WILLIAM DAVIDSON INSTITUTE
AT THE UNIVERSITY OF MICHIGAN

Leveraging Remittances as Information

SUMMARY

A vibrant Small and Medium Enterprise (SME) sector plays a significant role in the economic growth and development of a country. Data show that formal SMEs account for about 60% of the total employment and 40% of the national income in emerging economies.[1] However, SMEs require capital to grow and this is often lacking for businesses of this size.[2]

We propose to use remittances as a source of information and collateral for the lender, thereby increasing the financing available to SMEs in emerging economies. This, in turn, can increase the SME's growth and lead to an increase in assets under management and profits for financial institutions.

THE CHALLENGE

The International Finance Corporation (IFC) estimates the financing gap for formal SMEs to be close to a trillion dollars.[3] The SME Finance Forum defines the financing gap as the difference between the current supply of financing available to micro-, small-, and medium-sized enterprises and those enterprises' demand for financing. [4] It gives some idea of the market opportunity for banks and financial institutions that are able to develop a profitable way of serving these enterprises.

Access to finance is one of the most severe constraints faced by SMEs in emerging economies. Most of the small enterprises in these economies constitute the "missing middle," as they are considered too big for microfinance institutions (MFIs) and too small or risky for traditional finance providers such as commercial banks.

BASIC FRAMEWORK TO ADDRESS THE FINANCING GAP AND CAPTURE SME FINANCING MARKET

Remittances, the money sent back home by the diaspora to their families, may be able to provide a stable and sustainable solution to the challenges of SME financing. These flows have been more stable than private capital flows and have exceeded the size of Official Development Assistance (ODA) for many years now.[5] In 2017, a record $477 billion dollars was transferred in remittances globally.[6]

We propose to develop and test a mechanism that uses remittances to increase access to finance for SMEs in emerging economies and reduce the financing gap. Research on

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[1] http://www.worldbank.org/en/topic/smefinance
[2] https://www.smefinanceforum.org/data-sites/msme-finance-gap
[3] IFC Advisory Services, Access to Credit Among Micro, Small, and Medium Enterprises, Aug 2013
[4] https://www.smefinanceforum.org/data-sites/msme-finance-gap
[5] http://www.worldbank.org/en/news/infographic/2017/04/21/trends-in-migration-and-remittances-2017
[6] https://www.worldbank.org/en/news/press-release/2018/04/23/record-high-remittances-to-low-and-middle-income-countries-in-2017

William Davidson Institute at the University of Michigan
724 E University Ave. Wyly Hall, 1st Floor
Ann Arbor, MI 48109-1234
USA

TEL: 734.763.5020
FAX: 734.763.5850
wdi.umich.edu

remittances shows that the magnitude of remittances is correlated with new business growth and access to capital[7,8] and that remittances directed to specific activities can have a significant effect.[9] Building on this research, we propose to create a financial mechanism that amplifies the benefits of remittances by including a financial institution in the fund-transfer process between the diaspora and their family or friends. The benefit of this mechanism derives from two of the root causes of the SME financing gap:

1. A lack of information about the borrower
2. A lack of reliable information regarding the investment after funds have been disbursed

Information about an individual borrower can be prohibitively costly for a financial institution – credit ratings don't exist in most of these markets. Remittances address this problem in two ways. First, the remittance can serve as collateral for a loan. In the extreme case in which the entire loan is covered by the remittance, the financial institution has no risk. Second, remittances are transfers of cash but they can also represent a transfer of information about the recipient. Individuals who send money to a family member or friend know something about the character/behavior of that family member or friend that a financial institution will not know. Financial institutions can use the information implied in the transfer to inform/develop the credit rating of a potential borrower.

Once the funds are disbursed, it is difficult to track the performance of the business that borrowed the money. This is especially true for someone living abroad who may have no expertise in assessing financial statements or business performance. Local financial institutions will be better positioned both geographically and professionally to monitor an investment once made. Thus, remitters who send money as an investment can use the local financial institution to monitor any investment made in the local community.

