The Sanford C. Bernstein & Co. Center for Leadership and Ethics

Inclusive Growth for Entrepreneurs

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(In order of symposium agenda)

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The Sanford C. Bernstein & Co. Center for Leadership and Ethics at Columbia Business School, in cooperation with alumni, business practitioners, and academic colleagues, conducted a conference in February 2014 to launch its new research program focusing on inclusive growth and entrepreneurship. The center has previously organized conferences and workshops focusing on the causes, consequences, and ethical questions arising out of the financial crisis of 2008. The February 2014 conference bridged these past events to a new program focusing on the institutional and private effort to learn from the crisis in 2008, and to extend the franchises of accessible finance and skilled employment.

Inclusive growth refers to the practice of extending the opportunities of ownership and employment to traditionally excluded sectors of society. While the obvious examples of such exclusion are the poor in developing countries, there are also many communities within developed nations—e.g., abandoned urban areas, as well as struggling workers in richer countries—who are excluded from prosperity. Inclusive growth depends on policies by governments as well as financing, investment, and advisory services by the private sector, in support of local entrepreneurs to develop sustainable and scalable enterprises.

Traditionally, governments and nonprofit organizations have been a primary source of assistance, services, and incentives in the form of community development programs, capacity-building grants, and contracting to private businesses. In recent years, existing and new enterprises have also developed important businesses based on new ways to finance and to improve the management of small- and medium-sized firms.

Yet efforts to create vibrant small and medium enterprises in the neediest environments often confront resistance stemming from the failure of institutional structures to encourage and finance local entrepreneurs. Evidence of this resistance is found amid telling statistics on the variance in business life cycles around the globe. In the US, new businesses tend to start off small and, conditional on having a successful product or service, grow rapidly over time. In a country such as India, however, the size of firms is surprisingly flat over their life cycles. Whereas in the US, a 40-year-old firm is, on average, seven times larger than a five-year-old firm, the average older firms are only roughly double the size of younger firms in India and Mexico. Policy experiments have revealed that Indian firms are severely credit constrained; conversely, experimental evidence from Egypt has shown a growth on return—20% per annum—from relaxing financing constraints on microenterprises. Research on depressed communities in rich countries also reveals the same contrast between the presence of many small businesses and the absence of scalable enterprises. Somehow, capitalism is not sufficiently inclusive.

Our conference on inclusive growth and entrepreneurship brought together academics, public policy makers, and the private sector to share common learning from their experiences in the United States and in developing countries. We were delighted to have the assistance of old and new friends to help us launch our initiative. In particular, we thank Lew Kaden for championing the initial idea.

The following report provides a front seat to the many discussions of that day. We owe our thanks to Mark Lee Hunter, who brings his investigative journalism skills to enacting and contextualizing the excitement of that day. This time, he also places the conference in the context of our past conferences on the crisis, asking what we know now that we did not before. We are also very thankful to the wonderful staff at the center, to the editorship of Heather Barbakoff, the administrative genius of Tiffany Pollack, and domain knowledge of Sandra Navalli. We are pleased to acknowledge the financial support of the Skylark Foundation and Dean’s Seed Funds for Centers, as well as the help of Elena Piercy, Samantha Nathan and our external relations office.

We wish you good reading, and also viewing—the day’s videos are also available online.
Executive Summary: Toward an inflexion point for inclusive finance

The financial crisis showed that major banks are not only too big to fail, but they are too big to help. Their inability or unwillingness to address these markets complicates the achievement of “an economy that provides sufficient growth to meet its varied goals, in an inclusive way, [with] equality of opportunity and outcomes,” in the phrase of Lew Kaden, former Vice Chairman of Citigroup.

There are other obstacles to inclusive growth. One resides in the way that poverty shrinks the ability of individuals to imagine and execute strategies of enrichment. Another can be located in unreasonable expectations—for example, that anyone and everyone can become a successful entrepreneur.

Yet inclusive solutions and strategies are emerging, and some of them are working. An alternative financial sector provides bridge and growth loans to small businesses—often at a high, but bearable, price. A body of specialized knowledge concerning the needs and expertise appropriate to helping small businesses grow is being assembled and applied. The advent of mobile communications technologies enables big data collection, and with it risk analysis that can support financial services to previously excluded communities or persons.

When the pieces are added up, this conference suggested that the financial crisis might have generated structural changes to the financial services market and its institutions. This trend was not evoked in the Bernstein Center’s first conference on the subject in December 2008; then, the concern was how to restore a broken system and ensure that it could function securely. The underlying assumption was that nothing could replace the extant financial system. That assumption no longer holds.

What weakened this assumption? One answer is that the crisis legitimated what were formerly dismissed as merely “radical” concerns, chief among them the potential social impacts of financial innovation. In a 2010 Bernstein Center conference focused on the effects of quantitative models as a potential driver of the crisis, Bruce Kogut, professor and director of the Sanford C. Bernstein & Co. Center for Leadership and Ethics at Columbia Business School, observed that the financial industry could no longer benefit from the general presumption that innovation is always desirable:

“There hasn’t been a debate as to whether financial innovation is responsible for consequences in society at large. If financial innovation is a poker game for a few insiders, we don’t care. But there are externalities, and we haven’t discussed the effects on innocent bystanders.”

One of those effects, and the cornerstone of the present conference, resides in the recognition that for many, the system is and may always be inaccessible for the most needy. This is at once a tragedy and a market opportunity. The discussion made plain that inclusive growth is driven to a steadily increasing extent by forces outside, or parallel to, the traditional financial “system.” The mainstream of finance is no longer the only or even dominant stream for important segments of society; there are many streams, in the developed countries as well as in the developing ones.

Conference participants recognized that a significant piece of the US economy now shares similar conditions and dynamics of developing world economies. As Bruce Kogut put it: “When we look everywhere in the developed world we see a widening gap between a dynamic wealthy class and a class of people who are falling behind. This is troubling to anyone in the course of their career, [who is wondering,] ‘What will the world look like?’” By no coincidence, he observed, there is intense interest in how market-based financial solutions can help those who are falling behind.
Nonetheless, government remains a key player in this movement. On the one hand, in the wake of the crisis, stricter regulation provides large financial institutions with reasons not to take supplemental risks in unfamiliar markets. Simultaneously, regulatory rules encourage institutional investors to create opportunities for minority-owned businesses, creating a market for agents who understand environments far from Wall Street.

Finally, new ambitions and technologies are converging outside the big banks to enable lean, fast-moving service providers. For hundreds of millions of people worldwide, including ambitious entrepreneurs as well as the poor, these new alternatives are already the only accessible financial services. Thus hopes that financial innovation can make a positive difference in society are reawakening, but in an unexpected way; new actors are creating solutions to the industry’s absence in large sectors.

Whether these players will make a decisive or even major impact beyond the known impact of microfinance is still unclear. But they are already positively impacting many lives, and they are already insiders in what increasingly resembles an alternative and yet complementary financial industry serving the excluded. As speaker Tony Goland, a director at McKinsey & Company, commented, “We’re at an inflexion point—everything that’s needed for financial inclusion is on the table. Who’s going to put those pieces together?” The conference captured key elements of that trend and question.

I. Optimism > realism: Reasons to believe in inclusive growth

Lew Kaden can be considered among the mainstream figures seeking to widen the financial industry’s social base and developmental impact. Though 200 million people have been affected by microfinance loans, Kaden starkly noted that the sector has not solved the problem of financial exclusion.

“Among poorer families all over the world, access to financial services we take for granted is unknown… even 65 to 70 million Americans have no access to traditional financial services.” These people are not limited to the poor, noted Kaden, but are at every demographic level until the very privileged. The markets have hardly ignored this need, but any market substitutes have been worse.

