The benefits of Private Credit Bureaus for Microfinance:

wider access to credit; consumers' empowerment, lower over indebtedness, reduced cross-lending

January 2015

Summary

The importance of credit reporting for microcredit

- Why use it?
- Main functionalities and steps of the process
- Conclusion

CREDITINFO

- "Financial Infrastructure broadly defined comprises the underlying foundation for a country's financial
- system. It includes all institutions, information, technologies, rules and standards that enable financial
- intermediation. Poor financial infrastructure in many developing countries poses a considerable constraint upon financial institutions to expand their offering of financial services to underserved segments of the population and the economy. It also creates risks which can threaten the stability of the financial system as a whole.

CREDITINFO

CREDIT BUREAUS - Unnecessary Evil or Blessing?

- Credit bureaus are considered essential elements of the financial infrastructure to help facilitate access to finance by the underserved
- Today, less than 25 % of the people living in developing countries have access to formal financial services, compared to up to 90 % in developed markets.
- Financial sector development unleashes the productive power of enterprises and facilitates inclusion of the informal sector in the formal economy.

Source: CREDIT BUREAU KNOWLEDGE GUIDE 2nd Ed – International Finance Corporation (World Bank Group)

CREDITINFO

CREDIT BUREAUS - Unnecessary Evil or Blessing?

- Credit bureaus are considered essential elements of the financial infrastructure to help facilitate access to finance by the underserved
- Today, less than 25 % of the people living in developing countries have access to formal financial services, compared to up to 90 % in developed markets.
- Financial sector development unleashes the productive power of enterprises and facilitates inclusion of the informal sector in the formal economy.

Source: CREDIT BUREAU KNOWLEDGE GUIDE 2nd Ed – International Finance Corporation (World Bank Group)

CREDITINFO

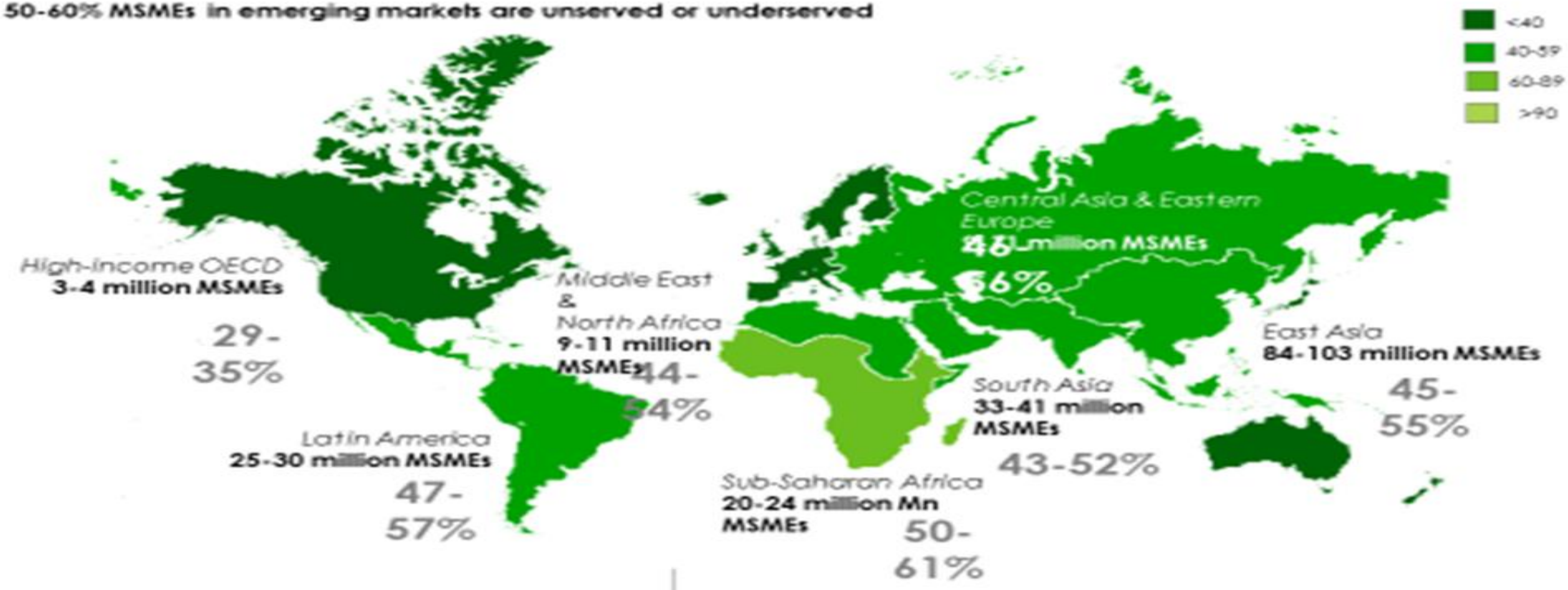
Credit reporting systems are very important in today's financial system. Creditors consider information held by these systems a primary factor when they evaluate the creditworthiness of data subjects and monitor the credit circumstances of consumers. This information flow enables credit markets to function more efficiently and at lower cost than would otherwise be possible."

