
GrowthCap
*Building SME-focused capacity*

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PROJECT BRIEFING NOTE 3


# PURSUING SME BANKING EXCELLENCE


**By Tim Atterton**

## INTRODUCTION

It is universally accepted that a vibrant, robust and growing SME sector is a vital component of any healthy economy. SMEs are now regarded as the drivers of most economies as they create employment and income opportunities; they underpin a diversified economy that is resilient during downturn, foster innovation, support the equitable distribution of wealth and help to maintain civil society. In developing economies, low and middle income countries, SMEs provide vital linkages between the formal and informal sector and are an important cog in many corporate supply chains. Success in the SME segment is also critical for future profitability and growth of banks and other Financial Institutions (FIs).

As opportunities to generate returns from government securities, corporate and consumer lending diminish, banks need to become more engaged, proactive and innovative in the SME arena.

Despite this commercial imperative, there are few examples of banks being able to build demonstrable goodwill in the SME community, or establish long-term sustainable competitive advantage in the increasingly competitive SME market. However unpalatable this statement may be; it is underpinned by the fact that banks are invariably scored poorly by SMEs when asked if they would recommend their banks to others businesses (i.e. using the NPS – Net Promoter's Score methodology). This lack of regard is most likely attributable to the fact that banks invariably struggle to adopt an SME-centric approach in their operations or configure their financial offer for the convenience of the SME customer. Rarely do banks aspire to understand and see the world through the eyes of an SME and develop products and service delivery strategies that are truly responsive to their

### 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 looks at the typical challenges that banks face in trying to establish long-term sustainable competitive advantage in what is an increasingly competitive SME market. It suggests a number steps that banks need to consider in order to move towards this goal.



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**If banks are to profit from the SME market, there is an urgent need for them to become more demand-driven and in-tune with the needs of their small and medium business customers, and respond accordingly.**

evolving business circumstances. This is particularly true in respect of fast growing cash-hungry, businesses that may present excellent long-term commercial opportunity but are asset poor and are unable to meet the collateral requirements of risk averse commercial banks.

## STRATEGY

Common Errors:

**1. Lack of a formal SME Banking Strategic Plan.** Although many banks embrace fully the necessity to offer products and services to the SME sector (i.e. they demonstrate 'strategic intent'), they rarely take the time to prepare a comprehensive, SMART(Specific Measurable Achievable, Realistic and Timely) SME Strategic Plan that is consistent with their overall banking strategy. As a consequence, they are not able to articulate any compelling competitive advantage in the SME banking market. They also tend to suffer from a lack of discipline in execution and experience downstream implementation problems that manifest in false starts, random activity and frustrated efforts. This deficiency is not unique to SME banking but nevertheless is a major constraint to success that requires redress.

**Solution:** Banks need to develop new perspective on their SME banking offer and invest appropriate time and resource from the outset to prepare a SMART SME Strategy and Implementation Plan.

**2. Failure to engage the Senior Management Team fully in the SME Strategy.** In 2004, the Boston Consulting Group identified a range of critical factors for successful SME banking. These factors included *'a clear Institutional commitment to servicing the SME market that is endorsed fully by senior management'.* All too often, the senior management team (SMT) pay lip service to the SME strategy. Superficially, they support efforts to increase the SME customer portfolio without necessarily pledging support from their service area. As the SME strategy emerges, the SMT fails to respond to the internal challenges that arise and to support necessary change. Also, the champions of the SME strategy struggle to leverage critical resources in competition with other internal strategic demands.

**Solution:** Ensure that the SMT backs the SME strategy from the outset and is prepared to fully support its implementation and allocate necessary time and resource to ensure success. In particular, include SME-specific Key Performance Indicators (KPIs) in the CEO's contract of employment and annual performance criteria.

**3. Failure to segment the SME market appropriately.** By definition, the SME market is heterogeneous rather that homogeneous in nature, and effective market segmentation is a prerequisite for success. Most segmentation approaches are superficial (at best) often based on turnover thresholds, maximum borrowing limits or public policy that have little relevance to the actual SME life-world. Segmentation is a core component of any effective marketing strategy, and SME banking is no exception.