Technology in the service of inclusion

Kaden expressed a shared hope among conference participants: “Changes in technology”—in particular, mobile communications—“and a new attitude among policy makers have put more emphasis on, and possibilities of, finding solutions” to the massive hole in financial services coverage. The development of mobile banking has changed the landscape, enabling financial inclusion to be seen as beyond access to microloans and savings accounts. Instead, financial services must include products which meet the needs of a particular part of the population, such as saving accounts, insurance and risk management, and the ability to transfer funds across geographies and borders.

Kaden expressed a conference consensus: while technology alone will hardly solve these problems, solutions targeted at specific issues, and in particular mobile financial services, can certainly make a difference for millions of individuals in numerous countries.

The bet is that mobile technologies make it possible to offer these services at acceptable levels of risk and lower costs to new populations. Mobile communication technology will accelerate this “transformative” trend, predicted Kaden, as microfinance expands “beyond credit only, to linking credit to payments, the ability to transfer funds, insurance and risk management.”

Kaden referred to one sector where such business models and technologies could have massive impact: remittances from migrant workers. Numerous developing countries, and millions of families, are dependent on this resource for survival. In transition economies,
developing economies and Least Developed Countries (LDCs) together, remittances were approaching $500 billion annually in 2011 and have surely passed that figure now. The financial services industry has, in effect, imposed an onerous private tax on these flows. Moving cash across borders is costly, especially for those who can least bear the cost. Migrant workers who send remittances to their families in developing countries pay from 6 to 12 percent of the sums transferred, depending on the region. Tens of billions of dollars are paid annually to transfer agents by the people who can least afford the payments.

It is no small event that “technology has begun to make transfers possible for close to zero cost,” Kaden said. He noted that “Citi, because of its presence in 110 countries, has the capacity to be on both ends of that [transfer] process.” Given the scale of remittances, even much smaller fees could generate significant revenues. Players willing to handle the risks of operating in remote places, and smart enough to build low-cost remittance platforms based on mobile technologies can reduce costs to customers. By the same token, they can also reduce the risks of advancing credit or services to remote customers, noted Erick A. Brimen, a principal of the entrepreneur matching firm CoFoundersLab: “A lot of these decisions involve risk reward analysis, and to understand the risk you need more data. We’re in a great time—we have greater access to individuals we could not reach without driving to a village. Instead we can use mobile phones to collect data. “There was absolutely no disagreement that this is feasible, and could be “very effective for credit risk management,” according to Goland.

However, data can also be misused, and often is. As Kesha Cash ’10, co-founder of the minority-focused investing initiative Jalia Ventures and director of investments at Impact America Fund, said, “My biggest fear is that we go down this big data path and it gets into the hands of people who continue to take advantage of the poor.” Online payday loan services that capture and sell user data are one current example. Legitimate banks, too, can lose data to unscrupulous operators. The benefits of gathering and using such data far outweigh the risks, argued Goland:

“The use of data collected from mobile devices is going to be critical to solving poverty. Anonymity is not the friend of the poor. We’re looking at business models that use data for the benefit also of the people we’re collecting it from, and the potential of this non-traditional data to help close the gap on financial services and a lot of other social issues.”

However, he added: “We believe there should be a Hippocratic oath for financial inclusion: first, do no harm.” As he implied, that’s not yet general practice.

Who will come to the party?

In the United States, Kaden noted that Walmart, Visa, MasterCard and American Express have experimented in mobile markets, along with “alternative online banks” like Simple, a fast growing Oregon-based 2009 startup that was acquired in February by the Spanish bank Banco Bilbao Vizcaya Argentaria (BVVA). But, he added, there has been less experimentation and engagement in the United States when compared to the rest of the developing world. A key reason, he suggested, was that initiatives in the developing world deliberately engage more players than the typical US startup formula of “skunk works” plus angels. Without these models, the necessary transformation won’t happen.

Goland agreed, “No one institution can deliver [it all], it’s too expensive.” At least one conference participant, Tim Ferguson of Next Street Financial LLC, is already building such coalitions. A question remains, and was raised by Gita Johar, senior vice dean and Meyer Feldberg Professor of Business at Columbia Business School: “Why are we still talking and key players haven’t stepped in?”

Can business schools help fill the “missing middle”?

Bruce Kogut pointedly added business schools, and the people they train and engage, to Kaden’s list: “When we look at what a business school can contribute, maybe it’s to identify people… who can talk about smarter money and smarter entrepreneurship, a more modern approach to entrepreneurship.” He noted: “A venture capital community to fund part of these projects didn’t exist 20 years ago.”
He was also alluding to “things that are happening outside business schools.” The sector is not doing enough to address critical issues, he argued:

“There’s a problem—a missing middle of medium and small enterprises. If you look at the distribution, what’s missing is not microfinance, but an entrepreneur who is not just sustaining himself, but growing the business. Our sense is that we’re not doing enough in the area of helping entrepreneurs to grow to size and scale.”

The missing middle emerged in different contexts throughout the day. Ellen Morris, a principal and co-founder of Embark: Energy-Education-Entrepreneurship in Tanzania, who attended the conference, observed “we see a middle financing gap for small amounts of capital, for people trying to grow a business.” Cash said, “Eighty percent of entrepreneurs in America are solo. They’re feeding their families on their small businesses. According to the Association for Enterprise Opportunity, if one in three microbusinesses actually created an additional job we’d be at full employment. How do these businesses grow? Create more scale and capacity?”

Looking forward, said Kogut, business schools “can fundraise more, to do better research.” Useful research will be dependent on practitioners in the field, he said: “We can’t do everything in business schools, but we can run regressions on your data points, and use analytics to see what works and is most effective in achieving inclusive growth.

Specific suggestions for studies came later that morning. Some were cognizant of the fact that leaders in this emerging field are learning as they go. All were revelatory of the fact that business school research typically addresses the needs and examples of the very large firms that hire MBAs, employ consultants, and achieve the biggest, most attention-grabbing success stories:

Kesha Cash proposed a “tactical research project” to study mission management for impact investing firms—notably associated costs, and “how to ensure that as mission-driven companies grow we are accounting for the financial and human resources needed to effectively address large social problems.”

Erick Brimen noted, “The entrepreneurial system in the US, still the best, has a low rate of success. A huge portion of that has to do with cofounders. The teams fall apart… how do we facilitate the formation of teams in a way that facilitates their survival?”

Goland asked for studies of “how to build knowledge and capability of the customers” for alternative financial services. He added, “That field is wide open.” In 2008 Stephan Meier, now associate professor of management at Columbia Business School, told the Bernstein Center’s first conference on the crisis that “borrowers don’t know basic mortgage terms.” They now have more options, but apparently not a great deal more knowledge about them.

II. How scarcity narrows the bandwidth of the poor, and how to widen it

Sendhil Mullainathan, Professor of Economics at Harvard, says he “became convinced five years ago that financial inclusion was basic to changing the economy, in the US and abroad.” In the meanwhile, he realized that he was “missing a big part of the picture.” Specifically, he was not yet paying attention to how poverty looks to a poor person, and how that perception alters their options.

“Start with a vegetable vendor—a typical business person, sits on a street corner, buys 1,000 rupees of fruit, $20 worth, sells them during the day. At the end of the day she has a net profit of 100 rupees. The simplest business model you can imagine: human capital, herself, and capital for the fruit.”

The capital comes from a moneylender who charges 5 percent on the 1,000 rupees. That 50-rupee charge “is half her profit,” said Mullainathan.

If she reduced her consumption of tea and dhosa just a bit, she’d save five rupees a day. Anyone could see that in 200 days she could save the 1,000 rupees that she borrows from the moneylender. “In fact, she’d save it in forty days, with compounding,” said Mullainathan. Since she wouldn’t need to pay interest on her working capital, the effect would be to “double her income in 40 days.”