These opening paragraphs from the World Bank Publication, **General Principles for Credit Reporting (September 2011)** outline essentially the reason why the World Bank and its associate company the International Finance Corporation (IFC), are actively promoting the creation of formal credit reporting environments in countries. Since 2002, these agencies have collaborated on monitoring the credit reporting environments in more than 180 countries and incorporating the annual survey results into the annual **Doing Business** report which is disseminated to interested stakeholders such as governments, bureaus, registries and creditors

Total # of unserved or underserved MSMEs excluding high-income OECD: 181-221 Mn 45-55%

Total # of unserved or underserved MSMEs: 184-225 Mn 45-55%

50-60% MSMEs in emerging markets are unserved or underserved



IFC International Finance Corporation

SOURCE: MSME database 2011, McKinsey & Company

Is Jamaica Following the Credit Bureau Trend?

2009, Pittsburg : G20 Leaders announced

The creation of the Financial Inclusion Experts Group (FIEG)

- Two primary roles:
  - Support innovative modes of financial service delivery aimed at the poor
  - Scaling up models of SME finance
- Created 2 Sub (working) Groups:
  - Access Through Innovation (CGAP, Brazil and Australia)
  - SME Finance (IFC, Germany and South Africa)
- SME Finance Sub Group:
  - Best practice stock taking
  - SME Finance Challenge

2010, Seoul:

Conversion of FIEG to Global Partnership for Financial Inclusion(GPFI)

- IFC designated as one of the implementing partners
- SME Finance Forum and SME Finance Initiative (2012)

CREDITINFO

Global Partnership for Financial Inclusion (GPFI)

Scaling-Up SME Access to Financial Services

- Role of SMEs in Economic Development
- Non Financial Barriers to SME Development
- Access to Finance as a Key Constraint to SME Development
- Exploring Various SME Finance Models
- Suggested Actions and Policy recommendation
- Credit reporting case studies (p.61-66)*

SME Finance Policy Guide

- A refined roadmap for FI strategies and SME Finance action plans covering all sub-groups*
- Role of credit reporting in SME Finance (p. 31-36)

*(i) i.e. focal areas: women-owned SMEs, SMEs in the agricultural sector, SMEs in LDCs
(ii) Mix of private (4) and public (6) examples from EAP contributions

CREDITINFO

Killing collateral = formalising the "*informals*"?

- The only definition of SME that counts in finance is: **formal or informal?**
- Would a bank accept such a SME client?
- **Profile:**
  - Small entrepreneur
  - New client
  - Textile sector
  - Annual turnover $ 3,500,000
  - 3 employees (including themself)
  - No known or account with you
  - Not reliable data/docs on the SME
  - No information
  - No collateral (real estate)
- **Loan applied for: $ 1,000,000**