By combining the funding and information of remitters with the management and information gathering ability of a bank, these two challenges can be addressed to increase the SMEs' access to capital in a way that is profitable for the bank.

Our proposed mechanism still needs to be tested and piloted, and we are seeking to partner with a financial institution to test and improve it. The basic framework for the mechanism is as follows:

[7] Vaaler, Paul, (2011), "Immigrant Remittances and the Venture Investment Environment of Developing Countries", Journal of International Business Studies.
[8] Vaaler, Paul, (2011), "Diaspora Concentration and the Venture Investment Impact of Remittances", Journal of International Management.
[9] Kate Ambler & Diego Aycinena & Dean Yang, (2015), "Channeling Remittances to Education: A Field Experiment among Migrants from El Salvador," American Economic Journal: Applied Economics, American Economic Association, vol. 7(2), pages 207-232, April.

- ***Process:*** Instead of remitting the money for a loan directly, we propose a mechanism through which the remitter places funds in an account in the financial institution either in the remitter's current country or in the country where the borrower is located. A hold is then put on the remitter's account. As the loan is paid back, the hold on the remitter's funds is gradually released. For example, if someone working in the U.S. wanted to loan money to her brother in Country A, instead of actually transferring the money, she could open an account at Bank A that would serve as collateral for a loan to her brother. As her brother pays off the debt to Bank A, the hold on the remitter's bank account is reduced. If the loan is not repaid on time, Bank A can use some of the remaining funds in the remitter's account to make the necessary payment. The Bank could also, for a fee, take the lead on tracking the use and performance of the loan, providing regular statements to the remitter and acting as a neutral third party in any disputes.

- ***Benefits for the remitter:***

    - Reduction in transaction costs: Using agents such as Western Union or others to transfer cash can result in a large number of transaction fees. By simply placing and removing holds on an account, these fees can be reduced both during the initial disbursal of funds and in the subsequent repayment.

    - Reduction in monitoring costs: Remitters that lend money to a family member are in a better position than a bank or financial institution to understand the character of the borrower and monitor the behavior. However, they may not have the expertise of the bank or financial institution in assessing the competence of the borrower or the decisions made by the borrower. A financial institution or bank located in the country has an advantage both of proximity and of experience in monitoring loans and thus can reduce the monitoring cost, lowering the risk for the lender, the cost for the borrower, and increasing the availability of loaned funds.

    - Contribution towards strengthening the economy overall: Many in the diaspora community express the desire to help their home country grow economically. Providing loans of this nature can help address the SME funding gap, which can have a long-term positive benefit on the home country's economy.

- ***Benefits for the financial institution:***

    - Significant reduction in risk: From the bank's perspective, the loan can be virtually risk free. All funds loaned out can be completely backed by funds being held in the remitter's account. If the loan is not repaid in full, the funds in the remitter's bank account can be taken as collateral.

- Access to new markets and industries: It is currently prohibitively costly to lend money to SMEs in many markets because of lack of information on the borrower. Remittances as loans represent a transfer of information as well as money. The financial institution can use the information implied in the transfer from the remitter and observe the borrower's payments back to develop an assessment of credit worthiness of the borrower at virtually no risk to the financial institution. Based on that information, the bank could, in the future, expand the loan to the borrower beyond the amount of the remittance using the remittance as collateral on a portion of the loan rather than the entire loan (e.g., lend out $10,000 for a remittance of $6000). By teaming up with remitters, the bank can combine its skills in assessing competence of the borrower with the remitter's knowledge of the behavior of the borrower to gain access to those remitters' social networks and therefore access to business they otherwise would not have.

- Access to hard currency: In some countries, access to hard currency is particularly valuable. In such cases, remittances can be an important source of hard currency.

If interested in collaborating with us to implement this mechanism and develop proof of concept, please contact us at wdi-finance@umich.edu.