Financial and Human Capital of Microentrepreneurs and Financing by Microfinance Institutions (MFIs) in Cameroon

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ABSTRACT

Objective –This study determines the nature and the direction of how financial and human capital influence the financing of microentrepreneurs in Cameroon. Compared with past research, this work uses existing microentrepreneurs only, which are considered as the only ones having access to the financing of MFIs.

Methodology/Technique – This study employs an explanatory approach and uses the Five Cs model and primary data to explain the influence of financial capital (capacity, collateral, capital and condition) and human capital (character) on the financing of microentrepreneurs by MFIs.

Findings – On the one hand, the findings show that character, capacity and collateral significantly increase financing of microentrepreneurs by MFIs. On the other hand, the findings reveal that that condition is significant and has an inverse relationship with lending to microentrepreneurs. Collateral was found to be not significant.

Novelty: Compared with past research, this work uses existing microentrepreneurs only, which are considered as the only ones having access to the financing of MFIs. This study examines the relationship between financial and human capital to capacity, collateral capital and condition and character of microentrepreneurs.

Type of Paper: Empirical

Keywords: Capacity; Character Collateral; Condition; Capital; Financing of Microentrepreneurs; Microfinance Institutions.

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JEL Classification: G21, G32, L22, O15.

1. Introduction

Globalization practices emerged in the 1990s as a result of three principles: disintermediation, deregulation and desegmentation. These elements, known as the three D's, accelerated the exclusion of many economic agents such as microentrepreneurs from finances.

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Yunus fought against this discrimination in funding in the early 1970s by establishing the Grameen Bank to satisfy the financing needs of poor female entrepreneurs of Chittagong (Etsy, 2011). This was the beginning of modern microfinance used as a tool to alleviate poverty (Pitt & Khandker, 1998). Many studies agree with this finding (Webb, Morris & Pillay, 2013), however many others such as Armendariz and Morduch, 2010, Duvendack et. al., 2011, and Roodman, 2012 contradict this result. The consensus is that microfinance is a tool that increases the availability of financial resources to microentrepreneurs and enables them to start a business which has a positive impact on their future and lives (Barnejee et. al., 2009).

One of the reasons behind the differing views on the effects of microfinance on poverty alleviation are weak methodologies and inadequate data (Duvendack et. al., 2011) as well as deviations from initial practices to commercialization. The latter requires MFIs to generate profits from each operation it carries out by increasing debit interest rate returns and reducing the cost of lending.

In Cameroon, microentrepreneurs play a great role in Cameroon economy. They are owners of 45% of enterprises operating in Cameroon (Informal Sector Enterprises Survey (ISES), 2010) and most of these ones are in formal. The informal characteristic affects adversely on their financing. ISES (2010) shows that 95.7% of informal microentrepreneurs finances from informal sources. Very few of these enterprises have then access to formal sources like regulated MFIs and commercial banks. They are excluded from formal sources because they cannot afford financial and physical collaterals requested for their financing (Messomo, 2013c). Besides, based on the theory of asymmetric information, the financing of microentrepreneurs generates high monitoring and moral hazard ex post costs to traditional lenders.

Looking at the shortcomings above associated with the specific nature of microentrepreneurs, this study is made up therefore to search for alternative mechanisms to fund microentrepreneurs in Cameroon. Some of these ones are human capital, long term relationships, reputation and social capital. These instruments are in the relationship banking and human capital theories. It is true that, not all the types of microentrepreneurs are beneficiaries of the lending benefits provided by these theories. Only existing microentrepreneurs are subject to these advantages. This is because, according to Ledgerwood (1998), they have financial and human capital capacities and potentialities attractive to the financing by MFIs.

In the commercialization approach, MFIs increase their loan income by decreasing the loan delinquency using collateral as incentives (Besanko & Thankor, 1987) and by focusing on experienced and highly skilled microentrepreneurs for lending (Edgcomb, 2002). They cut on the cost of financing of microentrepreneurs by decreasing their cost of selection, counseling and monitoring in lending. Thus, financial and human capitals are essential in the lending practices of microentrepreneurs in the commercialization approach. From this explanation, the following questions arise: Which components of financial and human capital affect the financing of microentrepreneurs by MFIs in Cameroon? In what ways do they affect it?

