GrowthCap
Building SME-focused capacity

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PROJECT BRIEFING NOTE 2

STATE OF PRACTICE OF SME BANKING

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INTRODUCTION

Small and Medium Enterprises (SMEs) are a vital part of the economy in both developed and developing countries alike. Small businesses are able to recognise and capitalise on market opportunities, spurring socioeconomic development. They are a primary source of job creation and GDP growth, and typically play a big part in any economy, growing at a faster rate than economies as a whole[1].

In Kenya, they are responsible for approximately 80% of employment and contribute approximately 20% to GDP[2]. Despite SMEs' significant contribution to economic diversification and social stability, they continue to face major constraints to growth. Unlike large corporates, SMEs are disadvantaged in being able to access finance, because formal financial institutions have traditionally perceived them as high risk and costly to serve.

The financial sector's attitude towards SMEs is starting to change, in large part because SMEs form such a significant part of the market in most countries, including Kenya. Bankers worldwide recognise that successfully serving the SME market requires new approaches and products, not just variations on corporate and retail banking. Perhaps the most significant lesson being learned is that the SME market can be highly attractive and profitable, and indeed will be for those banks that wholeheartedly embrace SME banking, rather than regarding it as marginal or second best.

This note summarises the changes in the field and the state of current practice and best practice in SME banking. This is not static area of activity. There is considerable innovation and experimentation going

1 Per McKinsey & Company, Micro-, small, and medium-sized enterprises in emerging markets; how banks can grasp a $350 billion opportunity, 2012. MSME banking revenues are growing at 20% per annum from a $150 billion base. In Sub-Saharan Africa the study shows a $5 billion base as of 2010, projected to be $12 billion in 2015.

2 African Economic Outlook, Kenya 2012, AfDB, OECD, UNDP, and UNECA.

About GrowthCap

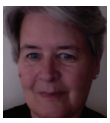
Over the past few years FSDK has been at the forefront of SME banking development through conducting market assessments and studies in areas such as trade finance and SME equity funds, as well as supporting development of the credit reference bureau. Through its partnerships with its Action Research Partners (ARPs), FSDK's GrowthCap initiative is supporting adoption of SME best practices by individual financial service providers.

This paper is part of a series of resources that are being developed out of work with the ARPs. The Notes provide information on best practices and are intended for use by financial service providers and those supporting such institutions which are entering the SME market.

Abstract

This briefing note describes the emergence of SME banking as a separate line of business, and informs on the distinctive characteristics of SME banking compared to corporate and retail banking. It also describes SME banking best practices in banks around the world, and in Kenya in particular.

About the authors



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on, with successful approaches being widely imitated and further developed.

It is also important to understand that the capacity to deliver SME banking services is not confined only to banks and other financial service providers such as microfinance institutions (MFIs), cooperatives, chamas, and SACCOs. For the economy as a whole SME banking development is catalysed by meso- and macro-level environmental support which facilitate both SME growth and financial service delivery to SMEs, including a favourable legal and regulatory environment (e.g. tax and licensing requirements at the macro level), as well as enabling institutions and policies such as credit bureaus, movable collateral registries, and smooth contract enforcement mechanisms at the intermediate or meso environmental level. These services facilitate the delivery of cost-effective SME banking services, making the SME sector more attractive for financial institutions.

> "Perhaps the most significant lesson being learned is that the SME market can be highly attractive and profitable

