Executive Summary of Evaluation

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<th>Name of Evaluation</th>
<th>Poverty Literature Review Summary: Financial Infrastructure and Poverty Reduction¹</th>
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Background

Building financial infrastructure (FI) by way of Credit Reporting and Secured Transactions in the financial sector has a significant indirect impact on poverty through financial deepening and economic growth. By addressing information asymmetries in the market, credit bureaus and collateral registries allow lenders to manage their risk and return thereby expanding credit at lower interest rates and more efficiently. For the borrowers, this financial infrastructure allows a mechanism to filter for credit worthy individuals and small & medium enterprises (SMEs). Building of a credit reputation allows them to increase their long term ability to grow and an incentive not to default. The direct effects of a growing SME base on poverty come through potential job creation. However, the current evidence on explicit links of financial infrastructure directly to poverty is still scarce and points to a knowledge gap which is important to address to allow for strengthening of measurement of these impacts but also to feed into future strategy and project design.

Objectives

This note summarizes a literature review conducted by IFC on identifying the transmission links of investing in financial infrastructure, specifically Credit Reporting and Secured Transactions to poverty and economic growth. This exercise was undertaken as part of IFC’s Poverty Action Plan, to better understand how IFC operations in specific sectors across its investment and advisory operations result in eradicating poverty and boosting shared prosperity.

IFC established the Global Credit Bureau Program (GCBP) in 2001 to foster the development of private credit bureaus in emerging markets. In recent years, the Program has gradually expanded its scope beyond private credit bureaus and is also working with public credit registries (PCRs) and on public-private partnerships in credit reporting. To reflect these changes, the Program has been renamed as the Global Credit Reporting Program (GCRP). Since its inception the program has provided support in over 60 emerging-market countries worldwide.

¹ This note has been summarized from the poverty literature review ‘Financial Infrastructure & Links to Poverty’, available on IFC’s poverty webpage: http://ifcnet.ifc.org/ifcint/deveffectiveness.nsf/Content/home

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In 2010, GCRP helped generate 31 million inquiries worth an estimated $6.2 billion in new financing to about 6 million retail and small business clients. In coordination with the World Bank's Doing Business team, the program monitors the credit reporting environment in over 180 countries worldwide. The program has also provided key contributions to developing the first-ever universal standards on credit reporting (General Principles of Credit Reporting).

IFC’s Secured Lending Program promotes and facilitates the development of efficient secured transactions systems and collateral registries to expand access to finance throughout the globe with special focus on increasing SME financing. IFC currently provides secured transactions advice to 23 client countries with a growing portfolio behind an increase in demand for these services.

Analysis

Indirect effects of FI on poverty through economic growth

Financial infrastructure (FI) comprising both secured transactions and credit reporting systems are a core part of all financial systems. The quality of financial infrastructure determines the efficiency of intermediation, the ability of lenders to evaluate risk and of consumers to obtain credit, insurance and other financial products at competitive terms. Another study (Dahan et al, 2008) finds that implementing a form of secured lending can also attract foreign investment due to legal certainty.

Hence, by strengthening the mechanisms to evaluate risk and return to investment, managing and allocating risk, strengthening financial infrastructure promotes private sector lending and therefore financial development and growth. Several empirical studies have shown the correlation between financial deepening and positive effects on poverty levels and income equality. Countries with higher levels of financial development experienced faster reductions in the share of population living on less than $1 a day over the 1980s and 1990s. There are several mechanisms through which this financial deepening could result in overall growth.

Increasing Private Credit Flows: Several studies find that better creditor rights and the presence of credit registries are associated with a higher ratio of private credit to GDP. A change from no coverage to 100 percent full-file coverage is associated with private sector lending rising between 48 percent and 60 percent of GDP, depending on the exclusion of outlier observations.2

In countries where security interests are perfected and there is a predictable priority system for creditors in cases of loan default, credit to the private sector as a percentage of gross domestic product (GDP) averages 60 percent compared with only 30 to 32 percent on average for countries without these creditor protections. Therefore, modern secured transactions systems increase the level of credit.

2 Through the IFC Secured Lending Program over US$ 3.5 trillion have been facilitated to enterprises in China since 2007, of which US$ 1.1 trillion have been extended to SMEs. In Ghana, the Law to pledge collateral has been reformed and a collateral registry has been established. This registry is mostly used by individuals and SMEs, accounting for over 85% of the charges received during 2011. It has also made possible to leverage over $2 billion while the increase of women borrowers has been steady, accumulating 47% of the total charges made in the second semester of 2011. (Taken from Bank of Ghana Collateral Registry Operational Report, 2011)
Supporting financial development by reducing non-performing loan rate: Credit bureaus and registries allow lenders to evaluate risks more accurately and improve the quality of their portfolios. A study conducted by the Inter-American Development Bank found that banks which loaned primarily to consumers and small businesses and used private bureau data had non-performance rates that were 7.75 percentage points lower than ones which did not. Another study looking at 43 countries including most OECD countries estimated that sharing of positive credit information reduced credit risk by between one third and one half.

