



## **The Entrepreneurial Finance Lab**

### **Center for International Development - Harvard University**

The Entrepreneurial Finance Lab (EFL) is a new initiative at Harvard's Center for International Development. Our mission is to help unlock the entrepreneurial potential of the developing world's 'missing middle'.

#### ***The 'missing middle' and barriers to finance***

Emerging and developing economies have a large number of micro-firms and some large firms, but far fewer small and medium enterprises (SMEs) compared to developed economies. Despite evidence of high returns, most SMEs in developing countries are shut out of the financial system.

Existing lending models - microcredit, banks, and VCs – face fundamental barriers in this segment. Microcredit may reach micro-enterprises, but such firms rarely graduate to SMEs. The microcredit model falls short when larger and riskier investments are needed and cash flows are not immediate. For banks, the transaction costs in having an experienced officer evaluate a business plan are too large to make this segment viable, forcing them to focus on collateral rather than entrepreneurial potential. For VCs, SMEs in developing countries do not have traditional exit options like IPOs. VCs are experts in evaluating the potential of the entrepreneur and their business proposition, but the transaction costs of this type of screening are so high that only the highest-potential investments can be considered.

This was also a problem in the advanced economies until very recently. Banks finally penetrated the SME segment in the 1990s through the application of credit scoring to small business loans. They evaluate the entrepreneur's own abilities and trustworthiness as represented in their individual credit history, instead of focusing on the particular business proposition. Most importantly, they were able to do it in a low cost automated way, so that the smaller loan amounts weren't overwhelmed by large transaction costs.

But what does one do in developing countries? Traditional scoring is next to impossible in these low-information environments, yet this is precisely where access to finance in the missing middle is the most problematic. Is there another way to evaluate an entrepreneur's own abilities and trustworthiness more directly, and in a low-cost, automated, and reliable way?

#### ***Our Flagship Project: Psychometric Screening***

Our flagship project is to examine the role psychometric testing can play in selecting entrepreneurs for financing, with the aim of developing technology that allows the private

sector to finance this segment in a profitable and sustainable way. Advances in psychometric testing and new research into the psychological, social, and cognitive characteristics of successful developing country entrepreneurs provide field-proven ways to measure a potential borrower's entrepreneurial potential directly, with low transaction costs and few information requirements. These tests can be automated, do not require a credit history, and are resistant to manipulation. When combined with the right financial contracts and other sources of information, they could represent a breakthrough in profitable lending to the missing middle. We have already developed and piloted a prototype in South Africa, which has shown significant promise.

***The EFL is focused on three activities:***

- 1) Test Development. This activity consists of identifying, modifying and developing new modules to build into our entrepreneur screening tool.
- 2) Pilot Trials. We will evaluate the effectiveness of these screening tools in identifying successful and trustworthy entrepreneurs. We also hope to explore the tool's combination with alternative financial contracts like micro equity and income-contingent lending. These pilots will be pursued in Latin America, Africa, South Asia, and Eastern Europe.
- 3) Diffusion. We will promote successful modules to financial institutions, allowing them to increase their efficiency in existing market segments and move down-market into the missing middle in a significant and sustainable way.

***We are currently looking for the following types of partners:***

- Researchers in entrepreneurship, organizational psychology, psychometrics, and related disciplines who can contribute to test design and analysis and are interested in academic collaboration.
- Firms in the testing industry that own or could develop tests to measure entrepreneurial acumen and reliability.
- Organizations (banks, VCs, MFIs, NGOs etc.) with access to a sample of entrepreneurs and knowledge of their performance, to which we could apply our test. We will pilot various screening tests to the sample and compare the results to past client performance, future performance, or in the case of new clients, the outcome of the partner's own screening process.

**For more details, please email [bailey\\_klinger@ksg.harvard.edu](mailto:bailey_klinger@ksg.harvard.edu)**