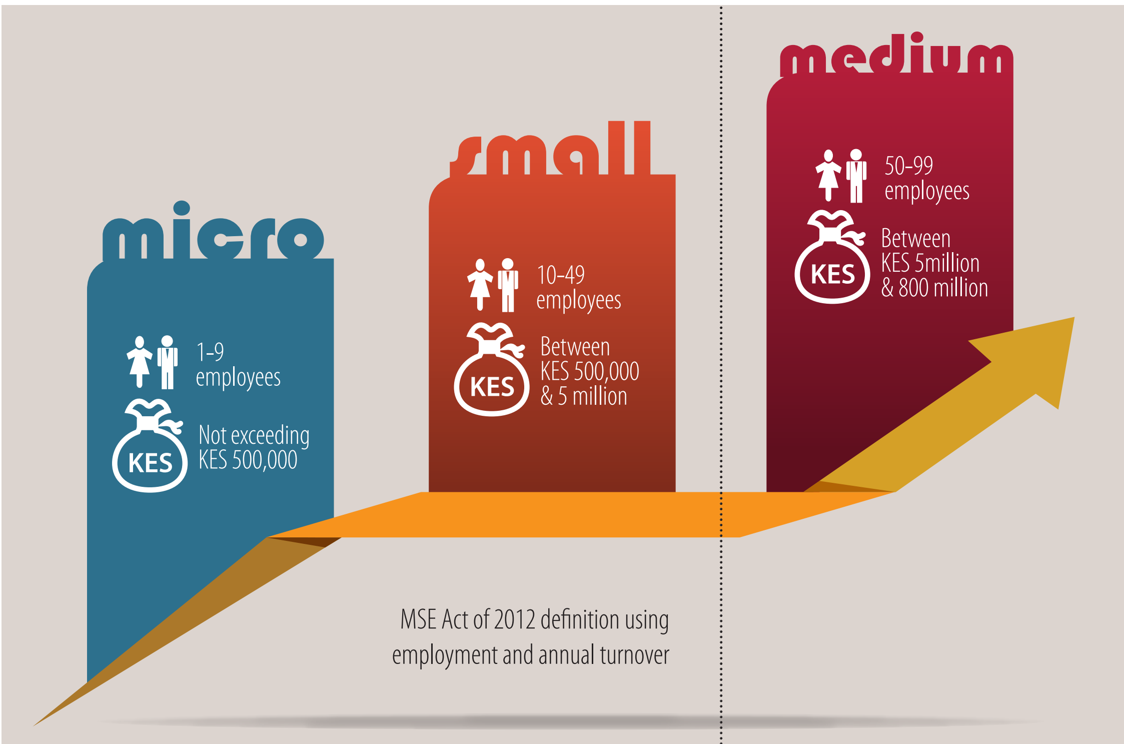
GrowthCap is working on macro- and meso-level interventions to enhance the SME banking segment, and is also working with individual financial institutions best practices, specifically selecting choices that are relevant for and can best be executed by those institutions for their target SME clients.

UNDERSTANDING SMES AND THEIR NEEDS

Before discussing SME banking practice it is important to understand what an SME is, what are its characteristics and constraints, and what its needs are, so that the relevance of SME banking practices can be understood in the context of addressing needs and overcoming barriers.

Definitions of small and medium sized enterprises vary widely from country to country. Financial institutions and even donor programmes within the country will also have their own definitions to suit their needs. Preliminary findings of the 2014 survey conducted by FSD of the supply side of SME finance in Kenya revealed that financial institutions across the board define businesses by the loan size, with some also using annual turnover; very few banks are able to provide classification based on the number of employees.

In Kenya the MSE Act of 2012 uses employment and annual turnover to define micro and small enterprises as shown in the diagram below.



This act does not define medium enterprises, which might be characterised as 50 – 99 employees turnover between KES 5 million and 800 million.

However, the definition and understanding of medium enterprises is less important than that of the small and very small enterprises, because the larger the business becomes the more access to finance it has.

Another term that is often used interchangeably with SME is MSME, or micro, small, and medium size enterprises. While not so defined by the government, there is understanding among government officials and the financial sector, particularly microfinance institutions, that there are two types of micro enterprises. The first of these are lifestyle micro enterprises, small scale traders and operators whose financial needs are met, if at all, by group loans, group savings schemes, and moneylenders. The second category of micro businesses, known as very small enterprises (VSEs), are included with SMEs when referring to MSMEs. These are those small businesses that are growing and with some support are expected to become SMEs.

This Note, like the GrowthCap Project, focuses on access to finance for SMEs. Lifestyle micro enterprises (group lending types) are not discussed as such, as well as funds for start ups targeting the poor or disadvantaged persons, e.g. women and youth small scale funds, as the scale of needs and constraints is different.

While definitions of this type are useful for understanding government interest and support to smaller businesses, financial institutions will create their own definitions of SMEs, which typically reflect their market interest, and will tend not be as broad as the definitions given above. A recent study showed that banks in eastern Africa use loan size, number of staff, turnover, and capital employed to define what they consider to be small and medium enterprises[3]. A GrowthFin study on trade finance[4] included what it described as a common understanding of an SME as having a:

- Yearly turnover ranging from KES 5-20 million to KES 100-150 million;
- Maximum number of employees 100-150;
- Financing needs do not exceed KES 50 million.

3 Calice, Pietro, Victor M. Chando, and Sofiane Sekioua, Bank Financing to Small and Medium Enterprises in East Africa: Findings of a Survey in Kenya, Tanzania, Uganda and Zambia, Working Paper Series, African Development Bank, March 2012.