But in most cases, she wouldn’t change: “She’s got it right within her grasp, but doesn’t take it. Why? Why is she in a debt trap? The usurious rates are one issue, but she’s making a choice too.” The question doesn’t apply only to poor Indians, noted Mullainathan, “This also happens in the US—debt traps are very common.”

This was the introduction to a general case: “Across so many domains, you find a group of researchers who study behavior, ask what’s good behavior, and ask for variables that affect it, and income is always there.”

Are the poor, then, different from the rest of us - besides the obvious fact that they have less money? Not quite, said Mullainathan:

“I’m exactly like the vendor. She could take actions today to reduce her debt. She has income but a lot of it goes to pay down debts. She’s in a money debt trap. I’ve personally said yes to too many things. I should take fewer—pay down my commitments. I’m in a time debt trap. I borrow time. Money poor people say, ‘I can...
pay this later.’ Time poor people say, ‘This can wait.’"

The inescapable common factor, he suggested, “is the psychology of scarcity—how we behave when we have too little. The behavior that follows is an inevitable development of the psychology.”

Though economics tells us “everything is scarce,” said Mullainathan, the psychology of scarcity tells us that some things are more rare than others: “The days you’re busy, time feels more scarce. The days you’re not, it’s still scarce, but you don’t feel it.” What matters is “the perceived feeling of scarcity.”

At “the heart of every psychology of scarcity,” he said, is that one thinks of nothing else but what feels scarce. The Minnesota Starvation Experiment, in which 36 volunteers were starved so that the victorious allies of World War II could learn how to feed the famine-wrecked populations of Europe, discovered that by accident:

“In the footnotes of the study, [the researchers] noted what happens to their [subjects] psychology. Big surprise, they became cranky. One of their favorite hobbies was to read cookbooks, or read newspapers for the price of food. You’d ask what they’d do when they left the study. Half said, ‘Open a restaurant.’ None did. They went to watch movies together. They’d watch the comedies and laugh, but for some of the jokes the rest of the theatre would laugh, and these men were silent. Whenever there was food in the scene where the punch line was delivered, the men just saw food. They heard nothing else. That’s the psychology of hunger: Food drives your mind.”

The phenomenon recurs when experimental subjects are asked to complete words from strings of letters, or find words in a grid of letters; thirsty people will see “water” before people who aren’t thirsty, and dieters will see “donut” in an alphabet cloud.

The poor, at an automatic level, are thinking about money, all the time. The main thing we must understand to understand poverty is that the poor have monetary concerns top of mind. Rent is due at the end of the month… these thoughts and issues constantly come to mind.

One consequence is that “the poor know the price of things. They are better money managers.” He offered an example, “When you get into a taxi, what does it cost [when the driver flips the meter]? We asked the question in Boston. The rich didn’t know; the poor know. But the rich are the ones who take taxis.”

“This [psychology] is not pathological,” argued Mullainathan. “It’s functional. It focuses people on a need. It’s a primitive part of the brain that focuses attention on something you need.”

However, he added, “The process becomes dysfunctional when you’re trying to do something else.” The effect is to “tax our bandwidth—pull our mind away to thinking about money.” That can be mortal to the process of creating a business or running it effectively, he observed:

“When have you felt the most creative? It’s part of two forces. Creativity needs time pressure. You get a breakthrough when under time pressure. But you also need a lot of time to not be under pressure, to think randomly. People are wrong when they say necessity is the mother of invention; you need necessity, but also freedom of mind, and that’s what poverty takes away from you.”

The effects of narrowing bandwidth can be measured, Mullainathan argued that in experiments he conducted at a mall in Trenton, NJ, participants were given the Raven’s Matrix test of fluid intelligence, and “tickled a little bit”—that is, he nudged subjects to think about cake or money. The resultant impact on their IQs, he said, was “huge.”

Mullainathan concluded:
“I thought about poverty as a problem of money. I was wrong. What they lack even more is bandwidth. When we talk about finance, we talk about bandwidth. Smoothing finances for a sugar cane farmer is smoothing the bandwidth. We are not simply changing a bit of money—we are changing the psychological existence that affects these behaviors.”

Kesha Cash of Impact America Fund said, “I grew up low income and faced bandwidth issues. I completely agree. Our work is to spur entrepreneurship in the community by providing access to resources—but this also requires a shift in thinking.”

Answering questions from the crowd, Mullainathan drew out a key practical implication:

“Poverty is not a state of affairs, it’s a thing that changes all the time. But we don’t think about that when we go in (with financial services). The timing matters. Being short in making rent this week can have big impact. Financial services that plug these holes can help.”

At two different moments, Tony Goland proposed that the best solution to this problem is “to move from short term loans to a line of credit... low dollar, unsecured credit to manage spikes in cash flows.” Which raises an operational question, he noted, “How do you do that in a way where you don’t have high charge-offs? That exists in the world, but it hasn’t been developed yet for the people we’re discussing.”

Later that morning, Christopher Blattman, an assistant professor of political science and international and public Affairs at Columbia University, proposed that cash grants to the poor can provide some of them with the bandwidth needed to change their situations. Blattman said his current work is centered on “a majority of the world... poor, unemployed men and women.” They are engaged in 10-15 hours of low-paid, low-productivity work per week. In their world, “You’re not totally unemployed, or you don’t eat,” he noted. “They earn under one dollar a day.” They pose a double problem to developed countries, said Blattman. “We worry about the poor because we’re humanitarians—or because of what they might do.” In East and West Africa, former combatants in civil wars may join criminal gangs or become traffickers in illegal markets, like former soldiers everywhere.

Rather than ask how to create jobs for these people, as “most institutions” do, said Blattman, “The right question, I think, is ‘What’s holding the poor back?’” The conventional answer is that they lack skills, and it implies that the solution is job training. But that ignores a basic condition of LDCs, he noted, “There are few companies to work for.” Moreover, he said, “We’re finding so far that three-fourths of the people who have factory jobs quit—they hate it, [these are] low paid, miserable jobs.” Emily Breza, an associate professor at Columbia Business School, added, “Or they want a government job where they sign the name and go home. At some stages of development there aren’t jobs. So they have to be entrepreneurs.”

So they need capital. Though “capital is a constraint” for this population, microfinance alone won’t remove it for them, said Blattman. They can’t afford or effectively use short-term loans at high interest rates. Moreover, microfinance solutions often assume that recipients will become entrepreneurs. In Blattman’s research he went to great effort to notice who would be a good entrepreneur, with a lot of data—with very little success,” he said. One problem was that many subjects didn’t accurately assess their own talents, skills, or ambitions.

Blattman eventually concluded that the most effective way to help this population is not to carefully target the most likely success stories, but to provide modest cash grants more widely, “If you spend hundreds of dollars targeting them, forget it. It has to be cheap. Drop it on more people, instead of targeting it well.” He alluded to conflicts about this approach with NGOs in the field stating, “A lot of nonprofits will talk about impacts.”
We’ll say, “How much does it cost by person?” To give a woman a cow in Rwanda costs $3,000. That’s an absurd proposition. Most training programs are equally ineffective. The impact per dollar is pathetic."

What, then, should be the role of NGOs toward entrepreneurship? Ellen Morris asked: “Should they step away and drop money from the sky?” No, replied Blattman. There is “a whole range of social services that cash can’t replace.” However, he said, “When it comes to business development and helping people generate incomes, this is going to be a hard benchmark for most organizations to match. A lot of NGOs are rethinking what they’re doing.”

Blattman tested the impact of cash transfers in Uganda, where following the civil war, women in 120 villages were given small grants, in cohorts of 900 spaced 18 months apart. Their average incomes were $10 per month. Most used the grants to begin small trading or retail businesses (like Mullainathan’s vegetable vendor). The outcome was that work hours increased by half, revenues doubles and savings tripled.  