The aim of this study is to determine the financial and human capital factors that influence the financing of microentrepreneurs in Cameroon. These ones assist in developing long term lending relationships between microentrepreneurs and MFIs. We expect the combination of financial and human capital to be an incentive to the financing of microentrepreneurs by MFIs. This is because financial and human capital creates confidence in the lending relationship between microentrepreneurs and MFIs. Human capital shows that microentrepreneurs have adequate competences to manage effectively loans granted, are able to repay them at the maturity and deserve to be funded more. Financial capital on the other side assists in reducing the financial losses of MFIs in potential credit default of microentrepreneurs. Compared with past research, this work uses existing and growth microentrepreneurs only, which are considered as the only ones having access to the financing of MFIs and are suitable to maximize their returns and minimize their cost of funding (Ledgerwood, 1998). It assesses how the combination of financial and human capital influences the financing of microentrepreneurs by MFIs in Cameroon. This positioning goes beyond past studies which focused their analyses either on financial capital or human capital at a time. This study employs an explanatory approach and uses primary data and the Five C's model to assess borrowers' creditworthiness (Lawrence, 1997) to identify the influence of financial and human capital on the financing of microentrepreneurs by MFIs. Three

core theories are mobilized for the purpose of this study namely the asymmetric information, the relationship banking and the human capital.

Our study contributes to the existing literature in two ways. First it provides the financial and human capital factors that MFIs considered as significant for the financing of existing microentrepreneurs in Cameroon. They are character, capacity, capital and conditions. By the nature of the capitals, character is a human capital, capacity, capital and conditions are financial. Second, this study provides financial and human capital that increase or decrease the financing of microentrepreneurs by MFIs in Cameroon. On the one hand, the findings show that character, capacity and capital significantly increase the financing of microentrepreneurs by MFIs in Cameroon. On the other hand, the findings reveal that conditions are significant and have an inverse relationship with lending to microentrepreneurs. The remaining elements of this work are divided into the following sections. Section 2 explains the diversified nature of microentrepreneurs. Section 2 also reviews financial and human capital and financing of microentrepreneurs by MFIs. Section 3 explores the methodology and Section 5 and 6 present the results and the discussion respectively. Section 7 concludes the study.

2. Diversified Nature of Microentrepreneurs

Microentrepreneurs are analyzed using many types of variables and criteria. This is due to their diversified nature. According to Ledgerwood (1998), microenterprises along with their microentrepreneurs are classified as existing microentrepreneurs, start-ups, unstable, stable and growth microentrepreneurs.

Existing microentrepreneurs are better off than start up ones. This is because their enterprises have been existing for a long time and have developed a good reputation that enables them to increase their sources of financing as well as to incur lower costs in financing. This is not the case for startup microentrepreneurs. They are often constrained in financing. Existing microentrepreneurs request loans to fund their working capital which enables them to carry out their daily activities. Informal sources of finance do not often satisfy these needs. Microfinance is a good alternative source of financing for existing microentrepreneurs. Unstable survivor microentrepreneurs are microenterprise owners with no other alternative source of employment. They are operators of unstable survival enterprises with a limited life span. Stable survivors are microentrepreneurs with microenterprises that rarely grow but provide microentrepreneurs with a suitable living standard. Growth microenterprises generate growth microentrepreneurs that operate with a motivation to grow their business into a small enterprise. According to Ledgerwood (1998), existing and growth microentrepreneurs are the focus of MFIs and have a high potential to create jobs and borrow from the financial sector. Our concern therefore is on these microentrepreneurs because, in contrast with the others, they have access to the financing of MFIs which is the purpose of this study.

3. Financial and Human Capital of Microentrepreneurs and Microfinance's Financing

Three key theories sustained the influence of financial and human capital in the financing of microentrepreneurs by MFIs in Cameroon. These are the theories of asymmetric information, relationship banking and human capital. The theory of asymmetric information was set up by Akerlof (1970). It shows that in a transactional relationship, parties do not have the same level of information. This type of relationship occurs in financing where lenders and borrowers do not have the same level of information in their financing relationship. This theory is examined subsequently in the microentrepreneurs and MFIs' relationship of financing. The second theory namely relationship banking resolves the disadvantage of the asymmetric information in lending. This theory falls within the modern theory of financial intermediation and portrays that long-term banking relationships control the asymmetric information in financing. These ones go beyond the commercial banks' practice and are in line with MFIs' habit of financing. The relationship banking theory is then used in this study to analyse the financing of microentrepreneurs by MFIs which also is done using the human capital theory in this study.