Also, banks struggle to identify segments and trends within their existing SME portfolios as they lack 'data discipline' and fail to adequately capture information that is available. Often, a manual data clean-up is necessary to inform forward strategic decision-making.

**Solution:** Adopt more sophisticated, SME-centric approaches to market segmentation (i.e. management competence, business maturity, supply-chain integration, gender or industry sector) and develop customised products and services with benefit focussed value propositions that respond to identified need.

**4. Ill-informed perceptions of unacceptable levels of exposure and associated risk.** Of course, SME banking can be risky if done badly and if the right processes and controls are not in place (all bad banking is risky!). However, when managed professionally and rigorously implemented, SME banking can be highly profitable. The cost benefit argument of SME banking is compelling. In many countries, full service Banks generate 35% or more of their total profits from SMEs. Banks need to maintain better and more accurate management information on the real-time performance of their SME operations to establish confidence in expanding their SME portfolios or, alternatively, introducing necessary remedial action.

**Solution:** Introduce more sophisticated management information systems that provide accurate contributions analysis and collate data that makes a strong case for and removes prejudice against SME lending.

## STRUCTURE

Common Errors:

**5. Adopting a sub-optimal SME banking business model.** Frequently, banks locate their SME divisions within either retail banking or corporate banking departments. Both options are problematic. SMEs have unique specialist needs and are either subsumed within retail banking or marginalised in corporate banking environments.

**Solution:** To be successful, establish a dedicated SME banking department as an autonomous business unit that reports directly to the CEO. As the needs of smaller SMEs tend to mirror the needs of consumer customers, a case can be made for retaining these accounts within a retail banking division. However, it is most likely appropriate to locate all SME accounts within a dedicated SME division but portfolio manage those that do not warrant individual, bespoke attention. These 'mass segment' SME accounts can be serviced from centralised, call centres with efficient management Information systems (MIS) /client relationship management (CRM) systems informing bank officers if and when interventions are required. This approach would ensure that SMEs with growth potential are identified and supported and also reduces the conflict that often results when customers are relocated from one business unit within a bank to another.

**6. Underestimating the importance of a diverse Branch distribution network in SME Banking.** Understandably, banks would like to reduce their overhead costs by rationalizing their branch networks. In general, SMEs are branch dependent and in many countries efforts to attract SMEs to non-branch offerings have been relatively unsuccessful. A devolved branch network seems to be a prerequisite for capturing a significant share of the SME market. The exception to this rule would be well-designed and managed agency networks. However, agency banking for SMEs does have limitations. Specifically, agency-banking dilutes customer loyalty. Also, banks adopting this approach may not be best placed to identify growing SMEs that carry the best opportunities for deposits, future lending transactions and cross-selling financial services.

**Solution:** Where possible, maintain a devolved branch network most likely, comprising dedicated commercial or business banking centres with specialist staff at all levels that have been trained to understand the commercial SME customer and respond to their needs. Maintaining branches in regional or rural areas is most likely prohibitively expensive but SME/business banking centres can be co-located within existing retail branches.

**"Include SME-specific Key Performance Indicators (KPIs) in the CEO's contract of employment and annual performance criteria.**

**Ansell Pharmaceuticals staff prepare product for shipment: SMEs provide vital linkages between the formal and informal sector and are an important cog in many corporate supply chains.**

## HUMAN RESOURCES

Common Errors:

**7. Appointing a Head of SME banking who lacks authority and gravitas.** Frequently, the Head of SME banking is a relatively inexperienced, middle-management appointment with operational and tactical roles, rather than strategic responsibilities. As such, they lack status within the Senior Management Team and struggle to secure the necessary resources to deliver on the task-in-hand.

**Solution:** The Head of SME banking needs to be a senior level appointment that will rank alongside other members of the executive team. As such, s/he commands the attention of their colleagues and is able to stand their ground during management discussions and make a compelling argument for scarce funds and resources.

