear, one-way chain of cause and effect.<sup>31</sup> Addressing the problem should therefore begin with a rigorous examination of the system, highlighting binding constraints and identifying potential points of intervention. In some cases, this analysis might conclude that a particular binding constraint cannot be addressed with the time and resources available, and therefore nothing should be done until some exogenous event comes along to change the system. A systems-thinking approach would also experi-

ment with different interventions in order to understand what works in a given context and what does not, rather than choosing a particular type of intervention in advance and sticking with it regardless of how well it performs. Finally, and most importantly, a systems-thinking approach would look for solutions that do not merely generate short-term results despite the larger systemic barriers, and would seek instead to change the system itself, thus converting a vicious cycle into a virtuous circle.

In the context of financial inclusion for the missing middle, employing a systems-thinking approach would require funders and implementers to adopt five principles:

- **Analyze before prescribing:** Begin by mapping the “ecosystem” surrounding SME finance in a given country and do not assume that what worked in one context will work in another. For example, capacity-building might be effective in increasing SME lending in a country where deposits are increasing and/or government debt is declining, leaving banks in need of new borrowers, but it is unlikely to work in a country where banks have already reached their LDR limit or are generating large margins by investing in treasury bills.
- **Set conditions for intervention:** Fund SME finance programs only in countries where those efforts are likely to bring about large-scale, systemic change—not just one-off results. Just as the Millennium Challenge Corporation provides funds only to countries that meet certain criteria for governance and social investment, so too should international donor agencies only work in countries that demonstrate a real commitment to financial inclusion—as evidenced, for example, by a reduction in public debt, improved creditors’ rights, and/or a loosening of restrictions on NBFIs.
- **Experiment with various interventions:** Prepare to shift resources from one program to another if the first one is not working. If a line of credit, for example, is underutilized or is funding loans to non-SME borrowers, close it down and use the funds to support training, or perhaps to launch a new NBFi focused on SMEs.
- **Explore indirect interventions:** Recognize that the most effective way to encourage banks to lend to SMEs might not involve working directly with either banks or SMEs. If the objective is lasting large-scale change, it makes sense to address root causes rather than to aim for quick fixes. For example, reforming the tax code might have a greater impact on financial inclusion for SMEs than guaranteeing loans or training bankers, provided that the tax reform leads to less public debt and/or less informality among enterprises.
- **Prepare to fail:** Be prepared to close down interventions that are not working and exit countries with governments that are not living up to their commitments. If partner banks or governments are not prepared to commit political and financial capital to the financial inclusion effort, why should external donors continue to do so? Without real commitment from local authorities and market actors, most efforts to improve financial inclusion for SMEs are doomed to fail. In such cases, donor money and time can (and should) be better spent elsewhere.

Anyone who has worked with donors like USAID or the World Bank will understand at once that these principles are highly aspirational. Donor agencies in general dislike complexity, have limited patience for indirect or systemic approaches, and find it exceedingly difficult to change or close down interventions once they have been launched.

So, for organizations that find a systems-thinking approach too onerous, there is an alternative: bypass the financial system entirely by funding an existing (or launching a new) NBFi that exists specifically to finance SMEs. Because NBFIs do not take deposits, they are not subject to the same regulatory restrictions as banks and thus can take on riskier SME clients and offer them more innovative forms of financing. One prominent example is GroFin, an NBFi that provides SMEs with a range of tailored financial products through offices in 12 countries and manages more than \$400 million in assets under management. GroFin, which was founded just over ten years ago and is funded by a mix of private corporations, foundations, and development finance institutions, claims to have generated \$2 billion in economic impact and to have helped create or sustain some 18,000 jobs.<sup>32</sup>

A more recent example is the Fund for Agri-Finance in Nigeria (FAFIN), which was launched in 2013 with seed funding from Germany's KfW Development Bank and the Nigerian government. It is managed by a private company, Sahel Capital. FAFIN provides innovative financing solutions—such as a debt/equity hybrid known as royalty-based financing—to SMEs in the agricultural sector, along with targeted technical assistance. FAFIN's initial funding was \$34 million and it is expected to reach \$100 million by attracting private investors.<sup>33</sup> In addition to the direct impact of economic growth and job creation, non-bank SME lenders can have a systemic impact by demonstrating that SME finance can be a lucrative business, thus “crowding in” private capital—eventually even from commercial banks.

As noted at the beginning of this article, donors spent some \$29 billion in 2012 to promote financial inclusion for the poor, despite a lack of evidence that the direct provision of financial services to poor households has any meaningful effect on alleviating poverty. In contrast, despite the massive potential to alleviate poverty by creating jobs, donors spent only around \$2 billion in 2013 on supporting SMEs, a modest 1 percent of all official development assistance.<sup>34</sup> If donor organizations were to refocus their resources on addressing the missing middle, either by adopting a system-thinking approach or by funding SME-focused NBFIs, or both, they would demonstrate much a more impressive, attributable, and direct impact... while helping hundreds of thousands of families escape poverty for good.

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