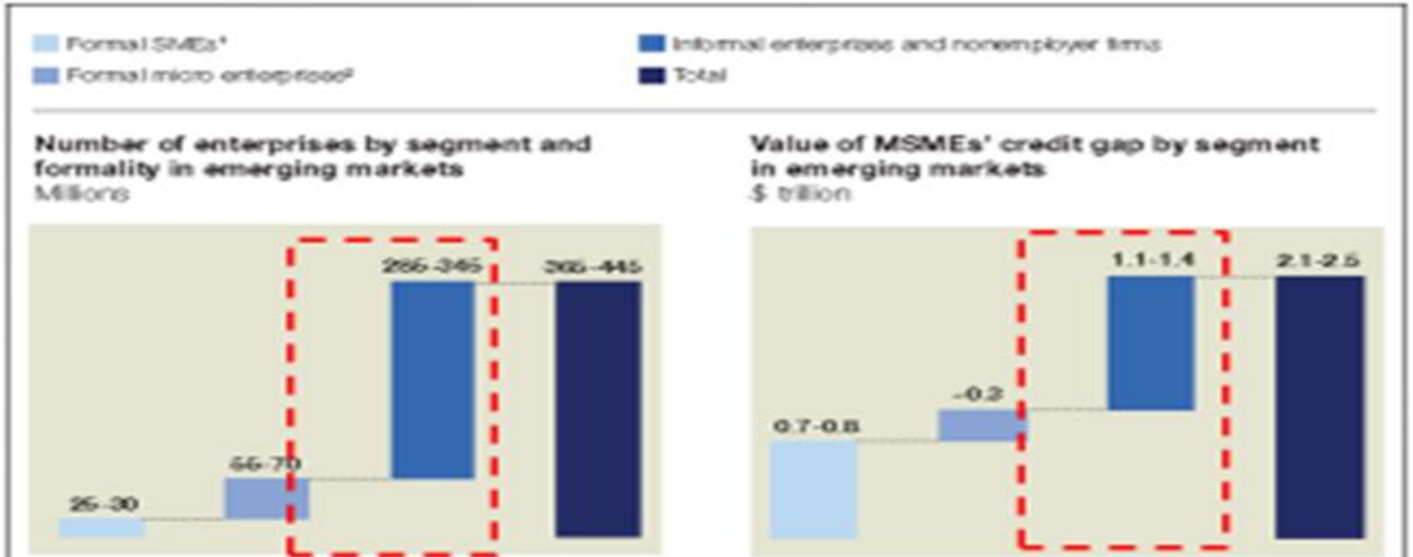
- **Questions**

• Would the bank grant him/her a $ 500,000 loan?	NO (90%)
• If yes, how long to process it?	3 weeks
• Would they need documentation?	YES
• Would they request collateral from him?	YES
• How many departments would work on that?	4-8
• Who would take a decision (a person)?	Credit committee
• How much would it cost to grant such loan?	$?? – $??

Credit reporting has therefore become increasingly recognised as a critical component of modern financial architecture. Essentially it provides critical information which is a generally well recognised economic principle. Markets need information in order to be efficient and in the financial market, credit information helps create that efficiency. It reduces what is known as “information asymmetry” where the borrower better knows the odds of repaying his or her debts than does the lender. This lack of full information will make the lender ‘hedge their bets’ and they may infuse a worse case pricing or security requirement because there is insufficient information.

Is Jamaica Following the Credit Bureau Trend?

- The number of MSME in emerging market ranges between 365 – 445 million
- Of which formal MFI are only 15% (55 mn) and formal SME 7% (25 mn)
- The remaining 78% are informal: or the *" Missing Middle"*
- Informal = non-bankable and... non-bankable = no credit
- Estimated total credit gap: $ 2.1 -2.5 trillion
- Of which 52%- 56% needed by informal sector ($ 1.1 – 1.4 trillion)