**8. Failing to introduce career structure and career progression for SME bankers.** Unfortunately, many career bankers regard SME banking as a stepping stone to more prestigious and better-rewarded careers in commercial and corporate banking. Banks tend to promote their better SME bankers to commercial and corporate banking positions rapidly rather than retain and promote them into higher ranking SME banking roles. Banks are also inclined to poach staff from their competitors rather than train new managers. This leads to the creation of a seller's market, a recruitment 'merry-go-round' and the necessity to pay inflated salaries. As a consequence, neither the national pool of SME bankers nor the overall SME banking body of knowledge grows as required. This situation also frustrates SME customers who are unable to build relationships with their nominated banker as the incumbent changes too often requiring them to invest time and valuable resources in establishing new relationships.

**Solution:** This market asymmetry can only be addressed by creating an expanding talent pool of suitably trained SME bankers and retaining them in this role as a worthwhile career opportunity. Establish firm career paths for SME bankers, retain them in SME banking roles for a longer period and ideally establish a formal training and accreditation process for SME bankers. Bespoke training and accreditation for SME bankers sends out a strong message to the market that the sector is important to the host bank and a key strategic priority.

## CREDIT

Common Errors:

**9. Pursuing 'safe lending' rather than supporting sound business propositions.** Conventionally, SME loan applications are assessed on four main criteria: liquidity, interest cover, asset cover and gearing. These measures are effective in terms of assessing the bank's exposure to a particular SME situation but are extremely limited in terms of assessing the financial health or future potential of an SME.

**Solution:** Provide relationship and credit managers with broader training in business profiling and financial literacy that gives greater insight into the financial health and well-being of the target SME. Also, provide cash-flow based lending based on the SMEs ability to meet the obligations of the loan.

**10. Basing lending decisions exclusively on sub-optimal financial information rather than a holistic assessment of the SME's business performance and its future potential.** Banks are heavily reliant upon access to structured financial information when assessing loan applications. Frequently, this information is either fabricated or just not available. When available, such information does not necessarily present a true and accurate picture of the actual health of the business.

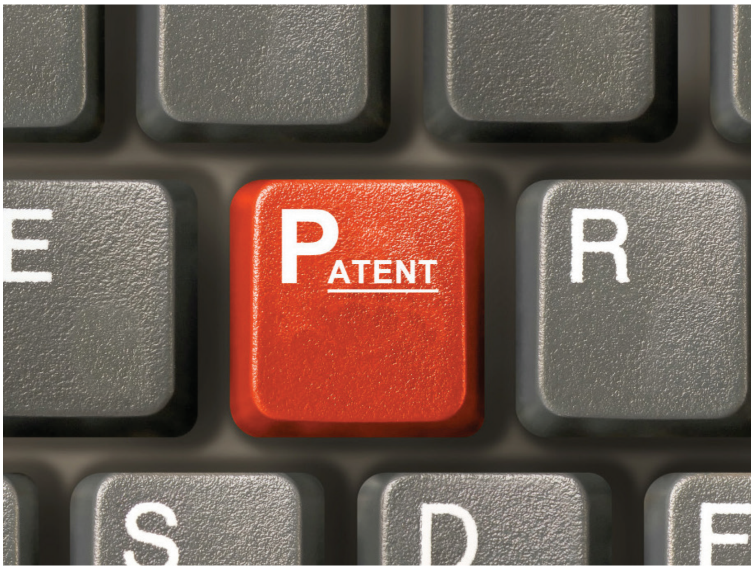
**Solution:** Train SME credit and relationship managers to assess business performance in a holistic way, rather than relying exclusively on historical financial statements. It is important that banks appreciate the difference between 'relationship lending' and 'transactional lending'. Transactional based lending is based on 'hard' information analysis such as financial statements, collateral and credit scoring and involves more arm's length interaction between the bank and the SME. Relationship lending is an alternative and powerful technique to resolve issues associated with information asymmetry. Relationship lending requires a bank to invest in proprietary, customer-specific information over time, and monitoring the efficacy of loans through multiple interactions over time. Relationship lending does not entirely preclude the need for hard, quantitative information; and is, by definition, resource intensive. Accordingly, relationship lending methodologies can only be applied to premium SMEs that demonstrate optimum returns to a bank (i.e. not the mass SME market). See point 19 below.