4 GFA Consulting Group, SME Trade Finance: Review Of Facilities Available In Kenya, for GrowthFin FSDK, July 2008.

Overall this definition is at the higher end of SME as per the government definition. On the other hand, very small businesses will be the target of some financial institutions, particularly those banks that up-scaled from MFI status, and the credit product that will be offered to them will be an individual loan rather than a group loan.

Other characteristics of SMEs that have been recognised in the market include the following:

- Businesses have enough records to create income and expense statements; business and personal records are separate or more separable.
- While small businesses are managed by the owner, the business has a life separate from the owner, and business operations are not wholly dependent upon the entrepreneur's time.
- Arm's length hiring starts occurring, businesses create employment for more than family members.
- Businesses may be registered or licensed[5].
- In addition to size, medium-sized businesses are often distinguished from small businesses by organisational structure, specifically delegation of authority to persons other than the owner. The first manager of the company

While small businesses are managed by the owner, the business has a life separate from the owner, and business operations are not wholly dependent upon the entrepreneur's time

5 In some cases banks consider registration or licensing to be a requirement for service by the SME department rather than service by a branch as a retail client. However, SMEs often remain unregistered to avoid taxation. Banks generally concede that identifying businesses that are included in the retail portfolio is a significant problem.

other than the owner is often in charge of financial recordkeeping.

- Small businesses are owned by an individual, a family, or by two partners; very rarely is ownership more widespread.
- While these businesses may be very profitable for their owners, SMEs typically will not grow very large. This partly reflects the limited amounts of capital that most owners have available for the business, but also reflects a desire of the owner to work for himself/herself, and not share ownership.
- Some SMEs are start-ups but it is a mistake to think of micro to small to medium as a progression to be expected. Most small businesses have been around for a while, and remain small.
- SMEs seeking funding from the capital markets are rare both because their lines of business seldom are lucrative enough to warrant interest from venture capitalists, and because owners want to remain in control. It is reasonable to define SMEs by the negative corollary that they do NOT have access to capital markets[6].

From the banks' perspective, this is a large group of customers that do need both working capital and term finance, and for whom banks are the primary source of external funding. How credit is being extended and other services being provided to SMEs, has been changing for the better. Perhaps more important, banks are seeing SMEs as a new line of business, that is best served through new methods and approaches. SMEs are not small corporates, and smart banks are seeing this.

6 The Growth Enterprise Market Segment (GEMS) program of the Nairobi Stock Exchange is working to list some of the largest SMEs. The number of these firms, however, absolutely would be very small, and these firms are large enough that they are unlikely to encounter difficulty in securing bank financing.

SME CONSTRAINTS AND NEEDS

There are typical constraints to SME access to finance, that banks need to address if they are to successfully serve SMEs. Two constraints that occur most often are:

- **Lack of quality financial statements** – Since smaller businesses are usually managed by the owner, financial statements are usually seen as unnecessary as all the pertinent information is contained in his or her head. Statements are not needed for business analysis or forward planning because the owner does all of the analysis and planning. Other reasons for not having quality financial statements are the expense of preparation, as well as tax avoidance. This is universally considered by the Kenyan banks to be a problem in serving SMEs[7].
- **Lack of traditional collateral** – SMEs have limited capital to start with, and resources are typically tied up in business assets – inventory, accounts receivable, business equipment. The business owner often will direct profits of the business into acquisition of land and buildings (personally titled) but if the business is growing, the need for working capital may restrict outlays of these types.

Other constraints in dealing with SMEs include the owners' lack of management skills, the scale of business operations, and literacy levels.

African Development Bank studies[8] have shown that East African banks do look for collateral on SME loans both because they consider the loans harder to evaluate and because the businesses are perceived as more informal. While a bank may take a conservative stance that it only will lend to businesses with quality financial statements that can pledge land and buildings, it will cut itself off from the great majority of SMEs and will miss the opportunity to develop what can be a lucrative line of business. Clearly SME banking lines of business are growing, and many of the banks in the region note that they are doing so to meet competitor changes, as well as have a first mover advantage.

7 Calice et al 2012
8 Ibid

One other factor that must be acknowledged as limiting expansion of SME banking is macroeconomic conditions, which is cited by 70% of Kenyan banks as a 'very significant obstacle" to expanding SME lending, vs. "SME-specific" factors cited by 54% of banks[9]. It is reasonable to conclude that this factor accounts for an overall conservative approach to credit by the banks.