When you’re making $10 a month, “getting another $10 is enormous.”

Similar results were demonstrated in Liberia. This time, the 1,330 participants were men, half of whom were in the control group. Their main job was “illegal resource extraction”—logging, tapping rubber, and hunting—and the tempting alternative employment opportunity was as mercenary soldiers. Those who participated in the program never abandoned illegal activities, but they increased their legal activities and income. They were offered four months training and $200 in inputs (seeds, tools, materials) to become vegetable or chicken farmers.

For the ones who chose vegetables, hours spent on illicit activities dropped by 20 percent and hours spent on farming grew by the same amount. The chickens “never arrived,” said Blattman. He added, "Men in the program who received capital moved less toward the border”—where fighting was still going on—“and took less of a part in (military) recruitment activities." Overall, the program achieved “sustainable agricultural livelihoods with modest increases in wealth” for participants.”

However, Blattman said, “The entrepreneurship I’m looking at won’t relieve poverty” at a national level. “The difference from Kenya to Chile to Vietnam, going from $2,000 per person per year, to $8,000 has never been done without value added manufacturing.” Without it, he said, a country “can’t produce middle class status. It’s a humanitarian effort in the meantime.”

III. Entrepreneurialism as development

“If you empower the individuals who are living the problems,” said Erick Brimen, chief operating officer and vice-president of finance of CoFoundersLab.com, “they come up with the solutions.” He was speaking on a panel that included McKinsey’s Tony Goland, an expert in global inclusive finance issues, and Kesha Cash, Director of Investments of Impact America Fund, which invests in businesses that aim to make a positive impact on under served communities in the US. They shared his optimism, but neither to the same extent, nor from the same perspectives.

All three are products of elite educational institutions, and exemplars of the modern entrepreneurial mind set evoked by Kogut. All are focused on helping entrepreneurs to thrive. But they are operating on very different fronts.

Goland is concerned with policy frameworks and infrastructures that can support inclusive innovations. Brimen hopes “to change the world for the better while at the same time generating tremendous wealth by solving a big problem, profitably.” His key market is comprised mainly of elite individuals like himself—educated, highly skilled, looking for partners to launch cutting-edge tech businesses.
Cash’s focus is on scaling early-stage enterprises with products and services that target communities that have been overlooked by traditional financial institutions (where she spent her early career) and most venture capitalists.

One of Cash’s portfolio companies is a technology firm called PIGEON.ly, which aggregates prison inmate data and provides lower cost communications services to inmates and their friends and families. She recounted:

“The founder is an ex-con, who spent four years in federal prison for trafficking marijuana. He was not accepted into the top tech accelerators because the people around the table don’t understand what it means to have a loved one in prison and the costs associated with that.” Investing in such enterprises requires going “beyond looking at the person, to understanding where they’re coming from,” she said. “It’s about understanding the depth of what the market opportunity means.” That understanding, she said, is “a cultural phenomenon.”

Put another way, the people who run financial institutions cannot grasp certain opportunities, because neither the entrepreneur nor the market is part of their world. A participant in the crowd, Betty Wong, put it simply, “Angels and VCs like to invest in people like them. But if there are people who are not like them… how do they break through?”

Brimen replied, “VCs want returns, not people like them. The question is access to them.”

Ronnie Chatterji, an associate professor at Duke’s Fuqua School of Business, commented, “If you know rich people it’s great; otherwise it’s hard to tap them. In business schools, most of our students are looking to start the next Facebook or Twitter, high growth aspirations. So there’s a cut between companies that get VC backing, and all the others.”

Kogut said, “The problem isn’t just finding money, it’s finding entrepreneurs. Are we reaching them? Are they out there?”

“ Depends on the definition,” Brimen replied.

“If we mean someone who has gone forward and taken a risk, it’s a small portion of the population. If we include people who have the potential, who see a problem they could solve, the numbers increase materially; most of the people in this room have thought of a problem we could solve, and the potential. Why do so few people take the step? You need people with the ability and the incentive, and you can improve both.”

One incentive, said Goland, may reside in “the supply chains of larger companies, who employ millions of micro-entrepreneurs. They have an interest in the health and well-being of their supply chains.”

**Inclusion requires innovation**

Among other things, non-inclusion is “a market failure—the supply (of financing) has not developed,” said Goland. “The incumbent institutions are focused on the affluent, they don’t understand lower income people, and they don’t have business models to serve them.” Cash agreed. “It’s not an easy thing to do. There are costs, it won’t make money right away, it’s a volume game.” Taken as an ensemble, the unserved market is big. Taken as individuals, it is not big at all.

Without innovation, Goland argued, there will never be an inclusive market in the financial industry. He targeted product development and marketing as sectors that are crying for fresh approaches. Goland said:

“ A single product model is not the solution. If you look ahead, the multi-product approach will be inevitable. You create bundles that meet varied needs. Whoever’s trying to sell it gets away from selling the project to understanding the needs, matching them to a bundle for particular clients.”

Elsewhere, he has argued that this will also require shifts in the infrastructure of banks (from new branches to “low-cost physical outlets” like storefronts) and in the
metrics required of their middle management levels. Goland alluded to those shifts when he said that banks must “help people develop the skills to get the benefit of what is offered to them. That’s very different from pushing a product.”

Whether or not bank managers can do that job, someone must, said Cash. “There’s an education piece that’s required.” She suggested that small businesses owners should “not just be given a loan, but should also be required to take certain tests to see if they understand what’s needed” to grow their business. She also pointedly asked who would pay for training them in financial basics.

Brimen argued that there exists “a world of opportunities” to educate would-be entrepreneurs. As with every solution advanced during the day, it will be necessary to monitor providers to ensure they are not merely ripping off less informed clients.

Goland proposed a different kind of crowdfunding (or crowdsourcing). “To bring people together to help each other is a powerful idea. Providing capital is one part of it. Sharing their experiences and knowledge, that potential is also there.” One way it could be done, he thought, was through massive open online courses (MOOCs).

This was one way in which new technologies might fill the financial education gap. Ellen Morris is testing another in Tanzania. She hopes “to create thousands of clean energy enterprises rather than the hundreds we have in the world today.” Launched in 2013, her NGO, Embark, hopes to coach and guide local entrepreneurs, face to face and through distance learning technologies, “to lower transaction costs and create a financially sustainable business model.”

Does post-crisis regulation impede innovation?

Goland suggested that the post-crisis regulatory environment blocks banks from developing viable new business models. “The financial industry is very highly regulated, which slows the ability to innovate…They are focused on safety and soundness, compliance. The regulators, too, are focused on safety and soundness and compliance, not innovation.”

Current regulation raises costs for new entrants, agreed Brimen:

“Why don’t the smaller players do it? There’s a pricing issue. They get priced out of the market if they go through the formal financial infrastructure, because of regulation, the costs associated with complying licensing, getting the charter. It might be appropriate for systemic institutions, but you’ll be pricing out entrepreneurial actors. Regulation should make it easier for people who want to engage to provide capital.”

For example, commented Tim Ferguson, managing partner of merchant bank Next Street Financial LLC, “It’s very difficult for CDFIs [Corporate Development Financial Institutions] to move from a housing orientation to small business, from a record keeping view.”

Goland underlined that the point is not “to weaken regulators,” but to redefine the problem they are “trying to solve... Right now they’re punishing evildoers, which is [only one] part of the problem. It makes things worse, because people pull back, there’s less capital for the poor, and [its] higher priced.”

Goland cited Brazil’s Bolsa Familia program, which uses electronic benefit cards to distribute transfer payments to 5 million families through ATMs, as an example of how regulators can “get beyond punishment to solve market failures.” The success of the program in reducing payment costs (from 14.7 percent of grants to 2.6 percent within five years) led to a further innovation:

“They said, ‘If we’re letting people get transfer payments through ATMs, banks can use the payments as collateral to reduce the cost of lending.”