**11. Expecting short-term lending to build long-term SME relationships.** Banks are reluctant to advance longer-term loans to SMEs in the belief that this increases their risk exposure. This may well be true. However, it is difficult to build long term SME relationships on the back of short term lending. SMEs will always be seeking alternative forms or suppliers of finance and short term lending mitigates against bank loyalty and encourages multi-banking. In effect banks tend to offer 'cosmetic' finance for SMEs. This type of finance largely supports SMEs to conduct their daily operations and business transactions but offers very little scope for enterprises to expand their productivity and eventually grow their businesses.

**Solution:** Where possible, consider the 'life-time value' of the SME to the bank rather than the value of an individual transaction. Introduce longer-term loan products that build longer-term relationships and SME loyalty and enable sustainable business growth that benefits both parties. Evidence world-wide suggests strongly that SMEs are reluctant to change banks unless they have no choice. Indeed the research demonstrates that less than one in five SMEs will change their banking relationship during the life of the business.

**12. Down-playing the need for collateral.** Banks are not venture capital organisations; they are in the business of collateral-based lending. The challenge in this regard is not to reduce or down-play the need for collateral but, rather, to explain the commercial imperative for seeking security from their SME customers and seek alternative forms of security that extend beyond conventional property-based personal assets. In particular, banks need to be more prepared to take a charge or debenture against business assets in lieu of personal property.

**Solution:** Banks need to be more transparent in communicating their need for security, and be prepared to extend the scope of collateral beyond personal, land or property based assets. This is particularly pertinent for many women-owned and also technology-based SMEs.




**Banks are reluctant to attach any value to intangible assets.**

**13. Ignoring the real value of intangible assets.** Unfortunately, there is no universally agreed formula for valuing intangible assets. This fact impacts negatively against the SME customer in their banking relationships as banks are reluctant to attach any value to intangible assets. Paradoxically, many SMEs are reluctant to invest in fixed assets as all their available financial resources are required to fund the working capital requirements of growth. In doing so, they are likely building goodwill within their businesses at the expense of tangible, fixed assets that appear on their balance sheets.

**Solution:** Banks need to be open to the suggestions that intangible assets and, in particular, goodwill have real value that can be factored in to lending arrangements.

**14. Under-estimating the importance of TAT – Turnaround Time.** In the SME life-world, speed of transaction is often the essence of closing successful commercial arrangements. Deals have to be expedited otherwise, opportunities will be lost. By delaying decision-making by weeks (and, in some cases, months) banks do enormous damage to both their SME customers and their SME relationships. Banks need to appreciate that only their marginal SME customers are prepared to wait for any extended period of time for their bank to deliberate on a loan application. Preferred, premium SME customers will be able to secure funds quickly from competitor banks if their own bank delays in decision making. Alienating your preferred customer base is the antithesis of good banking and extended turnaround times -TAT -will inevitably increase the incidence of non-performing loans.

**Solution:** Banks need to maintain internal credit policies and procedures that are SME-friendly and do not obstruct or frustrate front-line management capability and commitment. In particular, banks need to set targets for optimum turnaround time for considering and approving loan applications, and introduce systems and protocols that ensure compliance. Banks that deliver best practice in the SME market often target a 48 hour (sometimes 15 minute) approval cycle as part of their SME brand promise and guarantee 95% plus compliance.

