

# Center for International Development at Harvard University



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## Entrepreneurial Finance Lab



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 EFL is directed by Dr. Asim Khwaja and Dr. Bailey Klinger.

### The missing middle

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, these firms face critical problems in accessing finance, as existing lending models - microcredit, banks, and VCs - have been unable to reach them. 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. Banks have the liquidity, but face too high a transaction cost to evaluate small businesses and must rely on collateral. VCs are willing to incur large screening costs, but only for the few SMEs that can generate extremely high returns and viable exit options. In other words, current models are better at matching money to money (collateralized lending) or money to no money (microcredit) rather than money to profitable business ideas.

Banks in rich countries penetrated the missing middle in part by evaluating the entrepreneur's own abilities and trustworthiness instead of focusing on the particular business, much like VCs do. They could do this cheaply and accurately using individual credit histories. But what does one do in developing countries where such deep credit histories are not as widespread? Is there another way to evaluate an entrepreneur's own abilities and trustworthiness in a low-cost, automated, and reliable way?

### A new approach: psychometric screening

Advances in psychometric testing can provide ways to measure a potential borrower's entrepreneurial ability and honesty directly with low transaction costs and few information requirements. A battery of field-validated tests for personality, psychological and sociological traits, cognitive abilities, and honesty could provide direct measures of an entrepreneur's ability and integrity. These tests can be automated, do not require a credit history, and are resistant to manipulation. And when combined with the right financial contracts, they could represent a breakthrough in profitable lending to the missing middle. We have developed a prototype and tested it against a detailed and expensive due diligence process in a South African financial institution, and the early results are quite promising. With start-up support from Google.org, we have established the Entrepreneurial Finance Lab at Harvard University to develop and disseminate this and other technologies to unlock the potential of the missing middle.

### The way forward

The Entrepreneurial Finance Lab is seeking partners in the finance industry, primarily commercial banks, as well as VCs and NGOs with large sets of clients. The Lab will further refine the screening tool, and these partners will administer it to a sample of their clients. The predictive power of the test will be compared to the clients' actual business performance, giving a clear indication of the screening tool's accuracy. Armed with these results, the psychometric screening tool can be added on to the partner's existing methods to improve accuracy and reduce costs in existing segments, and will allow them to move down-market to profitable firms in the 'missing middle'. As compensation for their participation in the development and testing of this tool, partners will be provided with rights to the technology.

For more details, please email Sandra Oliveira, Program Administrator, at [sandra\\_oliveira@ksg.harvard.edu](mailto:sandra_oliveira@ksg.harvard.edu)

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