1 Registered enterprises, with 5 or more employees
2 Registered enterprises with 1-4 employees

Source: T.Goland, P.Stein, R.Schiff, "Two trillion and counting," 2010

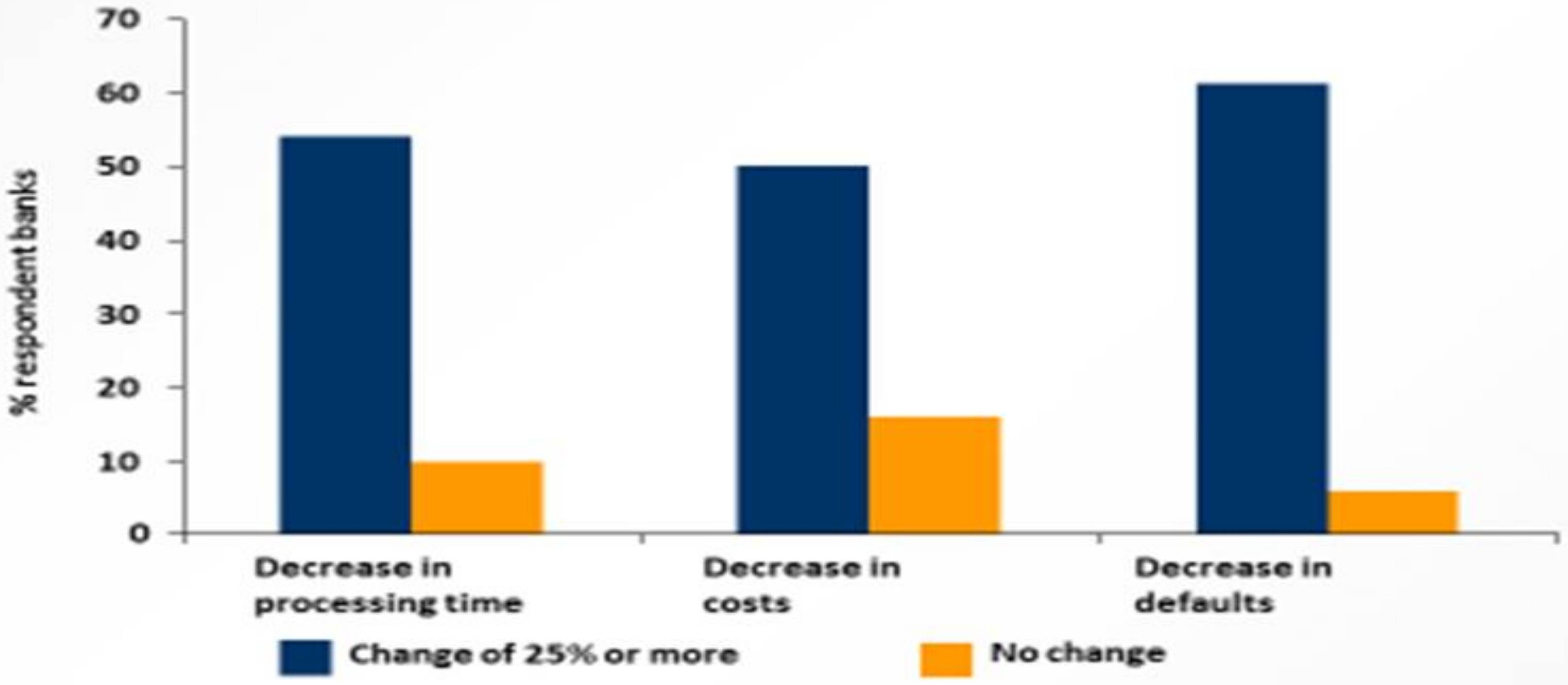
•QUESTION:
can this gap be reasonably reduced with the help of credit reporting plus advanced risk management/ underwriting techniques?

CREDITINFO

This lack of information is very symptomatic of the micro small and medium size sector (MSMEs) where the participants are self-employed or household based with no formal payslips or business plans or financial statements. Financial institutions are known generally to view this market segment as high risk and expensive to reach--the transaction costs of making a small loan are as high as those involved in making a large loan--and typically lack the know-how and risk management techniques required to serve small clients who lack financial track records or collateral. Because of this lack of supporting information, the due diligence is normally too expensive for the small amounts usually desired so at the end of the process, in order to recover the costs of the due diligence process there will be the tendency to extend the most onerous terms to credit facilities assuming the access is available any at all. This is both in terms of pricing as well as collateral security. And yet, the literature recognises that MSME's are critical to economic development. "Empirical studies show that SMEs contribute to over 55 percent of GDP and over 65 percent of total employment in high-income countries, SMEs and informal enterprises account for over 60 percent of GDP and over 70 percent of total employment in low-income countries, while they contribute over 95 percent of total employment and about 70 percent of GDP in middle-income countries" (OECD 2004a, p. 11).