## OPERATIONS

Common Errors:

**15. Not establishing strong linkages between Credit Managers and SME Relationship Managers.** Historically, it has been practice to isolate front-line SME staff from back office credit functions to ensure impartiality and avoid personal influence on decision making. Although this approach carries some logic, it is misplaced as valuable commercial information and business knowledge accrued by the front-line staff is excluded from the credit process. This can have the effect of de-motivating branch and relationship managers and extending decision-making time, and lead to lost opportunities and flawed decisions.

**Solution:** Establish firm operational linkages between credit managers, business branch managers and relationship managers and ideally establish cross-disciplinary teams that work together on a collaborative basis.

**16. Focusing too much on Product Development.** Banks should introduce attractive and competitive financial products that meet the distinct needs of SMEs. However banks spend an extraordinary amount of time and money on developing new SME products. Global research suggests strongly that SMEs find it difficult to differentiate between these products and would prefer a simpler offer based on fewer products. Also a larger basket of products creates greater complexity for both front-line and back-office staff who are required to understand and process an ever-expanding range of financial products.

**Solution:** Rationalise and simplify the product offering and communicate it more effectively to the SME community. Also, focus more resources on staff training and SME relationship building rather than on ad hoc product development.

**17. Spending too much quality time with marginal or unprofitable customers.** Naturally non-performing loans are a major consideration for all banks engaged with SMEs. However banks must safeguard against deploying disproportionate amounts of high value resources towards collections. The business maxim of deploying your best resources to your best customers applies here. Experienced branch managers and SME bankers should be assigned to work with good growing SMEs rather than customers in default.

**Solution:** Introduce processes and systems that identify small-wallet customers that will never become large-wallet and service them in a cost effective manner. Establish dedicated processes, systems and procedures for serving this customer segment, including collecting outstanding loans, and avoid burdening high-cost, experienced staff with such tasks.

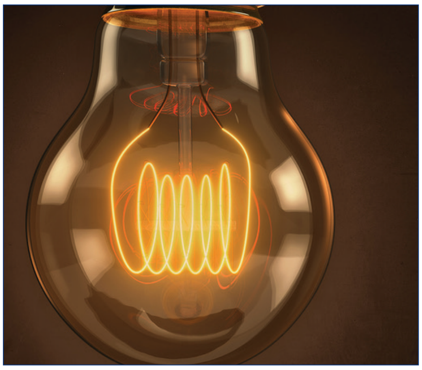
However, it is important that SME relationship managers and officers do not abrogate responsibility for their SME customers. In this respect, customer ownership is a vital consideration. A balance needs to be established whereby relationship managers are tasked to identify warning signals and be responsible for the interface with short-term delinquent customers without devoting too much time to non-performing loans. Longer-term delinquent SME customers need to be transferred to collection teams.

**18. Ignoring Opportunities Presented By Non-Borrowing Customers.** In many countries, non-borrowing SMEs generate greater return to their bank than borrowing customers through transactions, deposits and cross-selling opportunities. Of course, the risk profile of non-borrowing SMEs is much reduced. Non-borrowing SMEs provide deposits for on-lending and are potential customers other financial services such as insurance, pensions, payroll etc. and may also present future lending opportunities as their businesses grow or diversify in new directions.

**Solution:** Devote as much time to non-borrowing SMEs as borrowing SMEs as the former SMEs provide both deposits and future lending opportunities. In this regard, banks need to develop high performance sales teams to maximise the opportunity to 'cross sell' financial products and services.

**Common errors in operations**

Not establishing strong linkages between Credit Managers and SME Relationship Managers.



Focusing too much on Product Development

Spending too much quality time with marginal or unprofitable customers.


**Well managed SME Banks and their branches are privy to volumes of relevant SME data that can be harvested (or mined) and used to inform commercial decision-making.**

**19. Confusing 'Relationship Management' with 'Portfolio Management'.** Frequently, SME banks claim that they adopt a 'relationship management' methodology as a key aspect of their SME banking model. This recognises that for many SMEs, the banker is more important than the bank. However, having a relationship manager does not guarantee having a relationship. Also, banks frequently use 'relationship management' as a surrogate for 'selling'. In practice, adopting a true relationship management approach for an entire SME portfolio is all-but impossible as the associated opportunity cost is too great. Banks need to identify their premium SME customer base (and, most-likely, these will be those SME customers that demonstrate future growth potential) and attach specifically trained relationship managers to these accounts to maintain and grow the relationship. Global evidence suggests that banks generate most of their profits from 5% or less of their SME portfolio and that the proportion of the SME book that warrants true relationship management is unlikely to exceed 12% to 15% of their SME customers. All other SME accounts should be 'portfolio managed' by lesser qualified staff and through cheaper channels.