Access to finance for SMEs is stronger in Kenya than elsewhere in Sub-Saharan Africa, as IFC Enterprise Survey studies indicate. Access to finance is considered the greatest problem among businesses in the region, but Kenya only ranks this factor third behind *Practices of Competitors in the Informal Sector and Corruption among small businesses* (the ranking of access to finance by medium-sized businesses is even lower). Internal finance is still the most important source of funding for Kenyan businesses (60%) but bank finance, at 24%, is a significant source (vs. 78% and 10% respectively for the region)[10]. Virtually all businesses in Kenya have either a current or savings account.

It is acknowledged worldwide that SMEs are looking for three things from their banks:

9 Berg, Gunhild, and Michael Fuchs, Bank Financing of SMEs in Five Sub-Saharan African Countries: The Role of Competition, Innovation, and the Government, Policy Research Working Paper 6563, The World Bank, August 2013.

10 A World Bank Investment Client Survey 2002-2003, cited in SBA Consulting in Collaboration with Simba & Simba Advocates, SME Risk Capital Funds – Constraints to Kenya Institutional Investors, GrowthCap FSDK, July 2008, indicates that 50% of SME financing comes from self, family, and friends, and that a total of 38% is from bank lines of credit and term loans.

- Know me and understand me
- Fulfill my needs
- Provide fast answers and action

A bank that wants to be successful in SME banking will understand that the bank's interests coincide with the SME customer desires – knowing and understanding the customer is key to credit underwriting and risk management. Fulfilling SME's needs benefits the bank as multiple products and services can be provided, particularly as a desirable "one stop shop" and creating a fast turnaround time will also control costs and be cost-effective for the bank.

SME BANKING

SME Banking is a new and growing line of business for many financial institutions in the world, particularly in emerging markets. The increasing attention paid to SMEs as a customer group reflects a host of economic imperatives as noted earlier but also a number of commercial realties for financial providers, especially banks:

- The traditional bank credit customer is typically a corporate business. However, there are only a limited number of large corporates, particularly in emerging markets, hence they present a relatively small customer pool.

> "While SME banking may still be perceived as risky, a World Bank study has found that 20.5% of aggregate bank net income comes from SMEs

- In countries with growing capital markets corporates have been increasingly able to access cheaper funds directly by issuing bonds and commercial paper and in doing so are bypassing bank sources.
- Corporate businesses tend to bank with the largest banks in any country, and in emerging markets they will often be served by international banks. The market for serving these clients is highly competitive, so margins are small.

The potential for new bank revenue from SMEs is attractive because the category is large, yet lots of businesses are underserved or even unserved. SMEs also offer diversification of risk for banks from corporate and retail clients. In some markets, although not Kenya, banks serve SMEs as a part of social responsibility, either voluntarily or under government requirements.

The Kenyan market has already benefited from relatively strong competition among banks to serve SMEs, as well as strong MFI competitors that have become commercial banks with the intention of serving an SME target market. While SME banking may still be perceived as risky, a World Bank study has found that while 17.4% of aggregate Kenyan bank loan portfolios are in loans to SMEs, in fact 20.5% of aggregate bank net income is attributed to this segment.[11]

PROFITABILITY IN SME BANKING

SME banking can be a profitable line of business for a bank, but too frequently banks do not recognise that the revenue and cost structures of corporate and SME banking must be different. The formula for profit in banking is simple, and amounts to creation of a profitable income statement:

Revenue = Interest income from loans, fees from services. Interest income depends on the number of loans and the size of loans, in addition to the interest rate. Fee income depends on the number of transactions, and the size of the fee.

Expenses =

- **Cost of funds:** Banks do not lend their own capital, but fund loans either from deposits or from loans to the financial institution. Both of these have costs, including interest and reserves.
- **Operating costs:** These are the costs of bank operations other than cost of funds, and include salaries, occupancy, and IT/MIS.
- **Loan losses:** Not all loans are repaid, and an important cost for the bank to control is loan losses. This credit quality is typically managed through a strong underwriting procedure coupled with monitoring and good loan collection procedures.

Profit = Revenue – Expenses

The challenges in serving SMEs become more apparent on reviewing these basic equations:

- Loan sizes will be smaller than corporate loans, so the number of loans, and the interest rate, must be greater.
- Cost of funds is a neutral factor, but can be affected by the ability to source low-cost deposits from the SME customers themselves, and from businesses and individuals – owner, owner's family, employees – associated with the business.
- Operating costs must be held in check, and more efficient ways of dealing with customers are needed. This is the key area where SME banking innovation has been important.
- Loan losses and risk management will be important, and good approaches call for a turnaround in traditional thinking.