Full information sharing improves credit granting

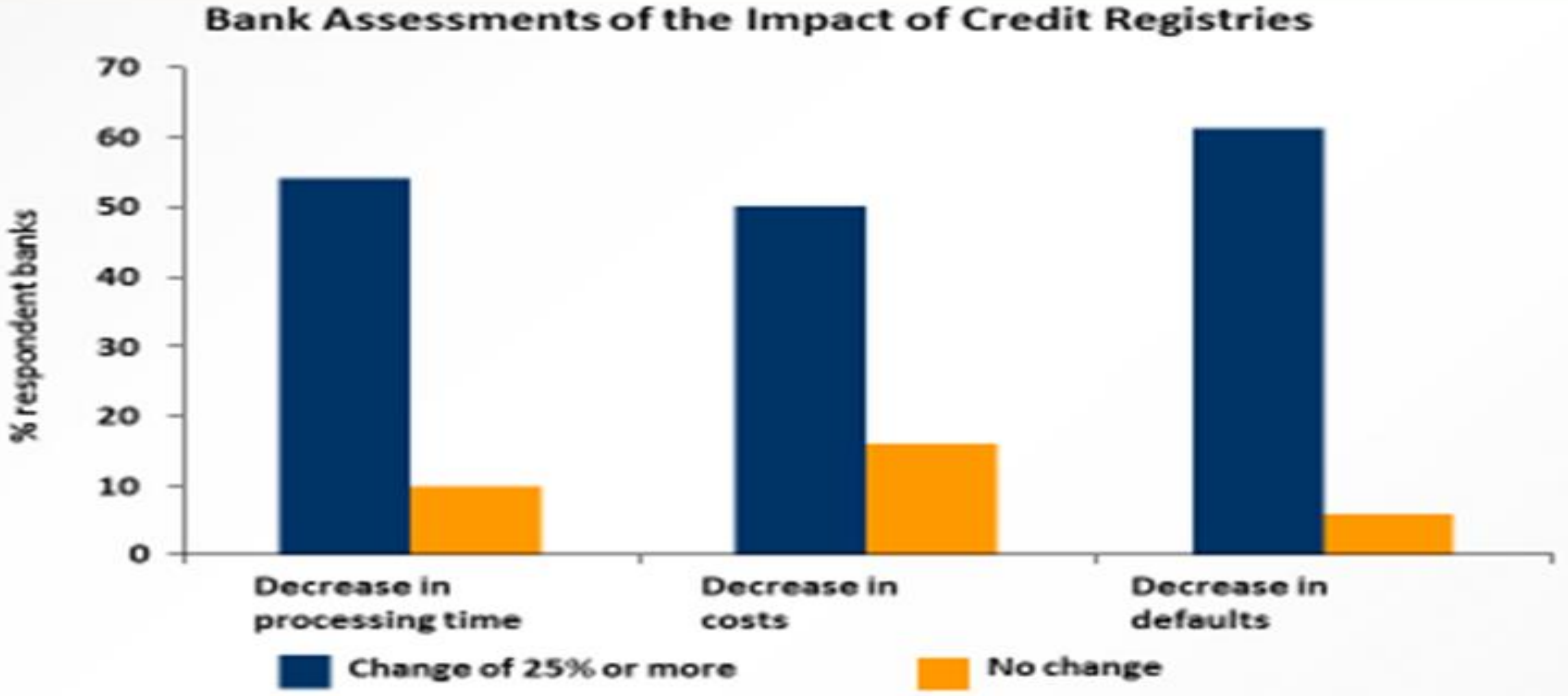
Bank Assessments of the Impact of Credit Registries



Source: Doing Business in 2004, based on World Bank surveys of banks in 54 countries in 2001-2002.

CREDITINFO

Full information sharing improves credit granting



Source: Doing Business in 2004, based on World Bank surveys of banks in 34 countries in 2001-2002.