Human capital theory was originally developed to focus on education (Becker, 1964; Schultz, 1961). “It indicates people have varying knowledge and skills that economic value” (Marvel et al., 2016). Human capital theory has evolved over years and applies to many areas of entrepreneurial finance. According to Unger et al. (2011), human capital is studied in two perspectives that are the input and the output views. In the first approach, one studies what generates human capital. These are education, professional training and experience. In the second orientation, one examines what human capital produces to the beneficiaries. These are skills, knowledge and competences. For firms, it increases their performance (Hogendoorn et al., 2019). This study focuses on the output approach to determine how human capital outcomes along with financial capital boost the lending to microentrepreneurs by MFIs.

Lending is a process that is made up of many steps. The literature identifies four core steps taken by financial institutions in lending. They are: the loan application, borrower selection, loan documentation and disbursement of funds, loan monitoring and loan repayment (McNaughton, 1992). The selection appears to be the most important step for four reasons. First, it signals the beginning of the lending process and involves the first contact and knowledge about the potential borrower. Second, the success of the selection positively determines the success of further lending stages. In other words, the selection of a good borrower reduces credit risk and does not require active monitoring. Third, the selection of the borrower gives access to the loan contract and funding. Fourth, the selection enables the lender to analyze the creditworthiness of the potential borrower to determine whether he/she (or it) is qualified for credit. In this case, the financing of microentrepreneurs by MFIs means, in this study, the selection of microentrepreneurs for credit.

Stiglitz and Weiss (1981) show that the terms of loan contracts, specifically interest rate and collaterals influence the behaviour of both lender and borrower in the lending relationship. These authors indicate that lenders use interest rate and collaterals to ration credit to borrowers who are considered as risky in the context of asymmetric information. These two factors of lending use by Stiglitz and Weiss (1981) also affect the lending to microentrepreneurs by MFIs and at a very high level. This is due to the nature of microentrepreneurs and the level of asymmetric information generated by their lending. Thus the level of interest rate charged to microentrepreneurs by MFIs is used to discriminate good microentrepreneurs from bad ones. The model of Stiglitz and Weiss (1981) is more effective where the interest rate is variable and decided by both the lender and the borrower. This is not always the case in microfinance where the interest rate is either flat or decided by the monetary authorities or by the MFI alone. Thus, other mechanisms need to be used to make the financing of microentrepreneurs by MFIs more effective like relationship banking and human capital. The first advocates multiple interactions with the same customer over time and/or across products (Boot, 2000). Such approach of financing provides benefits to both lenders and borrowers (Diamond, 1984). It reduces the cost of screening and monitoring for the lender as well as the value of interest rate and collaterals to be paid by the borrower. This is because relationship banking builds specific and private relationships between the lender and the borrower and contributes to decrease significantly the level of the asymmetric information in lending. Furthermore, it increases confidence between the parties involved in the lending relationship. This type of approach of financing is good for the financing of microentrepreneurs. It enables to set long-term relationships necessary for sustainable financing of microentrepreneurs. But, this approach is limited because it does not value the competences acquired by microentrepreneurs to have access to the financing of microentrepreneurs. Such competences are related to human capital.

Many studies show that human capital like experience and training facilitate the access to credit to microentrepreneurs (Edgcomb, 2002). Besides, investment in human capital empowers microentrepreneurs and secures their long-term development and provides microentrepreneurs competences required to increase the growth of their microenterprises. Thus, by integrating competences with financial capital to finance microbusiness owners, MFIs develop a solid tool of financing enabling to secure the repayment of microcredit granted to microentrepreneurs useful to build up long-term financing relationships.