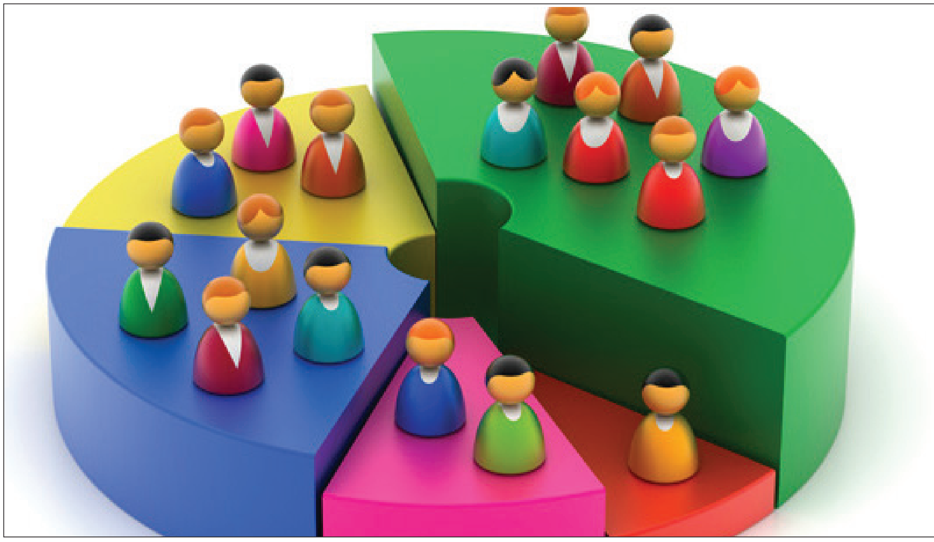
The construction of a profit and loss statement can be central to understanding how to be successful in SME banking. In a word, the bank needs to keep control of and develop techniques for handling a big volume of small loans, and will also benefit from cross-selling more services to the same clients.

Doing business as usual, for example with extensive analysis and time taken to decide upon a loan request, is not going to be profitable, thus bank approaches have to change.

SUPPORTING SUCCESSFUL SME BANKING PRACTICE

Banks that are successful in the field of SME financing are those who recognise that SMEs are their own customer category and the behaviour of these businesses is closer to that of retail banking than to corporate banking. Over time there have been several major trends or findings in serving SMEs, and these are discussed below.

11 Berg, Gunhild, and Michael Fuchs 2013.



Typical variables used in segmentation

- Loan size
- Business sales or asset size
- Incorporated or registered
- Industry sector or sub sector
- Business age/growth stage
- Profitability to the bank

UNDERSTANDING THE CLIENT GROUP AND SEGMENTATION

Segmentation is increasingly employed and becoming more sophisticated as banks are recognising that SMEs are not a homogenous group. SMEs are too broad a category to be served by singular standardised products. There is a need to recognise different sizes and characteristics of the businesses and business owners counted under the umbrella of SMEs, and these different subgroups or segments can have varying needs. Typical variables used in segmentation, either singly or collectively include the following:

- Loan size – may be considered the "default" segmentation of the customer base
- Business sales or asset size
- Incorporated or registered – depending on the market unincorporated businesses of SME size may not be included as SMEs (but are handled as retail or high net worth customers), often because the bank is not able to identify them as SMEs
- Industry or sector; subsector
- Geographical
- Business age/growth stage (many lenders exclude startups from credit)
- Profitability to the bank – not common because of information systems limitations, but regarded as desirable

Segmentation is used for market research and market target decisions, also for product development and product bundling decisions.

One common industry trend is to handle small and medium-sized businesses as separate segments. Research indicates that small businesses typically want a lower-priced product and will accept standardised features, whereas medium-sized businesses want more product flexibility and are willing to pay for it. Availability of quality financial statements may also spell the difference, and loan requests and terms may be more complex.

Banks that choose to segment by industry will be carving out particular services for their target segments, and a value chain approach, especially tied to the bank's corporate customers, is common. The bank may offer invoice discounting for accounts receivable resulting from sales to corporate customers, well-known large businesses in the market (whether or not they also maintain a relationship with the bank), also government and parastatals.

STAFF DEVELOPMENT AND BANK ORGANISATION

In the past relationship managers (RMs) were assigned to SME department tasked with developing SME loans as a training ground for corporate lending (or a dumping ground for unsuccessful corporate RMs) but banks are starting to recognise the different skills set needed for SME banking. Since credit decisions are typically made centrally and by a credit analyst[12],

12 Per the AfDB study, credit decisions are made centrally by a credit analyst for 88% of the East African banks surveyed; 81% of these say that the credit decision is separate from sales.