CREDITINFO

The issue is how to make the access easier; more efficient; less expensive and equitable and do so in a sustainable way. Because formal credit reporting environments have credit bureaus which business is the collection; storage; interpretation and dissemination of credit information the due diligence process of "knowing your customer" is made more efficient. And this is where the credit information that is provided by credit bureaus can help since historic credit behaviour is recognised as a proxy for the likelihood of future behaviour. In instances where an individual or MSME have had no formal credit exposure, alternative data from utility companies has also proven to be a good indicator. This is why Credit Bureaus will usually seek to source credit information from as many sources as possible including the utility companies.

The need to *"democratise"* credit

THE " CATCH-22" situation:

- Poor consumers, micro/informal entrepreneurs / they pay cash and have no credit history
- No credit history ("no file" or "thin file")
- They have difficulty in accessing credit
- Their transactions defined as "credit like / cash-like"
- Even in the US estimated in 35-50 million

Alternative data is the answer

- Includes: utilities, rentals, cable TV, pay-day loans, childcare, insurance
- Utilities are the most helpful since universal, homogeneous, reliable
- This data is very predictive (regularity on these payments is a strong risk indicator,
- It is a shortcut to build a credit history

CREDITINFO

The credit bureaus would have signed as many credit information providers as possible and already have in their database the borrowing behaviour of individuals and companies and the analytics behind the database would further distil that information into a credit score which is the Bureau's assessment of the probability of repayment of credit facilities by that credit applicant.

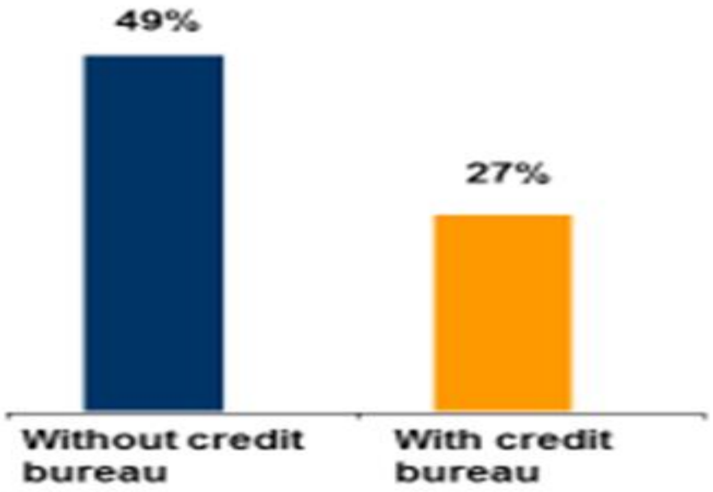
For a credit provider to be able to get all that background information on a credit applicant by just pressing a button, clearly makes their due diligence processes more efficient because it is quick; it is reliable (an unreliable credit bureau would not be long in business); it is cost effective and on top of all that it provides predictability. All of those cost savings should be able to be passed on to credit applicants and if the predictor of the likelihood of repayment is trusted, then the requirements for security can be significantly reduced. That at least is theory.

The credit reporting environment in Jamaica is new so we are just studying the impact of the effect of the credit reporting environment on the MSME sector. What I can say in the case of CredItinfo Jamaica is that the micro finance institutions were the one that reacted first in terms of both providing data to the bureau as well as utilising that data. Of the Credit Information Providers that are providing credit information, 33.3% of them are MFI and they are pulling 50% of the credit reports that are being pulled. We are also seeing an increase in the number of daily pulls that are being done. We are in the process of signing the utility companies and once they are brought into the in the mix, based on the international experience, we anticipate that even more MSME's will be able to access credit facilities. This because even if an entity is unbanked, there credit history can be assessed from the historic records of utility payments.