Gita Johar offered another example: Twice in the past decade, the Reserve Bank of India (RBI) has sought to promote financial inclusion through high-level committee reports. In 2004, the Khan Commission proposed innovations like allowing civil society organizations, e.g. NGOs and nonprofit microfinance institutions, to be intermediaries; relaxing “know your customer” rules; and “no-frills” accounts for the poor, supported by various communications technologies. Some states declared that by adopting the recommendations, they had achieved 100 percent financial inclusion.

However, by 2013, the global crisis and the repeated, severe failures in India’s microfinance sector (described
further below) led incoming RBI chairman Raghu Rajan to appoint a new “Committee on Comprehensive Financial Services for Small Businesses and Low Income Households.”

The overall impression was that regulators are off balance, caught between enabling and policing. One may debate whether and to what extent market actors anywhere have in fact been punished for their roles in the financial crisis. But that may be missing a deeper problem. Goland, like Mullainathan, was arguing that perceptions matter. The perception among banks, Goland suggested, is that in the current climate they will be punished severely for taking risks that don’t pan out. If we want them to take certain risks on behalf of creating a more inclusive society, he clearly implied, regulators will be obliged to cut some slack for financial institutions.

Not only heritage institutions, but inclusive alternatives are feeling this heat. Unlike the big institutions, they are not yet skilled in shaping the regulatory environment. That was implicit in a question from Brian Blake, a cofounder of Spring Bank, a Bronx-based community development financial institution (CDFI) and FDIC-certified lending institution that says it will “serve anyone who believes in the importance of keeping Main Street strong.” There are dozens of similar institutions, most founded in the past decade. Asked Blake, “What will it take to encourage the regulatory environment to develop an inclusive attitude?”

Goland’s answer, in effect, was that the new inclusive institutions must adopt the traditional sector’s focus on fact-based lobbying. He described the process:

“At one level it’s personal relationships. Build trust with the regulator. Not to be perceived as lobbying for position. If I stand in the regulator’s shoes, what do I see? Provide ideas and facts, not in a self-interested way create an environment where you can get reciprocity.”

When exceptions become rules: Crowdfunding, Bitcoin and Credit Unions

1. Crowdfunding works, but for whom?

Repeatedly Brimen drew attention to crowdfunding. First, he said, the practice “enables supply to reach demand in a way that bypasses the regulatory environment,” by reducing traditional points of friction in the capital raising process. Brimen also sees crowdfunding as “democratizing the flow of capital, bridging the gap in the supply of capital. Harnessing technologies available now. It’s tech-enabled peer to peer capitalization. It levels the playing field to a great extent.”

It is indisputable that crowdfunding has generated significant investments in new enterprises, in either absolute (over $1 million) or relative (surpassing founders’ targets) terms. Whether crowdfunding can systematically palliate market failures is another issue. If considered as part of a portfolio of solutions, rather than as a magic bullet, crowdfunding clearly makes increasing sense for many entrepreneurs to consider.

However, observed Cash, “We have to be careful with opportunities that allow low and moderate income people to invest—we saw where this led millions of people in the housing crisis.” In her view, crowdfunding has “great potential on a local level. If I live in NYC, investing my personal dollars in a supermarket in California doesn’t make much sense to me. In my neighborhood, where I can see and shop at the store and I know my neighbors, it makes more sense.”

Local projects like supermarkets appear less frequently, though they may be essential to a neighborhood. One of Jalia Ventures’ success stories is the Red Rabbit healthy school meal provider, which has expanded from 15 employees in 2010 to 130 employees serving 100 charter and private schools in New York. It relied on the founder’s savings, funds like Jalia and the Partnership Fund for New York City.
2. Is Bitcoin fresh competition or a grave mistake?

The panel divided about Bitcoin, the alternative currency scheme, which at the time of the conference was facing numerous scandals. Brimen believed “it holds great promise ...Your cell phone is enough to be in the system—to exchange from one country to another. It’s about time that the traditional financial system got some competition.”

Goland flatly countered, “Exposing people to risks they can’t understand or manage is a grave mistake. What we need to bring to financial inclusion are things that are proven, to take risk out and not add risk.”

3. Credit unions: Is smaller riskier?

A participant asked from the floor, “The big financial institutions are not sympathetic to smaller entities. [In their view] smaller equals more risk. What about credit unions?”

These are also called “community-run savings clubs.” In the UK, they are increasingly regarded as a viable, even urgent alternative to payday lenders who charge short-term rates that would total over 5,000 percent annually. Payday lenders have flourished in the aftermath of the financial crisis, as banks tightened loan criteria. The UK government increasingly regards their credit unions as viable alternative insurers for private debts. This is one place where regulators are enabling solutions, though it follows punishment. The new role of credit unions is a consequence of “Payment Protection Plans” that involved payments, but no protection, leading to some 20 billion GBP in fines and compensation costs for UK banks.

Goland commented:

“I think [the role is] consistent with the model that tries to get the surplus back to the consumer. It has to do with the distribution of the profit. [Microfinance innovator Muhammad] Yunus says the activity has to be profitable. The question is, what happens to the distribution of the profits—does it go back into the consumer base? I’m a big supporter of the idea of a cooperative environment as the right structure for these kinds of business models.”

IV. Not your typical bankers

Merchant banking in the inner city

After the entrepreneurs, representatives of the emerging financial sector took the stage. They might contest that label: Tim Ferguson defines his merchant bank, Next Street, as “a classic business model for a contemporary market”—or more precisely, for “the urban core and underserved markets.” Though this merchant bank provides access to capital, its major function is providing “the same quality of advisory services that McKinsey or BCG would provide to someone with $1.00 million or more of revenues,” said Ferguson. Among other things, Next Street is performing the educational function that was frequently referred to during the day for much smaller businesses (i.e., those with less than $3 million in revenues), at a high level and for 10–12 companies at a time. “Where we provide one on one advisory services, we become an extension of the owner of the business,” said Ferguson. “Our interest is to grow with them.”

Next Street’s clients range in size from $4 to $80 million, which Ferguson called “the real domestic missing middle.” About 70 percent are private business, and the remainder, nonprofits. Nearly all “don’t have access to debt that allows them to grow and expand,” said Ferguson. Next Street does “little lending” of its own, he added, though it can “provide access to capital” through counsel:

“We’ll sit with clients, talk with them, go to a bank with them. In one instance a client got turned down...
by a bank he’d done business with for 17 years. He didn’t realize the issue wasn’t him, it was the bank. My partner, a former banker, went to see the bank, and working with the bank found a solution that worked for the client.”

He called getting capital for these businesses from banks at the current time “extraordinarily difficult.” Under the Community Reinvestment Act (CRA), said Ferguson, banks are required to make loans to certain markets, most of which are backed by real estate. Many loans for the types of small companies that Next Street deals with are rejected by the banks: “The loan application rejection rate for African American and Hispanic-owned businesses is estimated to be 6 to 7 times the [application] rejection rate of businesses owned by whites,” he said.

“Government – federal, state, city,” said Ferguson, “have been early movers in opening their supply chains to minority- and women-owned businesses, recognizing that providing business opportunities is one way to help them to grow.” However the small business owner often needs help, which Next Street seeks to provide, to both access then execute on such opportunities. Ferguson gave an example:

“The Massachusetts Department of Transportation asked us to find minority and women owned businesses that could be part of their construction projects. We find the businesses, we work with them on a curriculum basis, in the classroom, then one on one as they go through the RFP process. The government agency provides the resource for this to happen. The shift we see taking place is a desire to make sure that small businesses have more access and have opportunities to bid, and that there’s real impact and results in the form of jobs and growth for the small business.”