A problem that plagues SMEs is the turnover in staff within the banks – managers leave or are promoted, and the SME has to take the time to educate a new bank person about their business

the SME outreach staff has a sales job much more so than a credit job, and does not need the in-depth analytical skills traditionally associated with a corporate loan officer. Incentive performance programmes vs. year-end bonuses based on achievements of targets are also becoming increasingly common, so that RMs will be compensated directly for performance, like salesmen. In some cases banks are totally separating sales from service, using a hunter (sales) and farmer (maintain relationship, cross-sell other products) approach.

A problem that has plagued SMEs has been turnover in staff within the banks – RMs leave or are promoted, and the SME has to take the time to educate a new bank person. Banks are increasingly dealing with this problem by creating relationship management teams to serve clients, so that there are contact backups. Furthermore often the team leader will not have his or her own portfolio, but is more responsible for coaching and planning, calling and outreach. This structure also benefits the bank because customers are less likely to leave and follow "their" banker to a new bank, a particular problem with relationship-based credit.

Training and staff development is an area that is getting increasing attention from best practice SME banks, and tends to be a weak area for Kenyan banks. RMs need sales skills and enough credit skills to be able to do a quick assessment of loan needs in order to explain the use of funds and source of repayment. Interview skills are important, as is business and management knowledge, to understand clients' business operations. Banks are increasingly recognising that SMEs do rely on their RMs as an informal adviser and need to be training staff to properly handle this role. On the whole banking staff members are being newly hired, often out of university, rather than being transferred from other departments, and will be developed within the bank, using both classroom programmes and on-the-job training. Recruiters are looking for "people skills", with the understanding that credit and business skills, as well as product knowledge, can be acquired through training.

There is no standard for where the SME portfolio should be housed within a bank, but the trend is to either create SME banking as its own department or to keep it in the retail division. In the corporate division a "bigger is better" mentality usually prevails and is hard to overcome, thus SME banking is only regarded as second-best. Historically branch managers have been a part of the lending chain, but as credit evaluation has been simplified they are usually not part of the process anymore, even if SME bankers are housed in their branch.[13] Many banks opt to create SME branches, special branches that serve SME customers and also consolidate SME RMs in the same office, thereby facilitating on the job training and development.

SME BANKING VS. SME LENDING

A major shift in evaluating the potential of the SME market is to shift the customer cultivation approach from only promoting credit to seeking to capture sales of all products. The benefits of this approach are largely obvious:

- SMEs need more banking services than just credit (and some only need non-credit services) and prefer a one-stop shop – from the bank's perspective it is seeking to capture a bigger share of wallet.
- The more products that are provided by a single bank the less likely a customer is to leave – this is particularly true of "sticky" products like the lead current account and payroll services.
- The lead bank (bank with the greatest number/volume of services provided to an SME customer) tends to have the most profitable relationship, the least attrition, and the lowest level of NPL.

This is the approach being taken by leading western banks, which often lead with non-credit products, primarily because they are seeking to capture SME business start-ups which would not yet qualify for credit, in markets that are fully banked.

13 Not surprisingly effective change management is a critical part of acceptance of SME banking.

In emerging markets, however, one study of leading SME banks[14] indicates that profits are largely from credit rather than from cross-sales, which contradicts the banking-lending argument presented above. Three explanations present themselves:

- Credit is a hurdle product for emerging market banks – SMEs may be unbanked before getting credit, and will make their banking choice solely on credit terms offered. In some markets credit is so crucial that other services are substantially giveaways.
- Cross-sales are enabled by good information systems. Financial institutions may not have comprehensive Customer Relationship Management (CRM) systems that allow tracking clients and associated companies and individuals (owner, owner's family) to identify target clients.
- Incentive plans and job targets often only quantify lending volume and lending quality goals, thus RMs have no reason to pursue cross-sales.

As IT/MIS systems are getting better and CRM systems are being installed, SME banking is becoming better understood and the "lending only" approach is going away, but this is a gradual process.

Kenya is an interesting case re non-credit financial services because of its worldwide leadership in mobile telephone money transfer services with the introduction of the M-pesa and Zap services by mobile telephone companies, Safaricom and Airtel respectively. With over 6.1 million subscribers, the M-pesa is becoming an important financial transaction tool for SMEs, with the unbanked even turning it into a banking institution. Banks are integrating mobile money in order to attract the small entrepreneurs, who require financial products including loans. For instance, CBA Bank and Safaricom have developed M-shwari, which allows for borrowing small amounts through the phone; Kenya Commercial Bank and Family Bank also have mobile banking products. NIC and Standard Chartered are offering internet banking as a substitute for time-consuming branch visits.