**Solution:** Only premium SMEs warrant dedicated and suitably trained SME relationship managers. As an indicative target, true relationship managers are unlikely to have the capacity to manage more than 50 to 100 key accounts. SME portfolio managers may well manage in excess of 250 accounts provided they are appropriately trained and supported.

**20. Not accessing information that is readily available.** Well managed SME Banks and their branches are privy to volumes of relevant SME data that can be harvested (or mined) and used to inform commercial decision-making. For example, a change in the frequency of account movement and size of transactions is a good indicator of either growth or possible trading problems within an SME. In either case, the bank / branch should pick up on this information and respond accordingly. Frequently, banks are too passive and miss opportunities to build relationships with growth SMEs or respond, in a timely fashion to accounts that are trending towards delinquency.

**Solution:** Use analytics and all available data to support SME banking strategy and decision-making and, also, to develop the SME customer base. In particular, introduce simple information capture and data mining techniques that monitor movement and trends in account transactions, and alert management of pending or occurring change in an SME. These systems need to be managed with discipline and rigor, and updated on a real time basis. Otherwise, information quickly becomes outdated and meaningless in terms of relevance or practical application.

**21. Lack of transparency and providing insufficient feedback to SME customers.** Due to either a lack of time or inclination, banks often fail to provide full transparency and feedback on decision-making to their SME customers. Often, loan applications are rejected without adequate explanation. This leads to customer dissatisfaction and also, denies the SME a learning opportunity. SMEs learn by doing, and the process of providing them with feedback is an important part of their development process. In providing considered feedback, banks are in practice educating their SME customers and making them better businesses.

**Solution:** Where possible, dedicate more time to full transparency and communicating both positive and negative feedback, to SME customers as a vital component of their business learning and education.

## SME ORIENTATION

Common Errors:

**22. Being supply-driven rather than demand-led. Banks rarely configure their SME offering or operations for the convenience of their SME customers.** As a consequence, banks are all-too often perceived as necessary evils, rather than a trusted stakeholder in the business growth and development process.

**Solution:** Adopt an SME-centric approach at all times, and evaluate the bank and its performance through the eyes of its SME customers. This requires positioning the bank to support the commercial success of its SME base and, on occasion, being prepared to accommodate temporary periods of trading difficulty.

**23. Assuming that the SME customer is ignorant.** SME owner-managers may well be uneducated, unprofessional and unsophisticated in their management approaches; but they are certainly not ignorant. Indeed, it is often apparent that SME operators have a good understanding of the SME banking environment in which they operate; and play the system to their advantage.

**Solution:** Banks and bankers should accord (much) greater respect to their SME customers and recognise that their existence and willingness to take risk provides the platform upon which most banks operate.

**24. Failure to understand the complexities of the SME life-world.** The organisational cultures that attach to the 'world of banking' and the 'world of SMEs' are diametrically opposite. The world of banking is formal, structured and organised whereas the world of SMEs is informal, entrepreneurial and unpredictable.

**Solution:** Bankers need to understand and appreciate: the complexity of the entrepreneurial personality and the management styles that prevail by necessity within most SMEs. In doing so, they will acquire empathy and much deeper understanding of the SME life-world, and be able to develop better relationships. Train bankers and other SME-facing front-line staff to understand, and empathise with, the SME life-world; and embody this understanding into their day to day banking practice.

