How FinTechs Can Help Finance MSMEs

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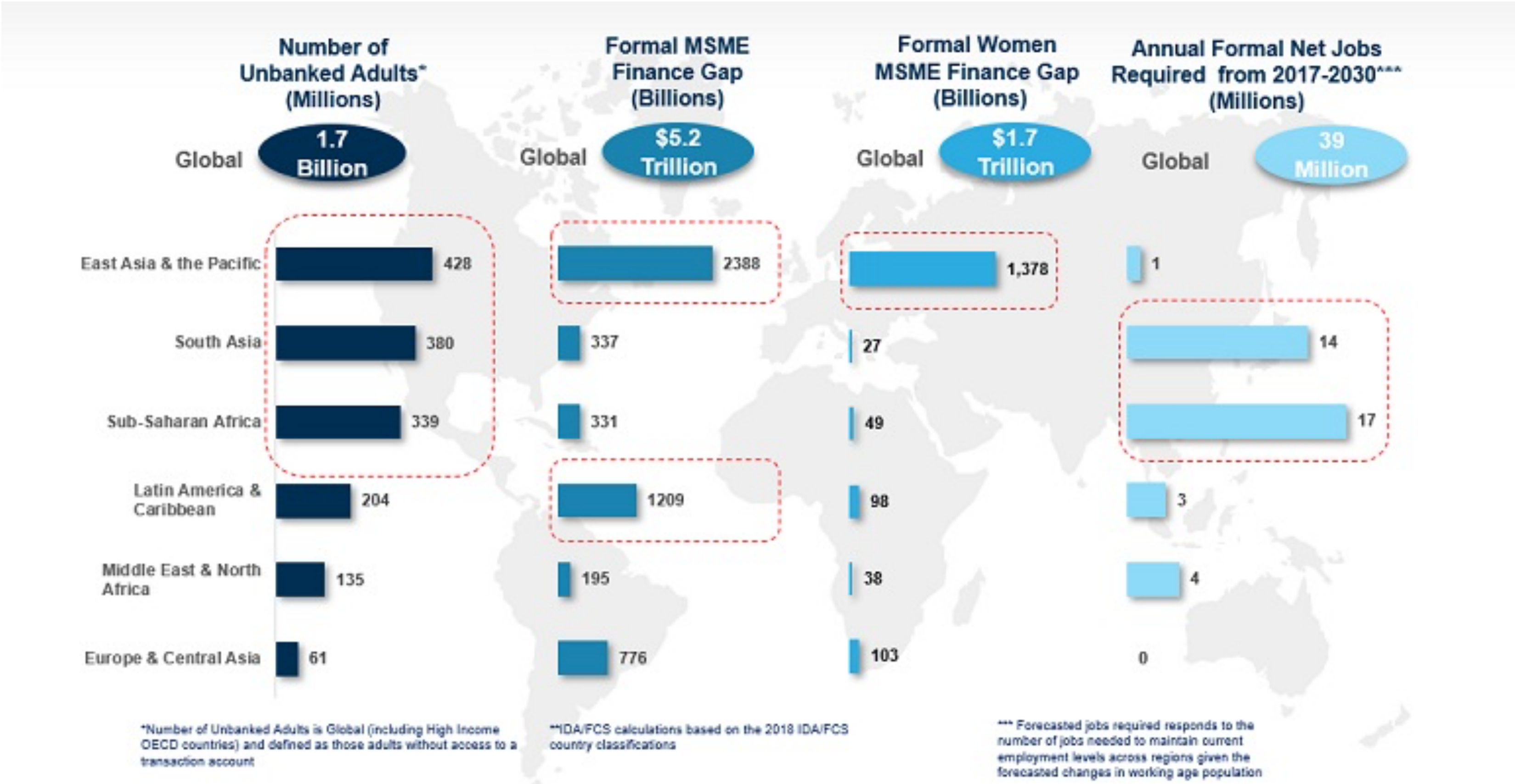
Importance of SMEs to the Economy

- According to the World Bank, SMEs make up:
  - 90 percent of businesses
  - 50 percent of workers
  - 40 percent of GDP
  - 7 out of 10 jobs will be generated by SMEs