CHANGES IN LOAN UNDERWRITING PROCEDURES

The initial approach into SME lending by many banks was to start with the corporate credit policy and procedure, and adjust it for a smaller sized business, which effectively amounted only to lowering the loan amounts and approval limits. SMEs were required to submit full financial statements, which were rigorously analysed using ratio evaluation techniques. Loan requests were then submitted to one or more credit committees for approval. The faults in this approach were numerous:

- While "acceptable" financial statements were submitted as required by the bank, the quality was poor – extensive analysis was not valid because the underlying numbers were not reliable. Furthermore, most SMEs that do not have financial statements will buy them from an accountant for a small fee and submit to the bank.
- A full write-up and committee presentation involved multiple people, hence was expensive in terms of personnel hours, therefore operating costs. Further, the committee members and management supervisors were not contributing any new analysis or insight to the process.
- Loan use and sources of repayment were simple and standardised, did not justify an elaborate write-up.
- The process was time-consuming, and;
- Since the loans were relatively small they did not generate enough income to justify the expense.

While a full analysis of larger SME loans is still performed, quite appropriately, by best practice banks, overall the lending process has been simplified for SME loans, and is similar to retail credit application approvals. Best practice banks are acknowledging that they are not going to get good financial statements; therefore they have adopted practices to take financial information on sales, expenditures, and cash flow, and will use this to gauge debt coverage – information is often taken from reviews of deposit account activity.

Some lending is relationship-based, relying on experience with the customer and references from suppliers and buyers; lending may also be asset-based and look to the conversion of an asset (inventory or accounts receivable) to cash, typically relying on assignment of a sales contract and proceeds, as is done in invoice discounting. Asset-based lending of this type also shows the innovation occurring in collateralising loans, moving away from requirements that loans be secured with land and buildings, and looking at a broader range of assets.[15] Some best practice banks (although not in Kenya) are simply

14 Kellogg, Clifton G., Phil Beavers, Aurica Balmus, and Anna Fogel, Success drivers of small business banks in developing economies: Four core studies compared with IFC's SME banking value chain, commissioned by CapitalPlus Exchange in collaboration with Shorebank International, Practical Action Publishing, 2011.

15 Kenya does have a movable collateral registry that is regarded as outdated and inefficient. The registry is currently undergoing an overhaul in order to make it viable and effective for SME lending. This will broaden the range of assets that can be used to secure loans, because bankers will be able to collect on security if necessary.

lending only on an unsecured basis, as they find that resources devoted to documentation and filing of security positions and later collections is not cost-effective, and also are finding that predictive information from credit bureaus and from their own files is highly accurate.

An important innovation in SME credit approvals has been the use of credit scoring. In some economies credit scorecards have been developed based on statistical information, particularly drawing on credit bureau sources. In emerging economies, including in Kenya, the banks have developed their own "expert models" based on account officer judgment. These are then tweaked over time as more experience is gained.

Scorecards are rarely used for automatic approvals, but are part of streamlining an approval process. Credit scoring may result in a lower non-performing loan (NPL) ratio, but the main benefits are consistency in process across credit officers and time savings for the bank. From the SME customers' perspective the use of credit scoring is an important part of reducing Turnaround Time (TAT), addressing the desire for a quick process.

"An important innovation in SME credit approvals has been the use of credit scoring.

RISK MANAGEMENT

Closely tied to the underwriting process is risk management, particularly credit risk management, which is being seen in a new light. Rather than controlling risk on a loan by loan basis, the focus is on control of the quality of the SME credit portfolio. In setting credit policy and procedures for SME lending this acknowledges that the process will be simple and highly standardised, intended to come to a reasonable assurance that a loan meets bank credit requirements. While seemingly counterintuitive, the analysis process stops once this threshold has been met. Although additional review and analysis may result in slightly better loan quality, the additional time and expenditure in personnel-hours to do this is more costly than is covered by the additional revenue. Banks are recognising that losses on SME loans do not singly affect the well-being of the bank, and are simply regarded as a cost of doing business. By contrast, the loss on a large corporate loan can have a serious effect on earnings and capital, so credit underwriting and decisions need to be reviewed centrally, even as high up as the board level.

