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## FEATURE ARTICLES

MICROBANKING BULLETIN, ISSUE 15, AUTUMN 2007

### Introduction

Small and medium enterprises (SMEs) are major contributors to GDP and employment in many parts of the world. Empirical studies note that SMEs and informal enterprises account for over 60 percent of GDP and over 70 percent of total employment in low-income countries.<sup>1</sup> The financial needs of SMEs are underserved and continue to be a constraint to their growth. Banks which have traditionally served the corporate and large business segment of the market view SMEs as a challenge due to information asymmetry, lack of collateral and higher costs to serve smaller transactions. However, as corporate banking margins continue to shrink and as increasing fiscal restraint lowers yields on government borrowing, banks have begun to assess the opportunities that SMEs offer in growth and portfolio diversification.

### Benchmarking SME Banking Practices – Emerging Lessons

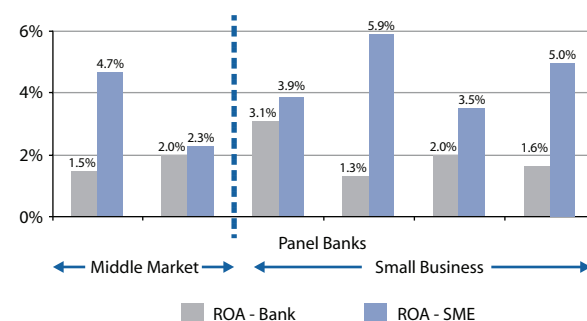
Benchmarking SME banking practices is an IFC initiative which aims to identify key success factors and highlight links between performance and business models, processes and tools adopted by participating banks. In its current phase, the project has focused on qualitative and quantitative benchmarking studies in five banks in OECD countries and six emerging market banks (banks located in the US, EU, Latin America, Asia, and Australia). In a second phase, the core set of benchmarks built will attract interest from additional emerging financial institutions interested in participating in the exercise.

<sup>1</sup> OECD. 2004. "Promoting SMEs for Development." Paper for the second Organization for Economic Cooperation and Development Conference of Ministers Responsible for Small and Medium-Sized Enterprises, "Promoting Entrepreneurship and Innovative SMEs in a Global Economy: Towards a More Responsible and Inclusive Globalization," Istanbul, June 3–5.

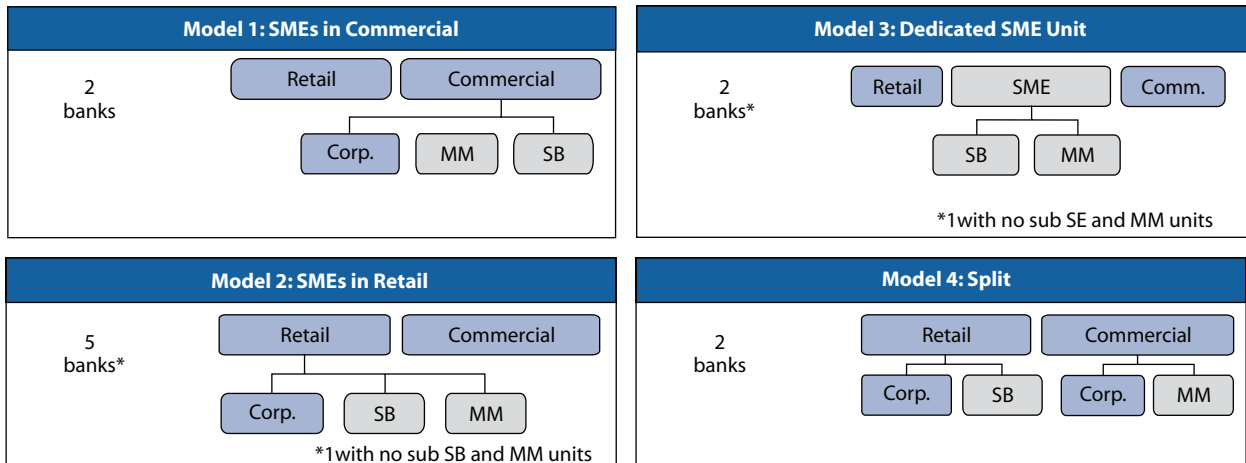
The surveyed banks highlighted fierce competition in the corporate and retail segments as a key factor to entering the SME market. The SME market is viewed as an untapped segment with margins for growth given shrinking margins in the corporate sector and increased competition in retail banking. In addition, SME banking is noted as a high margin business with a strong potential for profitability and important cross-selling and portfolio diversification opportunities. The banks surveyed for this project reveal that SME banking is a profitable business despite challenges, such as buy-in at both management and operational staff level and the need to adapt products and develop IT tools. As highlighted in Chart 1, SME portfolios generate higher return on assets (ROA) than total bank portfolios. Four out of five banks noted higher portfolio and income growth for the SME segment than the total bank.