In the classical lending process, the creditworthiness of the borrower is evaluated using the five C's. These are: character, capacity, capital, collateral and conditions. Character refers to the borrower's behavior, honesty and reputation in their past financial relationships. Qualitatively and subjectively, it also involves an examination of the borrower's educational background and employment history and business references such as their experience and skills (Segal, 2019). In this case, character relates to the borrower's human capital and reputation which is acquired by the borrower over time in his business and employment interactions. This is the definition adopted in this work for human capital of microentrepreneurs. Capacity refers to the borrower's ability to repay the loan granted at the maturity. This is done by examining the historical income and cash flow statements of the borrower (Anthony, 2006) or their current number and amount of outstanding debts compared to their income from various sources (Segal, 2019). A borrower's capital demonstrates the financial power of the applicant that is his ownership position or investment in the business project being financed. Collateral refers to the assets pledged to secure the loan (Lawrence & Charles, 1995). Collateral is seen as a last resort source of repayment of the loan in the event of credit default. Conditions are linked to the economic and business climate of the borrower and his activities. They differ from one borrower to another based on their locations. The five C's model presented above is used in this work to understand the relationship between the financial and human capital of microentrepreneurs and financing by MFIs. Character relates to the human capital of microentrepreneurs while capacity, collateral, capital and conditions are associated with financial capital in this study.

Many empirical studies apply the five C's model to examine the financing of microentrepreneurs by MFIs. For instance, Moti et. al. (2012) examined the effectiveness of credit management systems on loan performance in the Microfinance Sector in Kenya. They used the five C's model to examine the credit appraisal of clients and its effectiveness on loan performance. Chi square was used to measure the relationship between credit appraisal and loan performance. That study identified a significant relationship between character, capacity and collateral and loan performance. However, the relationship between conditions and capital was not significant. In a study carried out by Wulandari et. al. (2017) on the access to finance from different finance providers by farmers in Indonesia using the five C's model, it was shown that MFIs use more character, capacity and capital than conditions and collateral to finance farmer microentrepreneurs. In Cameroon, a study conducted by Messomo (2013c) sought to determine the profile of beneficiary microentrepreneurs of microcredit of MFIs in Cameroon using three types of MFIs of Independent Cooperative MFIs, Affiliated Cooperatives and Corporation MFIs. The results of that study show that Independent cooperatives use financial power (capacity) to grant microcredit to microentrepreneurs while affiliated cooperatives focus on business turnover (capacity) to provide loans to microentrepreneurs. Corporation MFIs on the other hand use collateral to grant microcredit to microentrepreneurs.

It can be seen from these studies that there are 3 common variables used by MFIs to lend to microentrepreneurs. These include: capacity, collateral and character. The other variables are not significant. This study will adopt those variables to determine whether they have the same effects on MFIs' financing of microentrepreneurs in Cameroon as compared with past studies. Hence, the following hypothesis is formed:

H: Capacity, collateral and character may cause a significant increase in the lending to microentrepreneurs by MFIs in Cameroon contrary whereas conditions and capital do not.

4. Methodology

The methodology of this study is divided as follows: the paper will begin with a definition of variables, followed by an explanation of the method of data collection and the method of data analysis. These elements are presented below.

4.1. Definition of variables and method of data collection

Two types of MFIs were used in this study to collect data on the financing of Microentrepreneurs in Cameroon. They are: Cooperatives and Corporation MFIs. According to Regulation No. 01/17/CEMAC/UMAC/COBAC of 27 September 2017 relating to Conditions of Operating Microfinance Activities in the Economic and Monetary Community of Central Africa, Cooperative MFIs are MFIs that collect savings and give out credit to their members. They dominate Cameroon's microfinance sector. Corporation MFIs on the other hand are MFIs that collect savings from the general public and provide credit to the public as a whole. In 2018, there were 47 MFIs (MINFI, 2018) in Cameroon. This study uses two sets of variables: the dependent and the independent variables. The dependent variable for H is the MFIs' financing. Its value is determined by the average number of monthly requests for loans of microentrepreneurs which are accepted by MFIs.