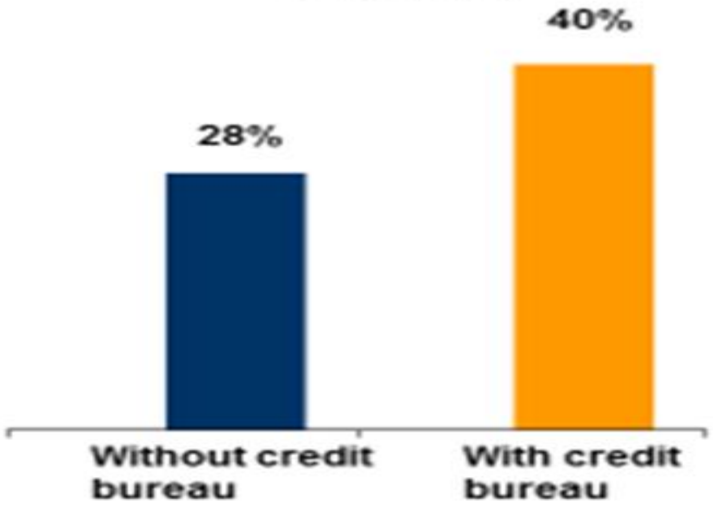
Small firms benefit from credit bureaus

Estimates based on data on 5000 firms in 51 countries

% of Small Firms Reporting High Financing Constraints



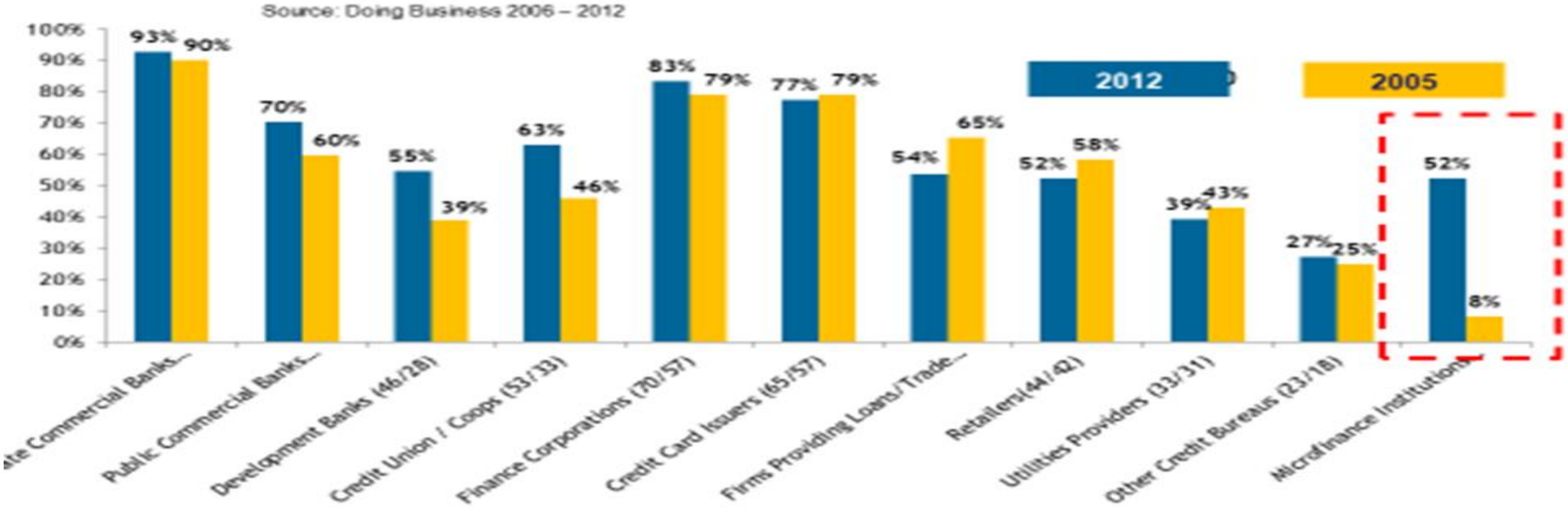
Probability of Obtaining a Bank Loan for a Small Firm



Source: Love & Mylenko (2003).

So, what's new?
A solid, steady, irreversible trend:

- MFIs increasingly utilize Private Credit Bureaus and share data
- In over 50% of countries in 2012 (only 8% in 2005)



Thank you

CREDITINFO