The banks' definitions of SMEs vary considerably in terms of criteria. Most banks noted that loan size is not an adequate criterion and have evolved to more sophisticated criterion based on thorough analysis of SME clients. Nine of the eleven surveyed banks use a client intrinsic characteristic as their primary criteria. The banks indicated that they define SMEs using data easily collected by front office staff and based on: (1) whether they are asset customers or liability only customers (2) risk/return profiles which enable the bank to determine potential revenue, adjust cost to serve and maximize profit.

**Chart 1. ROA SME versus Total Bank**



**Chart 2. SME Banking — Four Business Models**



Unsecured lending in the small business segment is higher overall in the banks in OECD countries compared to emerging market banks. Unsecured lending is 64 percent in the OECD banks analyzed, compared to 36 percent on average in their emerging market counterparts. This is likely due to the availability of better information on clients and credit scoring tools in OECD countries. The banks analyzed in emerging markets view the ability to provide unsecured loans as the next opportunity to expand into this market. Banks recognize that the market belongs to players that are able to decrease information asymmetry through strong internal databases and credit bureaus.

The banks have recently redesigned their organizational structure to support a strategy that focuses on addressing the SME segment. About half of the banks have organizational set ups which are less than two years old (while the SME models for 10 of the 11 banks are less than five years old) and only one surveyed bank sees its model as fully mature. Most of the surveyed banks separate small businesses from middle market clients and have shifted their organizational set-up from a geographic or functional focus to a business line focus. Four main business models have been identified and are highlighted in Chart 2. The chart reveals that five of the eleven surveyed banks use a model in which SME clients are part of the retail business line. Although the business models vary, the analysis did not reveal a correlation between model used and performance.

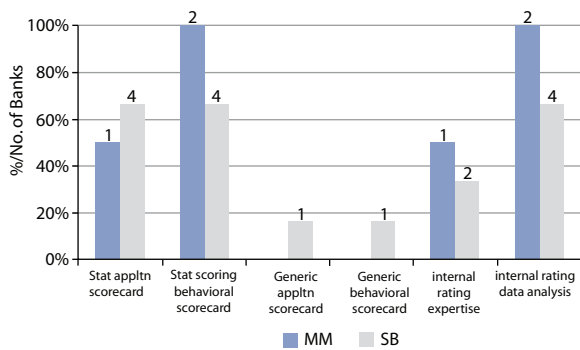
The analysis of the banks reveals a strong emphasis on specialization as all the banks have dedicated mid-market staff and 90 percent have dedicated small business staff, from sales to back-office to

management. Banks noted that in the absence of distinct units, staff tend to remain focused on retail and corporate clients which are respectively easier and more rewarding to serve. Commitment at the highest level of the bank and focus at the operational level have been crucial to the success of these banks in the SME market.