None of this is to say that a bank tolerates loan losses on SME loans, and appropriate collections will be pursued. However, some level of NPL is considered a part of doing business, expecting that problem credits arise from idiosyncratic causes rather than anything systematic. A best practice bank will monitor losses and look for trends, both in the portfolio and in the economy, and will refine procedures if a problem pattern is determined. Collection of problem loans will be pursued, often by hiring collection agencies, and collections are done in part to demonstrate the seriousness with which the bank deals with past due customers.

NON-FINANCIAL SERVICES

Banks are increasingly seeking to differentiate themselves in a competitive SME market by offering a range of non-financial services that are used to attract new clients, offered as 'extras' or 'bonuses' to retain existing clients, and used in a developmental way to help new and smaller business clients to grow their businesses and become more bankable, particularly to address shortcomings in financial statements and to provide mentorship and training for new businesses.

A range of non-financial services are on offer, usually falling into one of four broad areas of activity comprising:

- 1 to 1 advice from relationship managers;
- Dissemination of information and self-help knowledge through a variety of channels (websites, publications, business centres/clubs and events);
- Training programmes (face to face, distance learning and online); and
- Specialist consulting services.[16]

Non-financial services are not a core bank activity, and many banks offer these services through partnerships with third parties such as universities, consulting firms or trade institutions. These are a direct cost to banks as they are usually offered free of charge or at a greatly subsidised rate.

In Kenya some of the banks offer non-financial services in the form of bank clubs with associated business events for members such as trade missions. These typically have a membership fee, and only the banks' SME customers are eligible to join. Business training services are also offered to "emerging VSE" businesses by some financial institutions.

16 IFC and OeEB, Why Banks in Emerging Markets Are Increasingly Providing Non-financial Services to Small and Medium Enterprises, (2012).

To date the evidence of benefits that banks derive from the provision of non-financial services is anecdotal at best and more research is needed.

SERVING NICHE MARKETS

Some banks have been successful pursuing niche markets that have been mostly or fully neglected in the market, on the basis that the niche is large and can be profitable particularly if the bank has a "first strike" opportunity. Examples of market niches include sharia banking, agribusiness, women-owned businesses, youth, and recent start-ups Banks that serve these niches have found that the needs and constraints in serving this segment have caused them to develop or modify service delivery.

The current trends in providing non-financial services for SME clients as noted above stem in many cases from trying to provide additional service particularly to women-owned SMEs, as well as qualify them to meet the bank's credit standards. This approach has been so successful that it has been broadened to include more SMEs, particularly very small businesses, to assist them to become bankable, and has been a way for a financial institution to brand itself as SME-friendly.

The approach to niche businesses can be successful if pursued as a serious business target segment, but in some cases it is clear that the segment is only served out of a sense of social responsibility, which may well be misplaced. In best practice banks the niche SMEs will be served with a target of their being desirable and profitable customers for the bank.

IT/MIS SYSTEMS

Financial institution information systems, particularly CRM systems are becoming increasingly sophisticated, and are being used in best practice banks worldwide for market information, customer leads, and risk analytics. This can be considered a coming trend rather than a current practice in Kenya. However, CRM-sourced statistics can be used to develop predictive information on customer retention, cross-selling opportunities, and risk patterns, and can also be used for expansion planning.

Overall this acknowledges the increasing understanding that SME banking, particularly small business banking, behaves like the consumer sector.

SUMMARY

In summary, SMEs are a significant part of the economy, hence represent a substantial market opportunity for financial institutions, if their needs can be met and constraints to serving them can be overcome. Chief constraints for SMEs are lack of financial statements and lack of traditional collateral, which means that a bank that wants to serve SMEs will have to find substitutes or work-arounds.

Worldwide there is a trend among financial service providers to prioritising work on improving SME products and services. Major lessons learned include:

- SMEs are not "corporates, only smaller" but are a separate line of business, closer to retail.
- SMEs are typically looking for a one stop shop, and fast turnaround time service.
- SMEs need multiple financial services (e.g. deposits, transfers, fee-based services, insurance) not just credit.
- The key to SME business is volume, because loans and deposit accounts are smaller.
- Cost containment is equally important because of small transaction sizes, and the credit process in particular needs to be streamlined and simplified. Worldwide, credit scoring is being used increasingly for SME loans.
- Credit risk to the bank is in the portfolio, not in the individual credit, which supports adoption of standardised practices with minimal handling and fast turnaround times.
- While profitability in best practice banks is usually based on strong cross-selling of products, credit is the lead product in many markets, particularly emerging markets.
- The bank's choices on organisation, products, and delivery will hinge on its segmentation choices – SME is too wide a segment for banks to serve the entire market well.

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