Microcredit 3.0: The Potential of Financing Business Assets for Financially Excluded Entrepreneurs

By Joseph Curran

B.A. History; B.S. Political Science

Advisor: Keith Douglass Warner OFM; Reader: Naomi Andrews

Miller Center for Social Entrepreneurship

University Honors Program UHP Santa Clara University

Abstract

Microcredit -- the provision of small loans to underserved micro-entrepreneurs -- intends to address the problem of financial exclusion by enabling business investments that increase borrowers' incomes. However, randomized evaluations indicate that microcredit in the form of small cash-based loans fails to significantly increase borrowers' incomes because loans are used for consumption or business investments that do not become profitable. While innovations identified as "Microcredit 2.0" have improved loans to better fit the reality of low-income markets, cash-based loans that require immediate repayment discourage long-term business investments. Therefore, there is the need for continued improvement through a "Microcredit 3.0" development that helps borrowers make long-term investments that increase their incomes.

A promising mechanism for "Microcredit 3.0" is financing the purchase of an income generating asset for specific sectors of financial excluded micro-entrepreneurs. GSBI® alumni social enterprises Tugende, Three Wheels United, and Juhudi Kilimo provide examples of "Microcredit 3.0" that demonstrate how clients can use revenue derived from the assets to facilitate repayment and, upon ownership, use the assets to increase their incomes. While "Microcredit 3.0" has potential, it necessitates sufficiently low interest rates to avoid predatory lending, strong customer care to foster a positive reputation, and the use of technology to lower operational costs. Furthermore, expectations for the transformative power of microcredit should be modest because underserved micro-entrepreneurs are constrained by limited market opportunities. Nevertheless, findings indicate that investments into "Microcredit 3.0" are prudent; however, funders must recognize that high interest rates have adverse effects on clients and provide capital accordingly. Further research is needed to determine how well "Microcredit 3.0" helps clients improve their lives and the lives of their dependents and to discern viable markets for asset-based financing.

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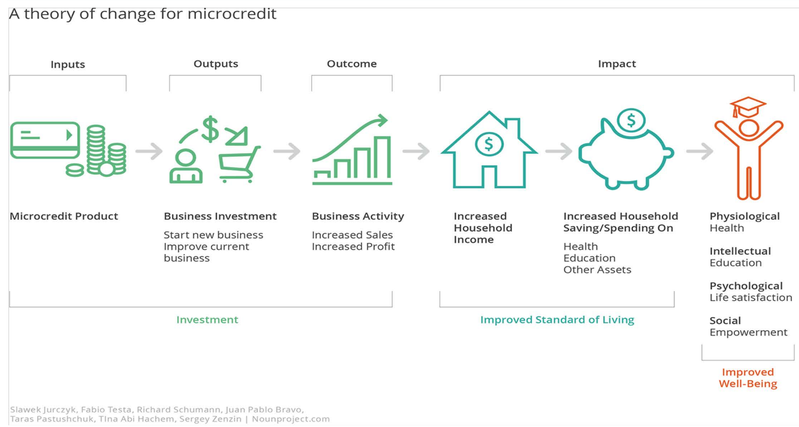
The Intention of Microcredit



Source: "Where Credit Is Due," *Abdul Latif Jameel Poverty Action Lab (J-PAL) and Innovations for Poverty Action (IPA)* J-PAL and IPA Policy Bulletin (2015): 6.

Microcredit Stages

Microcredit 1.0: Providing small cash-based loans to groups of poor, majority female borrowers with joint liability to repay.

Microcredit 2.0: Providing cash-based loans designed to fit the reality of low-income markets to poor, mostly female, individuals or groups.

Microcredit 3.0: Financing the purchase of an income generating asset for specific sectors of financially excluded micro-entrepreneurs.

Differences Between Microcredit Stages

Attributes	Microcredit 1.0	Microcredit 2.0	Microcredit 3.0
Clients are entrepreneurs	?	+	+
Loans are used for profitable business investments	?	?	+
Long-term business investments are incentivized	-	-	+
Trainings and auxiliary services are tailored to clients' businesses	-	-	+
Clients' business investments work as collateral for the loans	-	-	+
Loans increase clients' incomes	-	-	+

Conclusions

- Cash-based loans that require immediate repayment discourage long-term business investments and fail to help clients substantially increase their incomes
- "Microcredit 3.0" facilitates a long-term business investment and demonstrates promise in its ability to help micro-entrepreneurs excluded from financial services increase their incomes and improve their lives and the lives of their dependents
- There should be modest expectations for the transformative power of microcredit because underserved micro-entrepreneurs have limited market opportunities
- In order for "Microcredit 3.0" to avoid predatory lending, funders must recognize that high financial returns place an undue burden on borrowers
- In addition to large capital requirements, "Microcredit 3.0" enterprises require strong customer care and the adoption of mobile technology to effectively scale

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