The independent variables are: capacity, collateral, character, conditions and capital of microentrepreneurs. Capacity is measured by the percentage of the borrower's monthly debt compared to their expected monthly income. Collateral is the number times collateral values the loan amount demanded for borrowing by microentrepreneur as defined by the MFI. Character refers to the number of human capital limitations in business experience, skills, knowledge and reputation in the microentrepreneur's credit history. Conditions are the number of years requested by the microentrepreneur for the repayment of the loan based on the business sector of the microentrepreneur (Segal, 2019). Capital is measured by the percentage of equity of the microentrepreneur in the investment financed. The data on the dependent and independent variables was collected using a questionnaire targeting loan officers of 375 randomly selected MFIs located in three regions (Center, Littoral and North-West) with a high number of MFIs. Among the total questions administered, 325 were used for data analysis.

4.2. Method of Data Analysis

A multiple linear regression technique was used to analyze the data in this study. To validate the results, the coefficient of determination (R^2), the t-test and F-test were used. Those tests assess the significance of these models (F-test) and determine the significance of the independent variables' attributes that explain the variation of the dependent variable (t-test) and their explanatory capability (R^2). The significance of the models considered is appraised at 1%, 5% and 10%. The multiple linear regression equations individually test the two hypotheses based on the literature. The outcomes of these hypotheses were analyzed in one of two ways. Firstly, if the equation is significant, the signs of coefficients of the independent variables were evaluated to determine whether they have a positive or a negative relationship with the dependent variable. However, if the hypothesis is insignificant, it is rejected, and its alternative is accepted to derive the policy implications. The empirical model resulting from the data analysis of hypothesis H is:

$$\text{MFIsFinancing} = a_0 + a_1\text{Character} + a_2\text{Capacity} + a_3\text{Collateral} + a_4\text{Conditions} + a_5\text{Capital} + e$$

Where:

MFIsfinancing = MFIs's financing of microentrepreneurs; and
e =error term.

The reliability of the above model was analyzed using the Variance Inflation Factor (VIF). In this case, a VIF of less than 2.5 shows that our model is not exposed to collinearity between the variables.

5. Results

Two sets of results are analyzed in this study. They are: descriptive and regression results. Both explore the contribution of human and financial capital to the financing of the entrepreneurial process of microentrepreneurs by MFIs in Cameroon. Before the proper presentation of results, the VIF of the variables obtained from the data analyses are: MFIsfinancing= 2.010, Character =1.719, Capacity = 1.670, Collateral = 1.607, Conditions = 1.060 and Capital =1.030. Table 1 presents the descriptive results consisting of means, medians, standard deviations, minimum and maximum values. The relationships between these central tendencies are analyzed below.

Table 1: Descriptive Results

Items	MFIsfinancing	Character	Capacity	Collateral	Conditions	Capital
Mean	15.242	3.454	3.454	4.045	3.060	3.409
Median	15.000	4.000	4.000	4.000	3.000	3.000
Maximum	20.000	5.000	5.000	5.000	5.000	5.000
Minimum	9.000	1.000	1.000	1.000	1.000	1.000
Std. Dev.	2.327	1.303	1.394	1.182	1.330	1.080
Observations	325	325	325	325	325	325

Source: Field Study (2018)

Table 1 shows that, overall, MFIs agree to finance microentrepreneurs' an average of 15.242 times per month (MFIsFim belonging to H at Table 1). The outcome of the descriptive results of the independent variables in relation to this is different. It shows that character, capacity and capital contribute, on average, at least 3 times per months to the financing of microentrepreneurs in Cameroon, whilst collateral contribute at least 4 times per month on average. Furthermore, the descriptive results show that the standard deviations of the independent variables are almost identical, meaning that they have the same effect on the financing of microentrepreneurs by the MFIs in this study. These results are also assessed using regression analysis as shown in Table 2 below.

Table 2: MFIs' financing based on Human and Financial Capital of Microentrepreneurs

Dependent variable: : MFIs' financing to Microentrepreneurs				
Independent Variables	Coefficient	Std. Error	t-Statistic	Prob.
Character	0.600**	0.266	2.255	0.028
Capacity	1.007***	0.269	3.736	0.000
Collateral	-0.448	0.313	-1.434	0.157
Conditions	-0.556**	0.256	-2.170	0.034
Capital	0.973***	0.312	3.121	0.003
Constant	8.799***	1.804	5.986	0.000
R-squared	0.623			
Adjusted R-squared	0.566			
F-statistic	5.283			
Prob(F-statistic)	0.000			

Source: Field Study (2018)

*P < .10; **P < .05; ***P < .01

The results in Table 2 show that there is a significant multiple linear regression equation between MFIs' financing and Character, Capacity, Collateral, Conditions and Capital of Microentrepreneurs in Cameroon. The model is significant at 1% of the F-test. This implies that these factors of financial and human capital enable MFIs' financing of microbusinesses in Cameroon.