**25. Failure to understand the dynamics of SME growth.** SME growth is a complex process, and rarely linear. By definition, growing SMEs are likely to be undercapitalised and, possibly, over-trading by standard accounting definitions. On occasions, growing SMEs may experience a temporary period of technical insolvency. In addition to this they rarely understand their balance sheet or the fundamental need to build a strong balance sheet with adequate retained earnings, asset cover and gearing. Bankers need to understand the position that prevails in many growing SMEs and position themselves to support rather than frustrate growth oriented businesses thereby enhancing the bank's overall SME portfolio.

**Solution:** Provide specific training to selected SME bankers on the complexities of SME growth that equips them to effectively support the process

## IN SUMMARY

The above list is long and in all likelihood challenging. In some areas the suggestions flaunt the conventional wisdom of commercial banking practice. As the environment for SME banking becomes even more competitive, there is a need for industry-defining change that establishes long-term SME relationships without compromising good banking and profitable lending. Research indicates that the reward for any bank that gains a reputation for 'SME Banking Excellence' is a resilient customer portfolio, sustainable profitability at acceptable risk, a resilient and healthy balance sheet and content shareholders. Bankers and their advisers are encouraged to use the above list as a basis for discussion with a view to defining an appropriate agenda and strategy for change to capitalise on the high potential opportunity presented by the SME sector.

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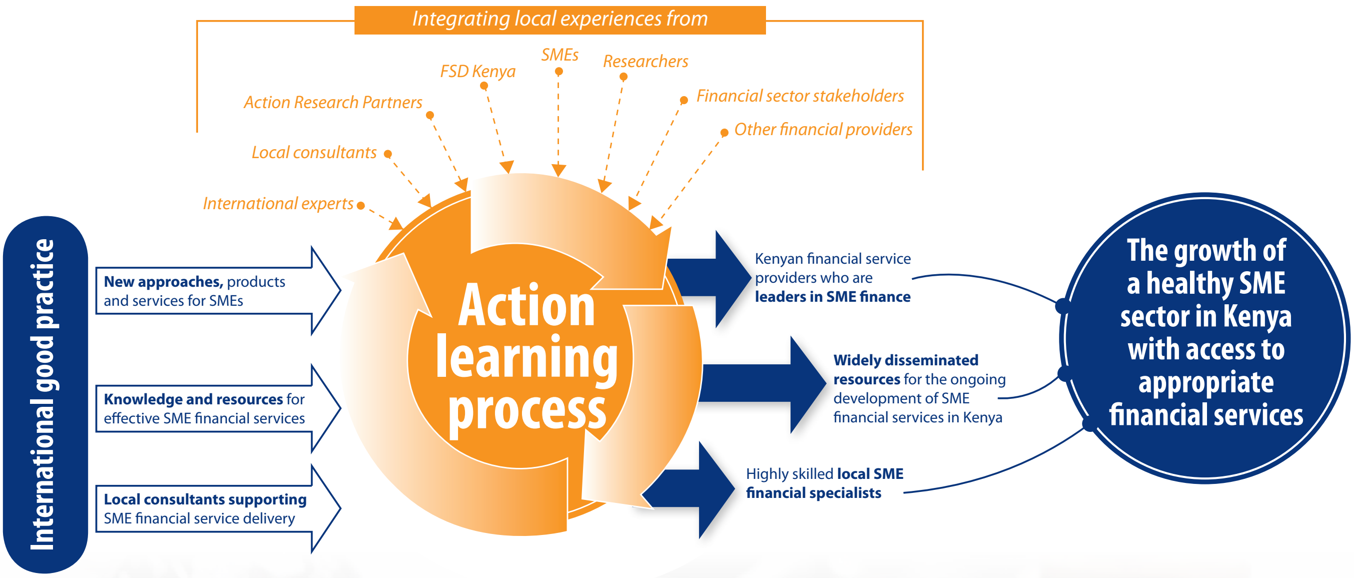
## THE GROWTH CAP PROCESS

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The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA), Agence Française de Développement (AFD) and the Bill and Melinda Gates Foundation.

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