Reducing transaction costs: In a survey of banks in 34 countries conducted in 2001 and 2002, more than 50 percent of the respondent banks said that information sharing reduced loan processing time, costs, and default rates by 25 percent or more (World Bank 2004). More recent studies analyze the use of collateral to secure a loan and they show that by using this system, firms get lower interest rates, thus reducing the cost of credit.

Strengthening property rights: The law and finance literature has stressed the importance of legal institutions (especially those protecting private property rights) in explaining international differences in financial development. Where legal systems enforce private property rights, support private contracts, and protect the legal rights of investors, lenders tend to be more willing to finance firms—in other words, stronger creditor rights tend to promote financial development.

Direct effects of FI on poverty through economic growth

The effects of easing flow of credit information on both households and SME’s can be significant, thereby expanding their options to grow and get income generating opportunities. For SME’s, empirical research shows that credit information sharing is critical to lower the financing constraints for small firms, as it mitigates the effects of information asymmetries in the market. A well-functioning credit reporting infrastructure helps SME lenders assess SMEs’ risk and creditworthiness profile, make informed credit granting decisions, and monitor and manage portfolio risk. In addition, credit bureaus act as a disciplining mechanism for SME borrowers since these borrowers are less inclined to default if they are aware that this default will affect their future applications for credit.

And as discussed above, analysis suggests that SME’s in countries with stronger secured transaction laws and registries have greater access to credit, better ratings of financial system stability, lower rates of nonperforming loans and a lower cost of credit.

A study by Love and Mylenko (2004) shows that the percent of firms reporting financing constraints declined from 49% in countries without credit information sharing systems to 27% in those countries that did have such systems. The same study showed that the probability of a small firm obtaining a bank loan increased from 28% in countries without credit bureaus to 40% in those that did have credit bureaus.

An important outcome of SME’s getting access to credit is the employment creation that occurs thereafter and the impact that can have on poverty. Using data from 76 countries, Ayyagari, Beck and Kunt (2007) find that in countries with efficient credit information sharing, the employment share of SMEs in manufacturing sectors is larger. The IFC Jobs Study on ‘Assessing Private Sector Contributions to Job Creation and Poverty Reduction’
highlights an evaluation of a reform in China on secured transactions and collateral registries that found that 21% of the impacted SME’s found this reform having boosted their job creation.3

Credit reporting enables households to access credit (retail or consumer credit) by developing reputational collateral. The effect of access to credit on households has been studied to some degree. While some research indicates that there are welfare effects of access to credit, others argue that the poor need a host of financial services (not just credit) such as savings and insurance to help with consumption smoothing and to counter negative income and health shocks.

While research on impact to the extreme poverty and on base of pyramid is sketchy, recent research on the use of alternative data for credit reporting (i.e. data from non-traditional sectors like utilities, telecommunications, etc.) show that certain segments of the population that are traditionally underserved financially stand to gain access to credit. In “Give Credit Where Credit is Due”, the authors find that 21% more credit applicants earning $20,000 or less annually in the United States see their credit applications be accepted and 15% more applicants amongst those earning between $20,000 and $29,999. These income groups would be considered as being below the poverty threshold according to national poverty line definitions.

Gaps in Knowledge

Although there are different institutions that acknowledge the importance of Secured Transactions and the existing literature links the use of such system to improve the financial markets conditions for SMEs and its impact to reduce poverty, no empirical research has been conducted to measure the impact that Secured Transactions Systems have on a firm or individual level.

The literature review also suggests that currently there is little research that links these financial infrastructure products to impact on the extreme poor and those at the base of pyramid. Some areas of further research could include assessing the impact of these two FI products on the income and consumption smoothing effects on households, and on business growth and job creation associated with SME’s.

Conclusions and Recommendations

Financial infrastructure is critical to financial market development, which promotes economic development and growth. There are numerous studies to show the impact that strengthened credit reporting and secured transactions has on expanding credit at potentially lower interest rates, specifically for individuals and SME’s.

The IFC Jobs Study and other studies show the critical constraint that access to credit poses for these small firms, which if removed, can result in job creation. Given that jobs are a key pathway out of poverty, financial infrastructure plays an important indirect role in impacting poverty. However, the current literature is scarce in validating these transmission links and point to a potential area of further research for all stakeholders including IFC.

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