Recall that Goland argued that multinational supply chains could play a similar role. However, Ferguson has seen “almost no movement” in his field from large corporations. Developments like Walmart’s Sustainability Initiative, which set rigorous environmental and resource compliance standards for suppliers to meet, have raised concerns that it may hamper such movement in the near term by raising the costs and lowering the margins of start-up suppliers.

A second strategy, clusters—which the Initiative for a Competitive Inner City developed—are places where similar businesses attract talent, ideas, and funding, selling services and products to each other as well as to customers near or far. Much thinking about economic clusters has focused on export-oriented development—say, how to turn Singapore into an Asian Silicon Valley. Next Street’s focus is projects that serve local demand, like the Gateway Culinary Incubator in New Haven. The incubator mapped gaps in the infrastructure and providers of the local food industry, and matched them to unused resources at Gateway Community College’s Long Wharf site. Similar projects were previously launched, with success, in San Francisco and Carbondale, PA.

Ronnie Chatterji later commented, “People often want to scale successful incubators.” If selection was the key success factor, said Chatterji, such a project “might not scale well.” The most successful incubators are hard to get into, so they get great applicants and great participants. That does not mean it can be replicated everywhere.

A third focus is on development projects of large institutions—at the moment, principally big universities with inner city real estate that “want to be safe, and to have economic vitality in their neighborhoods,” said Ferguson. They include Northeastern in Boston, Johns Hopkins in Baltimore, and the University of Chicago. In effect, their investments in new facilities are one of the ways used to build capacity in local firms.

Ferguson calls this trend “unlocking institutional capital”—that is, unsecured debt, subordinated to an organization’s senior bank debt. It is usually used for long-term investment needs. In exchange for taking a bigger risk than secured lenders, notes a firm specialized in the sector, “institutional investors assume minority ownership positions and become investment partners with business owners.”

1. In the case of Northeastern University, “as part of approval for a development plan, they agreed to be in a first-loss position for a small business loan fund,” said Ferguson. His firm’s roles are multiple here. After reviewing their financials, it is proposed that Next Street will lend to local contractors at rates that are more attractive than equivalent funding available in the market said Ferguson. Next Street is also reportedly helping “to assess (Northeastern’s) purchasing practices and find new opportunities for community involvement.”

20 In order to obtain the city government’s approval for its
$2 billion plans, the university also pledged “to increase its purchasing and contracting relationships with small businesses and women- and minority-owned ventures, and to hire more neighborhood residents and provide employment training, education programs and job fairs for community members,” as well as taking more local students and increasing their financial aid.

Ferguson commented, “This is a much better solution to engage communities around the campuses then to argue whether they should pay $5 million more in taxes. For the city, it’s jobs and as we know the best social program is a job.”

If this project is typical, while the stakeholders are smaller in scale here than in, say, investment banking, there are many more of them. By extension, it takes more time with stakeholders to make the deals work. Providing SMEs with top-level counsel is “very intensive” work, and “difficult to scale,” said Ferguson. There is surely bigger (if not easier) money to be made elsewhere, which may be why Kesha Cash suggested that players in this field must be careful not to drift from their social focus.

If Ferguson is right, they will have plenty of temptation, because the “shift toward a mission-based investment policy” is about to grow a lot bigger. “Some have predicted that could be a half-trillion dollar marketplace by the end of the decade,” he said. “That money will look to invest with an element that is not just financial based, but also has a mission based or social component to it. In other words it will be investors who are looking for a combination of social and financial returns.”

Credit for the missing middle

The premise that technology can enable loans to sectors excluded by banks underlies the business model of OnDeck, which promises to deliver “a new kind of business loan.” Its website states, “We actually want to lend to small business.” OnDeck’s CEO Noah Breslow said:

“More and more data about how these companies are performing is available online, through QuickBooks or online banking. Our idea was to build a platform to aggregate these data sources and use them to get loans more efficiently for these small companies.”

OnDeck, founded in 2007, is one facet of an increasingly successful movement. It consists of variants on a model that combines some sort of data platform with the possibilities to invest in loans or to borrow. Initially this was called the “P2P” (peer to peer) model, because the idea was that individuals would lend to other individuals. As the Prosper Club puts it: “We cut out the middleman to connect people who need money with those who have money to invest...so everyone prospers!”

The key players in this sector are not social enterprises. Fundera, a loan aggregator that is moving into small business loans, was founded by a serial high-tech entrepreneur. “We view them as kindred spirits; they will fall into the category of alternative financing, differentiated by asset classes,” Breslow commented. He also noted, “The average Prosper Club loan is $13,000; our average loan is $40,000.” He said, “There will be category leadership, and we think we’ll be one of the leaders.”

Overall, the sector has widened to the point where banks increasingly regard it as a competitive threat, especially for consumer loans. Its actors are also attracting mainstream funds to underwrite loans. As American Banker observed in February:

“Some online direct lending start-ups, though still considered part of the P2P sector, do not use ‘peers’ at all in the funding part of the equation. Instead of having individual mom-and-pop contributors risk small amounts, they line up big investors like hedge funds to buy their loans in bulk.”

OnDeck, too, is moving in that direction, said Breslow. “We’re partnering with economic development organizations, who are leveraging our platform, taking
their capital and credit model and plugging it into our platform.” Third-party investors are lately “willing to take more or all the risk” of OnDeck’s loans, said Breslow. The firm’s website invites banks and small business service providers, leasing companies, or sales organizations to connect themselves or their customers to OnDeck’s platform.

However, said Breslow, “We have to prove the model ourselves, using our own money, before we can get people to back us up.” The firm’s “OnDeck ScoreTM” system focuses on customers’ cash flow and payment behavior, instead of personal creditworthiness, according to its website. The data platform “took years to develop,” said Breslow, and it is unlike the P2P platforms, which use “conventional assessments.” So far, it has enabled OnDeck to lend more than $1 billion profitably, said Breslow. He noted: “We are in the first loss position, we hold those loans on our balance sheet.” In that way, he said, OnDeck is “more similar to a bank than a tech company.”

Besides access to credit, OnDeck cuts search costs and uncertainty for clients, said Breslow:

“In a traditional data environment it takes 30 days to get a term loan from a bank. You’ll have to go to multiple banks in parallel. In our website you can get a loan for $35,000 in ten minutes; for up to $250,000, in two days... People don’t factor search costs in. If you factor in search costs plus capital costs, our structure looks a lot more reasonable. Doctors are one of our big client bases. They have to go to the bank three times [to obtain a loan]. They do the [OnDeck] loan at 1.0 at night. We sell on access, speed, and convenience.”

Many of OnDeck’s customers use its loans to cover cash flow shortfalls. “What’s your average interest rate?” asked Kesha Cash. “It’s one thing to plug a hole, another to provide resources to grow.” Breslow replied, “Our interest rates are about 50 percent annualized. But APRs aren’t the best metric for short-term loans, since it’s an unbalanced comparison. What’s key is to match the payback on the loan with the payback on the project. It doesn’t make sense to take a five-year loan for a six month project, and vice versa. Additionally, when we started, companies turned down by banks had to use the Merchant Cash Reserve, which was about 150 percent APR. Our client will pay 15% in charges and interests over 6 months. We’re not the low cost solution. You compete on different dimensions. There’s a reason why FedEx and the Postal Service both exist.”

CDFIs are not a practical alternative, observed Ferguson, “Most CDFIs don’t lend to smaller businesses.” A member of the audience shot back: “I do.” Ferguson said, “You do, most don’t. It’s our obligation to make sure it happens.”

As Mullainathan had commented earlier in the day regarding village moneylenders: “If you have a fire, people will buy a bucket of water. The question isn’t how to get rid of moneylenders—it’s to replace them.”