MSME Labor and Funding Gap



Source: www.worldbank.org/en/topic/smefinance

Traditional Funding Sources for SMEs

- Family, friends, and informal sector
- Bank loans often use personal credit histories and ratings of owners
- Specialized financial institutions often supported by government make subsidized loans
- Government loan guarantees or grants to MSMEs

FinTech and Competition

- Lack of competition in banking markets reduce incentives to lend to SMEs
- FinTech firms increase access to financial services by lowering cost, increasing access, and better managing risk by using technology
- FinTech firms are more nimble in acquiring loans through online channels that may be sold to banks
- Using non-traditional information such as inflows and outflows of transaction accounts may decrease information asymmetries

SME Lending Challenges and Opportunities in US

- After financial crisis, traditional credit providers reduced lending
- Difficult for new businesses to access credit
- Use different sources of information (payments companies and retailers getting into lending, e.g. PayPal, Square, and Amazon)

Increased Bank Lending to SMEs Has Benefits

- Empirical work from Ghassibe, Appendino, and Mahmoudi (2019) finds higher employment and labor productivity growth gains at SMEs compared to other sized firms from:
  - Access to credit
  - Improved credit bureau coverage
  - Better insolvency regimes

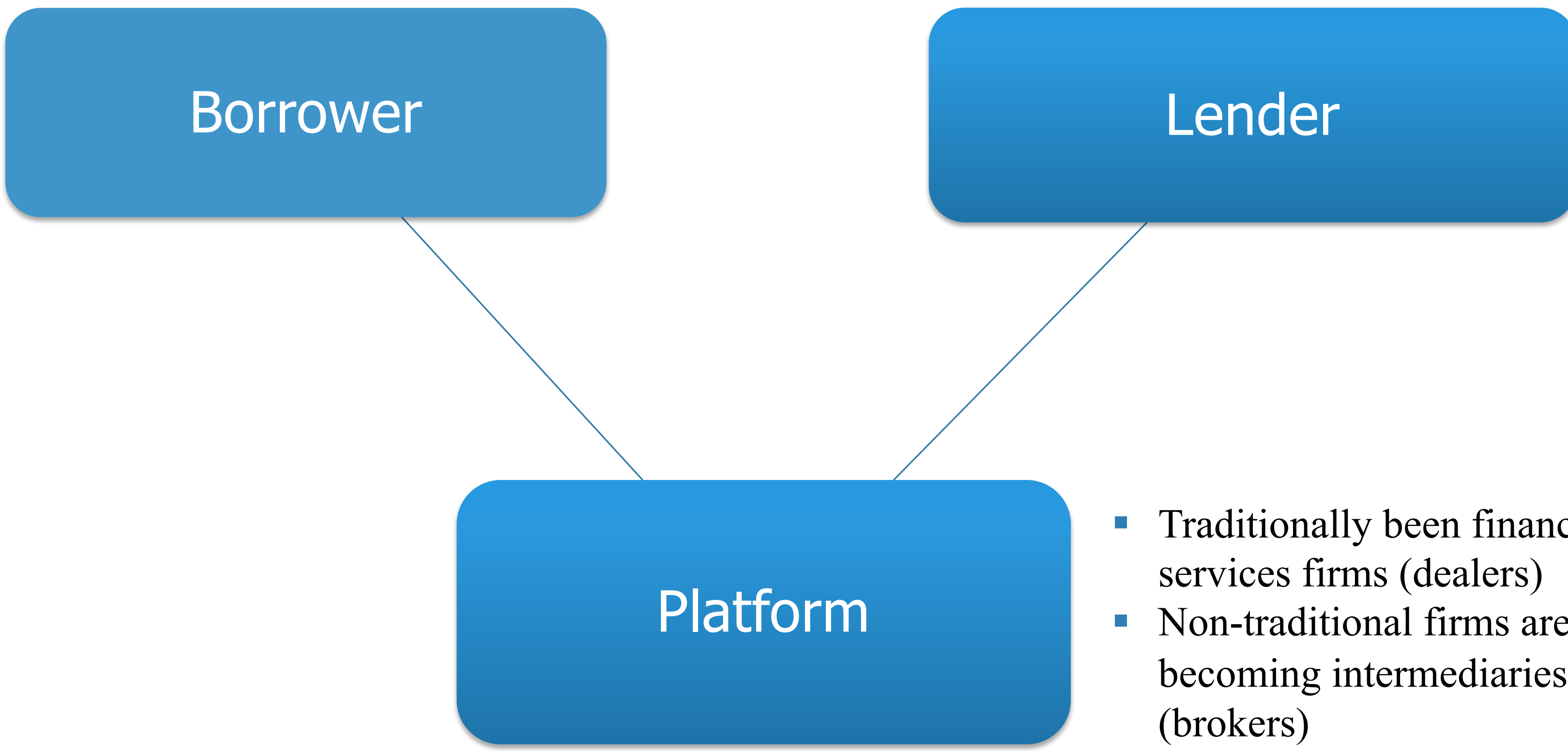
FinTech Lending

- Credit has existed since 3500 BC (agricultural) and not always extended by financial institutions
- Platforms match lenders (investors) with borrowers, e.g. Kabbage, Prosper, and Swift Capital (acquired by PayPal)
- Claessens *et al.* (2018) find that higher income countries with less competitive banking systems have greater FinTech lending
- Claessens *et al.* (2018) also find that greater FinTech lending occurs in countries where regulations are less stringent

Technological Tools (not exhaustive)

- **Mobile Technology** enables on-the-go connectivity to financial service providers and networks (reduces the need for extensive bank networks)
- **Data Analytics** provide tools to study large datasets previously unavailable (enhances or substitutes for traditional lending metrics)
- **Artificial Intelligence/Machine Learning** may better predictors for loan defaults but may face regulatory issues
- **Blockchain Technology** allows for recording of financial and other information on a distributed ledger
- **Crypto Assets** allow for alternative currencies and decentralized securities