The factors that explain the significance of the equation according to the t-test are: Character, Capacity, Conditions and Capital. Character relates to human capital and the last three relate to financial capital. The variables examined in this study support the financing of microentrepreneurs by an adjusted R² of 56.6%. This shows that the MFIs studied in Cameroon tend to require a mix of capital from microentrepreneurs to provide finance. In relation to the hypothesis, these results do not support the expected outcome. This is because collateral does not have a significant influence as predicted by the hypothesis. In addition, Condition and Capital are significant for the financing of microentrepreneurs which is inconsistent with the prediction of the hypothesis. Hence, according to the coefficients on the significant predictors of human and financial capital of microentrepreneurs, Capital, Character and Capacity significantly increase the financing of microentrepreneurs whilst Conditions decrease the financing of microentrepreneurs by MFIs. This is explained in the section below.

6. Discussion

The results of this study show that MFIs use the character, capacity and capital of microentrepreneurs to significantly increase their financing whilst conditions are used to decrease their financing. Collateral is not significant for the financing of microentrepreneurs by MFIs. These results can be explained by the fact that MFIs rely on the purpose of the loan (that is, the performance of the business being financed) to determine whether the microentrepreneurs can repay their loans on time. In this case, they place greater emphasis on elements of character and capacity that enable the microentrepreneurs to generate sufficient income from their investments for the repayment of the loan. Capital becomes an incentive in this case because it shows the commitment of microentrepreneurs to succeed in their businesses to secure the MFIs' loan repayment. The inverse relationship between conditions of microentrepreneurs and MFIs' financing can be explained by a decrease in the stability of the business environment of microentrepreneurs which is very uncertain due to its informality. The non-significance of the collateral can be justified by the fact that MFIs try to avoid relying on it for the repayment of loans granted to microentrepreneurs.

The reliance on collateral has adverse effects for MFIs such as moral hazard of borrowers and high transaction costs in the case of default. These findings are in line with the studies of Moti et. al. (2012) and Wulandari et. al. (2017) that demonstrate that character and capacity contribute significantly to the financing of microentrepreneurs by MFIs. On the contrary, they differ from other studies which show that collateral is not significant for the financing of microentrepreneurs in Cameroon by MFIs as in the study of Moti et. al. (2012). The differences might be arise because the present study employs OLS regressions and collected its data from 325 MFIs while Moti et. al. (2012) used ordered logit regressions and their data were collected from only 14 MFIs.

7. Conclusion

Microentrepreneurs are often excluded from formal sources of financing because of the nature of the risk they face in their activities (Armendariz de Aghion & Morduch, 2010). The emergence of new sources of finance such as microfinance aims to reduce the exclusion of these entrepreneurs from access to regulated financial institutions. Microentrepreneurs have many forms of capital at their disposal: social, physical, financial and human. Each of them has an impact on the financing of microbusiness units. This study focuses on determining the factors of financial and human capital through character, capacity, collateral and conditions of microentrepreneurs that affect their financing by MFIs in Cameroon. To meet this objective, data from 325 MFIs was analyzed using descriptive statistics and multiple linear regression equations.

The results show that character, capacity and capital of microentrepreneurs increases their financing by MFIs whilst their conditions decrease it. This type of lending is associated with informal microentrepreneurs. The findings contradict, in general, the theory that collateral is a key factor in lending (Stiglitz & Weiss, 1981). Based on these results, it is recommended that MFIs should lend to microentrepreneurs when their

financing decision and conditions have a positive relationship. It is also recommended that MFIs should use collateral in lending to microentrepreneurs both as a last resort and an incentive to ensure repayment of the loans. This will contribute to the development of sustainable financial relationships with these entrepreneurs. This study does not consider the legal status of the MFIs studied. Hence, further studies should be directed towards this approach in the context of Cameroon.

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