Asked if companies come back for a second loan, Breslow said:

“If 100 customers take one loan, 50 will take two, 25 will take three. Why do they come back? There’s episodic use of our product—every 18 months they need funds to grow, for inventory, or a second location. We also have a line of credit program—they use them on a cyclical basis, the company with one down season and three up, or a sporting goods store. That’s the dynamic. The average customer takes two loans.”

Suresh Sundaresan, the Chase Manhattan Bank Foundation Professor of Financial Institutions at Columbia University, asked Breslow how OnDeck’s model would be affected “if the economy picks up and interest rates increase.” Breslow replied:

“We get that question frequently. An increase of 450 basis points to 5 percent [from the current .5
percent], we would feel. Smaller spreads, not as much. It would mean the economy is doing better, and that’s good for small business. We’d see the effect on default rates."

The alternative sector is not a world apart, noted Ferguson:

“You look at it from the standpoint of traditional financial systems, any increase in the cost of funding will affect the providers of that capital. The banks are the core of the system. They will be impacted for the cost of their funds by whatever happens with the Fed.”

V. Entrepreneurship as development, at home and abroad

Microfinance > no finance

A decade ago microfinance was hailed as the best, if not the unique hope for eradicating poverty in developing countries – a claim, we should note, that was never made by Grameen Bank founder Muhammad Yunus, the creator of the sector. In 2005, the United Nations declared an International Year of Microcredit, and the following year Yunus was awarded the Nobel Peace Prize. That year over 3,000 microcredit organizations lent money to 113 million people. The size of the phenomenon generated close attention, and sharp criticism soon followed:

“Although microcredit yields some noneconomic benefits, it does not significantly alleviate poverty. Indeed, in some instances microcredit makes life at the bottom of the pyramid worse. Contrary to the hype about microcredit, the best way to eradicate poverty is to create jobs and to increase worker productivity.”

The financial crisis hammered the sector, raising microcredit default rates worldwide. NGOs, the core of the movement, were supplanted by banks and non-bank financial institutions (NBFIs), who made larger loans. Predatory lending practices appeared, and the social enterprise foundations of the movement weakened. Though Yunus had always argued that microfinance should be a sustainable (and hence reasonably profitable) activity for lenders as well as clients, by his own admission, he “didn’t expect… that people even want to make money out of poor people.” In Mexico, the 2008 IPO of Compartamos raised $400 million that richly rewarded investors, and resulted in criticism of its market-oriented model with its overemphasis on investor returns rather than social outcomes.

Elsewhere, microfinance sometimes resembled racketeering. At the end of the decade, officials of the Andhra Pradesh state in India attributed 54 suicides, mainly of farmers, to coercive microfinance payment collection practices. The immediate result was the Andhra Pradesh government’s 2010 “Regulation of Moneylending Act,” which severely tightened registration procedures and lending practices in the state. Lender tactics like going to a client’s door to collect payments, or demanding weekly instead of monthly payments, were banned. Borrowers took the new law as a chance to bail out. Recovery rates for microfinance lenders in the state fell from 99 percent to 10 percent, who then sharply cut back their business; loan portfolios dropped by 35 percent, and the number of clients fell 29 percent.

These setbacks leave open a fundamental question: “How much can we rely on microfinance?” said Emily Breza, Assistant Professor of Finance and Economics at Columbia Business School, and a specialist in development economics. More particularly, she asked: Does it foster business growth? Does the growth continue when the loans end? Which businesses benefit most? Can regulation protect loan recipients while maintaining their access to credit?

Breza’s insights were drawn from a study in Hyderabad, India, of microfinance practices among 6,800 households in 104 slum communities from 2005-08. Overall, the study found that microfinance supported business creation and growth (measured by assets and revenues). However, seasoned entrepreneurs—note that these are very, very small businesses—who “use microfinance to expand” benefited far more than business novices.

Brezza’s insights were drawn from a study in Hyderabad, India, of microfinance practices among 6,800 households in 104 slum communities from 2005-08. Overall, the study found that microfinance supported business creation and growth (measured by assets and revenues). However, seasoned entrepreneurs—note that these are very, very small businesses—who “use microfinance to expand” benefited far more than business novices.

The latter group, said Breza, were “not in business before microfinance came to town.” Only part of their loans was used for business purposes, and their business activities averaged a little over one hour per week. Seasoned entrepreneurs worked five times as many hours in their own businesses. They supplemented microfinance with “informal” loans, presumably at much higher interest rates. “These firms were capital constrained,” concluded Breza.
The most glaring implication for policy-makers, she said, is that “regulations to wipe out microfinance at one blow are quite negative.” Breza did not dispute that predatory lending practices exist in microfinance. But in trying to end them, the Andhra Pradesh ordinance made it much harder for skilled business people to overcome their capital constraints. These people were the best hope for creating jobs in their region, said Breza. Rather than put their preferred lenders out of business, she continued, it would make better sense to focus on stronger criteria for selecting borrowers.

Can everyone be an entrepreneur?

Ronnie Chatterji describes himself as “a fan of entrepreneurship.” He has noticed that he’s not alone: “MBA students want to do it. Either you’re an entrepreneur or you want to save the world, or both. A generation ago they were going into public service.” Amit Khandelwal, the Gary Winnick and Martin Granoff Associate Professor of Business at Columbia Business School, had seen it too, “There’s a shift. There’s been a massive decrease in the demand for finance electives. People are moving into entrepreneurship, social entrepreneurship in emerging markets.”

Politicians have noticed, too, said Chatterji. “Everyone, Democratic or Republican, wants a line in the speech about small business.” He marveled, “Entrepreneurship seems to be the answer to every question. How do we deal with poverty, and emerging markets that haven’t developed? Entrepreneurship!” Asked later for the meaning of the term, he ironized, “There’s not a razor-sharp definition.” The government collects statistics on self-employment, he noted, which is not quite or always the same thing.

The ambient, ambiguous enthusiasm makes it very hard to “take a realistic view of the small business sector,” said Chatterji:

“We’re getting ahead of what entrepreneurship can really do. …We end up confounding all small businesses as if they were the same. They’re not.”

Most important, said Chatterji, creating a business is not the same as creating jobs. “Politicians speak of small businesses because that creates jobs, supposedly. But most small businesses don’t have employees. Many are never going to grow beyond ten employees.” The key variable is the age of the enterprise, he said, “The main job creation is coming from young businesses that happen to be small.”

Chatterji focused in particular on capital constraints. Entrepreneurs mainly get capital from friends, family, or fools (the “3Fs”), as well as from banks—a bigger part of the equation than you might think—by cashing out their homes, and from maxing their credit cards. The cards provide “the most inclusive of all these options.”

Goland had alluded to credit card debt earlier in the day, noting, “The middle class in America enjoys unfettered access to unsecured credit.” Chatterji commented, “We know that credit cards and entrepreneurs are related—except we don’t really know. It’s hard to do the studies.” (Twice, Chatterji evoked problems with getting useful data. “The Small Business Administration will tell you how many clients came through the door, what they did for them, what were the outcomes. Those are good statistics, but don’t tell us everything we want to know.”)

Nonetheless, he and Robert C. Seamans showed that removal of credit card interest rate ceilings by states, following the US Supreme Court’s 1978 Marquette decision, led to increased entrepreneurial activity. Before 1978, capped interest rates on credit cards meant “if you’re a person seen as high risk… you don’t get a credit card.” Once it became legal to charge higher interest on cardholders, there ensued “expanded access to credit in the US economy, enabling liquidity-constrained individuals to borrow money and increase the rate of new business formation.” The impacts were “big,” said Chatterji, “especially among African-Americans. When credit is democratized, it helps people shut out by other channels.”
The financial crisis pushed policy makers in the other direction, said Chatterji. “We’ve been telling people to cut using credit cards for years.” In reality, he said, this is a policy choice; by loosening credit, “we might get some positive impacts, but also more bankruptcies.”

