A Better Financial Product for Young Entrepreneurs' Micro and Small Enterprises

Project Information Document (PID)

Case #	B
Project Name	A Better Financial Product for Young Entrepreneurs' Micro and Small Enterprises
Project Theme	Youth Unemployment
Region	Africa
Country	Togo

1. Project Context

The Youth Employment Network (YEN) is an interagency initiative of the UN, ILO and World Bank, created to increase the impact of actors working in the area of youth employment and pilot innovative approaches to tackling this challenge. The Youth to Youth Fund (Y2Y Fund) is one of YEN's key products. [1] It aims to create decent and productive jobs through entrepreneurship. It is a competitive grant and capacity building scheme that enables youth-led non-profit organizations to pilot and replicate innovative projects that create employment for young people by helping them set up small and micro enterprises in niche markets. Identifying niche market opportunities avoids the market saturation that often occurs when many necessity entrepreneurs copy the same simple business ideas in the same region. The Y2Y Fund is present in 8 countries in Africa, and will soon launch its first round in Togo.

The Y2Y Fund provides entrepreneurs with the "complete package"; business skills training, soft skills training, and technical skills, start-up capital, [2] practical learning experience, and mentorship. In addition, YEN is now expanding this package to include improved market access. For example youth can organize themselves into producer coops and get linked to intermediary aggregators who can provide a steady income to the youth. The aggregators take on the role of packaging and selling the products to wider markets that the youth would otherwise not reach on their own.

2. The Objectives

The Project Development Objective (PDO) is to provide targeted disadvantaged youth with access to the Y2Y Fund. One aspect of the Y2Y Fund that we are still not satisfied with is the provision of start-up capital. There are three standard financing options for micro and small enterprises, each with its own limitations.

2.1 Micro credit

The small, short-term loans that micro credit offers are mostly conducive to starting simple micro-enterprises with limited further growth or productivity gains, such as such as basic retail. Consequently many businesses don't survive over longer periods of time and the few that do tend to stay small. Another challenge is that the loans are often used for consumption smoothing, rather than investment into the business. The repayment of loans is not strongly linked to the growth of the business. While many MFI's can boast high repayment rates much research suggests that a large proportion of micro credit clients have been unable to grow their businesses overtime and find their way out of poverty. Instead clients frequently get caught in debt traps, and in some cases higher suicide rates have been linked to micro loans.

2.2 Monetary grants

While this mechanism helps to reduce the risk for young entrepreneurs to try more innovative ideas, grant funding sometimes leads to reduced motivation and the funding can still be used to for consumption smoothing. Grants often create a

[1] This video link provides a short film on the Fund: *http://www.youtube.com/watch?v=vEAAcYVvtPY*

[2] In West Africa this is provided as in-kind support. Support per cooperative is most often valued between $1000 and $5000, although in some cases it can rise to between $5,000 and $10,000, and even over $10,000 in a few rare cases.

short-term spike in income for the entrepreneurs and revenue in the business but this often tapers off with time, particularly when a savings plan is not attached to the grant.

2.3 In-kind start-up support

Providing the materials and equipment to start a business prevents the use of funds for consumption smoothing, but it has a similar effect on motivation as monetary grants if there is no repayment obligation. It also requires a good knowledge of what material and equipment is required and additional resources to invest in procurement.

2.4 Other financing products

YEN has been keen to explore other financing products. One area that holds some promise is profit-loss sharing mechanisms, where a longer-term relationship is created and both profits and losses are shared between the borrower and lender. In so doing profit-loss sharing mechanisms, more closely link the repayment of the financing partner with the success of a business, thereby increasing the incentive for a lender to ensure businesses succeed rather than limit themselves to just ensuring creditors pay them back. Minor efforts to test profit-sharing products in Guinea have shown that when young entrepreneurs receive start up material and equipment they are often willing to repay if the business is successful, however the cost to intermediaries of collecting the many micro payments is high.

At the moment most examples of profit loss sharing mechanisms are more theoretical than practical and most come from Islamic banking. As CGAP explains, [3] there are 5 standard financing products in Islamic banking two of which, Musharaka and Mudaraba, are based on sharing profit and loss. Musharaka is equity participation in a business venture, in which the parties share the profits or losses according to a predetermined ratio. While mudaraba denotes trustee financing, in which one party acts as financier by providing the funds, while the other party provides the managerial expertise in executing the project. In mudaraba, profits are shared according to a predetermined ratio but any financial losses are borne entirely by the financier while the manager loses time and effort (or other non-financial contribution). Both schemes require a high level of transparency for profits and losses to be distributed fairly.

3. The Opportunity

When the Fund launches in Togo, we want to launch it with a better financing product. The challenge is to design a financial product that is suitable for young Togolese entrepreneurs, (cooperatives) to start or expand a business. The financial product could be administered in cooperation with a local financial institute. Proposals should have the following qualities:

- Allow young entrepreneurs to mount enterprises more complex than basic retail
- More closely link lenders repayment with the success and growth of the business
- Incorporate a collection system for repayments that is time and cost efficient for micro payments in rural and urban contexts
- Appropriate for use in Togo; adapted to the local challenges and opportunities.
- Reduce the chance of the misuse of funds for non-business costs (such as consumption smoothing)

The following is encouraged, but not mandatory

- Based on a profit loss sharing mechanism
- Create triangular relations with aggregators and small or micro enterprises that supply them
- Sustainable in the long run

The financial product does not have to incorporate a profit-loss sharing mechanisms as found in Islamic banking, or the use of mobile money transfers. Participants are free to either think beyond these ideas or incorporate them as they wish.

[3] CCAP, Trends in Sharia-Compliant Financial Inclusion, Focus Edition No. 84, Mayada El-Zoghbi and Michael Tarazi. Report available online at http://www.cgap.org/sites/default/files/Focus-Note-Trends-in-Sharia-Compliant-Finanicial-Inclusion-Mar-2013.PDF

Annex 1: Supplemental reading

1) About the Y2Y Fund

   http://www.ilo.org/public/english/employment/yen/downloads/y2y_fund_brochure.pdf

2) About limitations of microfinance

   http://www.un.org/esa/desa/papers/2009/wp89_2009.pdf

   http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/6291.pdf

   http://www.econ.cam.ac.uk/faculty/chang/pubs/Microfinance.pdf

3) About Islamic banking

   http://www.cgap.org/sites/default/files/Focus-Note-Trends-in-Sharia-Compliant-Finanicial-Inclusion-Mar-2013.PDF

4) On aggregators

   http://web.mit.edu/idi/idi/Africa-%20PromiseAndProgress-MIM.pdf