Match/Search Process



- Traditionally been financial services firms (dealers)
- Non-traditional firms are becoming intermediaries (brokers)

U.S. Fintech Lenders and Their Other Activities

Breadth of services offered by digital lenders

	Lending verticals					Nonlending services			
						Payments			
Company name	Personal/ consumer	Mortgage	Business	Student	Patient	Card	Mobile	Processing	Asset management
Prosper	●								
LendingClub	●		●		●				●
SoFi	●	●		●		●	●		●
Avant	●					●			
Upstart	●								
Square	●		●			●	●	●	
OnDeck			●						
Kabbage			●			●		●*	
CommonBond				●					
PayPal	●		●			●	●	●	
Earnest	●			●					
LendingPoint	●				●				
GreenSky	●				●	●			
Credibly			●						
College Ave				●					
Best Egg	●								

Data compiled Oct. 1, 2018
* Kabbage has announced intention to offer point of sale system

Source: S&P Global Market Intelligence, 2018 US Fintech Market Report, https://www.spglobal.com/marketintelligence/en/documents/2018-us-fintech-market-report.pdf.

Evidence from U.S. Lending to SMEs

- Using PayPal and Kiva data, Ahmed *et al.* (2015) find:
  - 25% of PayPal Working Capital (PPWC) loans were dispersed in zip codes that lost more than 10 banks since the 2008 financial crisis
  - 61% of PPWC loans go to entrepreneurs and young firms in business for less than 5 years
  - PayPal sales increased by 22.4% from year-to-year in counties where 10 or more banks left vs overall retail businesses in the U.S. grew by 1.72% during the same period

Source of Funds

- While FinTech firms may improve the allocation of funds, the supply of funds may be limited in the region
- Remittances may be a large source of funds along with investments made by citizens living abroad
- Attract capital through retail markets (non-remittance retail capital flows)
- Raise capital through Security Token Offerings

FinTech Lending and Banks

- Banks partner with FinTech lending platforms
- Banks benefit from lower acquisition costs when they partner with FinTechs
- Banks may increase underwriting standards for the industry
- These partnerships may lead banks to own and operate their own platforms

Conclusion

- Greater financial inclusion of SMEs has positive impact on employment, labor productivity, and economic growth
- Competition from FinTechs could increase bank lending and non-bank lending
- FinTechs may provide better credit scoring algorithms and increase financial inclusion without increasing credit risk significantly
- However, we need to be cautious about economic downturns and implicit access to government safety nets