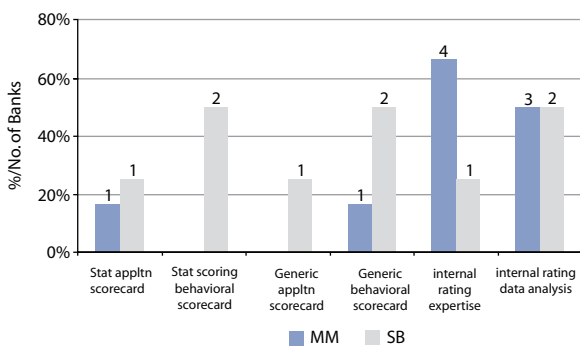
The banks have shifted their focus to SME banking from a narrower SME lending approach. Banks use credit to attract and retain clients but rely on substantial revenue generation from value-added products. Cross-selling is a major profit driver. The banks in the sample reveal that less than 40 percent of revenues are generated by credit products. This is due to the fact that not all SMEs need to borrow but they all need core banking products such as deposit and account management products to run their operations. A standardized product offering is seen across the participating banks for small businesses, with a more tailored offering for middle market clients. As banks gain experience they develop more sophisticated standardized products for smaller businesses.

Independent credit underwriting is the rule for the surveyed banks. Rather than using a standardized model, institutions aim to quantify risks and align processes with their risk appetite. The model is largely determined by the bank's history, target market and incentives for branch-based officers. The vast majority of the banks segregate sales and risks whereby relationship managers do not play a role in credit approval. The three common models noted are: (1) a centralized credit underwriting unit reporting directly to a global credit department with no links to business lines; (2) a decentralized credit underwriting team reporting to a global credit department with

**Chart 3. Uses of Scoring versus Rating - OECD Banks**



**Chart 4. Uses of Scoring vs. Rating - EM Banks**



a secondary reporting line to the branch manager and (3) use of automated scoring tools which are developed and validated with the independent or centralized credit team. It should be noted that centralized credit risk management does not prevent local underwriting, as six out of ten surveyed banks have the ability to provide decentralized decisions through the use of scoring tools for the small business segment. The use of credit scoring is quite developed even in emerging market banks.

The banks have aimed for a proactive but cost efficient sales and customer services strategy. A proactive sales strategy relies on a prospects database for leads and on dedicated sales staff. Ten of the eleven banks analyzed have a central leads origination team that manages a prospects database and allocates leads to business developers. The prospects database is generally purchased or built from multiple external sources, including credit-bureau information when available and affordable. Banks often employ the Hunters and Farmers approach to optimize client

acquisition and activation. This approach consists of separating the sales and relationship management functions, whereby the “hunters” perform sales and bring in new business and “farmers” focus solely on cross-selling and client support. As relationship management for small businesses can be costly, banks have had to innovate low cost delivery channels such as the use of call centers. The banks recognize that a multi-channel approach which consists of a wide branch network and low cost delivery channels is key to SME banking. For example, eight of the eleven banks have inbound and outbound call-centers for SMEs and three banks perform more than 90 percent of their small business transactions through such low-cost delivery channels like the internet.

The banks recognize the need for robust data and performance measurement as profitability analysis is essential for cost containment. To analyze data banks need strong analytic teams dedicated to the SME segments. Nine of the surveyed banks have the capability to calculate P&L at the business unit level in the small business sector and five in the medium market segment. However, only one bank out of seven in the medium segment can provide breakdowns of P&L at the branch and product levels. Risk analytics continues to be a challenge.

### Next Steps

This benchmarking exercise of SME banking practices is the first step towards the roll out of a more comprehensive exercise aimed at benchmarking emerging market banks practices in SME Banking. The tool will be extended to most of IFC’s client banks, on a voluntary and demand-driven basis, through an off-site instrument and/or through IFC TA Facilities, in an effort to continue benchmarking best practices and promoting SME banking in emerging markets. The initial lessons such as differentiating small and medium banking business, SME banking business models and the client’s need for non-lending products are useful lessons already for IFC’s technical assistance operations. In addition, the benchmarking work will be complemented with IFC’s SME banking CHECK methodology. CHECK consists of a diagnostic toolkit which is used to assess SME banking operations of IFC’s clients before designing a tailored action plan and technical assistance program to strengthen operations.