Chatterji suggested that this choice—do we want people to take a chance, and possibly fail?—hasn’t been discussed openly or well enough:

“The focus has to be away from how many businesses we got from it...just because someone starts a business is not necessarily a good impact. If they fail in a year with enormous debt, it’s not a great outcome. What are the metrics? We used to think home ownership was a great thing. Now we’re reflecting. Maybe the same thing is happening with entrepreneurship... Many will realize, ‘[entrepreneurship] is really hard. I’d be better off working for a small or large company.”

Who refuses to play the game?

Amit Khandelwal began with a simple idea: “What makes countries rich is how productively they use their resources.” In India, he had observed, “a lot of non-productive firms continue to exist.” The nation’s average productivity “is pulled down by them.” Khandelwal wondered, “Once a (more productive) technology is introduced, do people use it? Why aren’t people using the most improved technologies to begin with?”

He sought insight at Sialkot, Pakistan, where a cluster of 135 firms produce 70 percent of the hand-stitched soccer balls sold worldwide. The 5-10 firms that dominate high-quality production, and their smaller suppliers and competitors, all follow the same sequence of steps to make a ball. Materials account for 55 percent of their costs. However around 23 percent of the material used for the pentagon shapes that are stitched into a ball, is wasted.

Khandelwal’s team focused on that waste, and how it might be reduced. They offered $4,125 to a consultant to devise less wasteful cutting. He failed. They found that viable solutions had been outlined in China, the scholarly literature, and even Wikipedia. A new cutting die was created. It was cheap: the cost of deploying it would be recovered within three to eight weeks. “We were so confident of this technology, we were most interested in how it would spread,” said Khandelwal.

They offered 35 firms one of three “packages,” two of which involved incentives for adopting the new cutting dies. To their surprise, only six out of 35 firms signed on. The reason was employee resistance. “You have to understand how these individuals are paid—by the piece. So this individual, and others who had to modify their task, realized that the dies would slow them down,” Khandelwal explained. They then “misinformed the owners” about the benefits of the innovation.

The story might have ended differently if a trusted advisor to one or another firm had found a solution. But those advisors don’t exist—not enough of them, anyway, said Khandelwal. “There is no low-end consulting market in developing countries.” Even stranger, he said, is that no NGOs are providing it, so far as he knows— “Why is there no ‘MBAs without borders’?”

VI. Conclusion: Knowledge born of crisis

Markets do not regulate themselves, and neither do financial innovators: Those are the most constant themes in the past five years of the Bernstein Center’s conferences on the financial crisis.

The naïveté of financial actors—their tendencies to under-estimate risk, taking models of reality for reality itself, and to undervalue transparency and visibility in the run-up to crises—has been a surprising constant of these debates. There is an irony bordering on the absurd here, captured by Tano Santos, the Franklin Pitcher Johnson Jr. Professor of Finance and Economics at Columbia Business School, in the May 2010 conference: “Why do we need regulators to tell us not to do undocumented loans?”

In May and December 2010, scholars argued, and market actors confirmed, that a key driver of the
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The crisis was executive hubris. Until the crisis exploded, organizational leaders overrode warnings from inside their organizations. Emmanuel Derman, head of risk at Prisma Capital Partners and a Professor in the Department of Industrial Engineering and Operations Research at Columbia, said:

“There were a lot of situations where the people in charge of risk management didn’t have the power they should have, because others had made a lot of money over a few years, and that gives them a lot of power.”

A “primary goal” evoked by conference participants in May 2010 has not been fully realized: “to more closely align individual incentives for risk-taking with the longer-term stability of financial institutions while increasing transparency in markets and in measured risk.”

These conferences repeatedly documented that the people who caused the crisis were not those who paid for it. In 2009, Santos and Suresh Sundaresan warned that the crisis led to “a massive wealth transfer” to creditors of failed institutions, much of it from US taxpayers. In contrast, debt relief for homeowners and consumers, the first of the “urgent” steps recommended at that conference, was never fully achieved.

Financial education of some sort has continually appeared as an urgent need across five years of Bernstein conferences. It has taken varied forms.

In 2008, nearly one-third of homeowners with ARMs thought they had fixed-rate mortgages, and two thirds did not know that they might ask for a fixed rate; in that case, the lender would not inform them, as Stephan Meier, associate professor at Columbia Business School, told our first conference. Adam Parker, director of quantitative research at Sanford C. Bernstein & Co. LLC, told a conference audience in 2010, “We do a quant conference every year. In 2008 there were 400 people and 25 percent did not know what a risk model is.” At the present conference, training entrepreneurs to find and use capital appeared as an urgent need (or for some participants, an opportunity).

It is worth asking if the biggest hole in the current system, precisely, involves education. It is uncertain that business schools can or will lower the cost of that learning for a greater number of individuals and firms than at present. But there is clearly a demand for them to do so—as research houses, as instructors, and as theorists. Something has changed here, too. In 2009, personalities from leading business schools declared that they had nothing to do with causing or enabling the crisis. Of course they were not directly responsible; and of course, with a few exceptions, they had also done little to stop it. Now, increasing numbers of students, scholars and practitioners are seeking to increase wealth in the world more fairly and create a more inclusive economy and society. This is a significant ethical project. It remains to be seen how big its effect may be.

Endnotes

1. Mark Lee Hunter, rapporteur, “Preventing the Next


3. Remittances could also be a key development resource, argued the UN in 2012. Two curves make that theory very attractive: Foreign direct investment in the least developed countries (LDCs) declined every year since 2009, while across the developing world, the scale of remittances has multiplied by six times since 1990, tripling in the past decade alone, despite the financial crisis. See United Nations Conference on Trade and Development, “The Least Developed Countries Report 2012: Harnessing Remittances and Diaspora Knowledge to Build Productive Capacities”. Geneva, UNCTAD, 2012, via www.unctad.org/ldcr; p. 42.

4. Ibid, p. 44.

5. Ibid, p. 69.

6. In the US, the reform of the Electronic Fund Transfer Act, effective in Oct. 2013, addressed concerns about the transparency of agents and their fees, but

7. But banks hesitate – most spectacularly, Barclays, which in 2013 announced that it would no longer provide banking to firms offering transfer services to Somalia, before reconsidering that decision in the wake of an international protest campaign. Barclays cited concerns over money laundering and terrorism, as well as ‘commercial’ factors, among “the risks of the sector.” See Farhan Hassan, “Barclays says no to remittance lifeline.” New Internationalist Blog, July 18 2013. http://newint.org/blog/2013/07/18/barclays-remittance-money-transfer-somalia/

8. For examples of such issues, see the Engineering Social Systems group page at Harvard: http://www.hsph.harvard.edu/ess/bigdata.html.


15. This will require further development. After enormous initial enthusiasm, MOOCs are disappointing many. Among many recent reports, see Anon., “Data Mining Exposes Embarrassing Problems for Massive Open Online Courses,” MIT Technology Review, Dec. 18 2013, via http://www.technologyreview.com/view/522816/data-mining-exposes-embarrassing-problems-for-massive-open-online-courses/.

16. Led by Nachiket Mor, the former chairman of the ICICI Foundation for Inclusive Growth, its final report argues that any reforms must be based on four principles — stability, transparency, neutrality, and responsibility—with systemic stability first and foremost. Available at http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/CFS070114RFL.pdf.


[Image of two individuals discussing a document.]

Prof. Emily Breza of Columbia Business School; Prof. Christopher Blattman, of Columbia University; Prof. Ronnie Chatterji of Duke University; and Prof. Amit Khandelwal of Columbia Business School presented insights from their research.


The Sanford C. Bernstein & Co. Center for Leadership and Ethics is the umbrella for all activities on leadership, ethics and governance at Columbia Business School.

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