Benchmarking SME Banking Practices

Emerging Lessons and Best Practice

September 2007
SME Banking and IFC’s Role

Small and medium enterprises (SMEs) are major contributors to GDP and employment in many parts of the world. However, their financial needs are often underserved and this continues to be a constraint to their growth. Banks, which have traditionally served the corporate and large business segments of the market, view SMEs as a challenge due to information asymmetry, lack of collateral and the higher cost of serving smaller transactions. However, as corporate banking margins continue to shrink and increasing fiscal restraint lowers yields on government borrowing, banks have begun to assess the opportunities that SMEs offer in terms of growth and portfolio diversification.

In recent years, IFC, a member of the World Bank Group, has shifted its involvement with SMEs from direct investment in enterprises to mainly channeling funds through financial intermediaries.

IFC’s micro, small and medium enterprise (MSME) portfolio represents 24 percent of its total portfolio and 56 percent of its financial markets portfolio. Commitments to financial institutions for the MSME sector reached $1.9 billion in fiscal year 2007. As of December 2006, IFC’s financial institutions clients accounted for about five million MSME loans for a total value of $57.1 billion. In addition to its investments, IFC’s financial markets technical assistance activities in SME banking include creating SME operations, bank downscaling, scaling up microfinance institutions, and creating leasing operations and products.

Benchmarking SME Banking Practices

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, which began in 2005, the project has focused on qualitative and quantitative benchmarking studies at five banks in OECD countries and six emerging market banks located in the US, EU, Latin America, Asia, and Australia.

The results of the Benchmarking SME Banking Practices initiative point to a number of emerging lessons learned by banks offering SME banking. They have also enabled IFC to establish a core set of benchmarks and best practices, which are set out. In a second phase, the core set of benchmarks built will be used with additional emerging markets financial institutions interested in participating in the exercise.
**SME Segment Offers Growth & Profit**

The banks surveyed during the benchmarking exercise highlight fierce competition in the corporate and retail segments as a key factor in 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 seen as a high margin business with a strong potential for profitability and important cross-selling and portfolio diversification opportunities. The banks surveyed reveal that SME banking is a profitable business despite challenges such as the need for buy-in at both management and operational staff levels and the need to adapt products and develop IT tools. As highlighted in ROA SME Versus Total Bank, page 4, 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.

**Definitions of SMEs Vary**

The participating banks’ definitions of SMEs and the criteria used to categorize them vary considerably. Most banks note that loan size is not an adequate criteria and indicate that they have evolved more sophisticated criteria based on thorough analysis of their SME clients. Nine of the 11 surveyed banks use client intrinsic characteristics as their primary criteria. The banks suggested that they define SMEs using data easily collectable by front office staff and based on: (1) whether they are asset customers or liability only customers; and (2) risk/return profiles which enables the bank to determine potential revenue, adjust cost to serve, and maximize profit.

**Higher Unsecured Lending in OECD**

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 for the OECD banks analyzed compared to 36 percent on average for 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

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**Focus on IFC’s Core A2F Products**

Core/traditional A2F products are shaded in dark orange.

<table>
<thead>
<tr>
<th>Financial Intermediaries</th>
<th>Financial Infrastructure</th>
<th>Strategic Goals</th>
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<tr>
<td>SME Banking</td>
<td>Credit Bureaus</td>
<td>• Maximize IFC's development impact</td>
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<tr>
<td>Microfinance</td>
<td>Collateral Registries</td>
<td>• Differentiate IFC's product offerings</td>
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<tr>
<td>Housing Finance</td>
<td>Securities Markets</td>
<td>• Add value to IFC's clients</td>
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<tr>
<td>Leasing</td>
<td>Payment Systems &amp; Remittances</td>
<td>• Brand IFC's name</td>
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<td>Sustainability Finance</td>
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<td>Trade Finance</td>
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**Expand Access to Finance**

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**BENCHMARKING SME BANKING PRACTICES - SEPTEMBER 2007**
provide unsecured loans as the next opportunity to expand into this market. Banks recognize that the market belongs to players able to decrease information asymmetry through strong internal databases and credit bureaus.

**Focused SME Banking Strategy**

All the banks surveyed had recently redesigned their organizational structure to support a strategy that focuses on addressing the SME segment. About half 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 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 **SME Banking - Four Business Models**, right. The chart reveals that five of the 11 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 the model used and performance.

**Specialized Service for SMEs**

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 note that in the absence of distinct units, staff tend to remain focused on retail and corporate clients which are easier and, some feel, are 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.

**From Lending to Banking**

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 as not all SMEs need to borrow but they generally need core banking products such as deposit and account

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**SME Banking - Four Business Models**

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<tr>
<th>Model 1: SMEs in Commercial</th>
<th>Model 3: Dedicated SME Unit</th>
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<tbody>
<tr>
<td>2 banks</td>
<td>2 banks*</td>
</tr>
<tr>
<td>Retail</td>
<td>Retail</td>
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<tr>
<td>Commercial</td>
<td>SME</td>
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<tr>
<td>Corp. MM SB</td>
<td>MM SB</td>
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<td>*1 with no sub SB and MM units</td>
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<th>Model 2: SMEs in Retail</th>
<th>Model 4: Split</th>
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<tr>
<td>5 banks*</td>
<td>2 banks</td>
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<tr>
<td>Retail</td>
<td>Retail</td>
</tr>
<tr>
<td>Commercial</td>
<td>Commercial</td>
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<tr>
<td>Corp. SB MM</td>
<td>Cons. SB Corp. MM</td>
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<tr>
<td>*1 with no sub SB and MM units</td>
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**Abbreviation Key**

Corp. = Corporate; MM = Middle Market; SB = Small Businesses; Cons. = Consumer
management in order to run their operations. A standardized product offering for small businesses is seen across the participating banks, with a more tailored offering for middle market clients. As banks gain experience, they develop more sophisticated standardized products for smaller businesses.

**Credit Risk Management**

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 majority of the banks segregate sales and risk 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 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. Centralized credit risk management does not prevent local underwriting as six out of 10 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.

**Proactive Sales & Customer Service**

The banks aim 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 11 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 bureaus, when the information is 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

A proactive sales strategy and a multi-channel acquisition and servicing model are critical

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 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 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 consisting of a wide branch network and low cost delivery channels is key to SME banking. For example, eight of the 11 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 such as the internet.

**Measuring P&L**

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

The ability to measure profitability is essential for cost containment but Management Information Systems (MIS) remain a challenge

SME segments. Nine of the 11 surveyed banks have the capability to calculate profit and loss (P&L) at the business unit level in the small business segment and five in the medium market segment. However, only one bank out of seven in the medium market segment can provide breakdowns of P&L at the branch and product levels. Risk analytics continues to be a challenge.

**Next Steps**

This initiative designed to benchmark SME banking practices is the first step towards the roll out of a more comprehensive set of benchmarks for SME banking practices in emerging market banks. In an effort to continue establishing best practice and promoting SME banking in emerging markets, the core set of benchmarks will be extended to most of IFC’s client banks, on a voluntary and demand-driven basis, through an off-site instrument and/or IFC technical advisory facilities. The initial lessons that have emerged, such as differentiating the small and medium banking business, using SME banking business models, and the clients’ need for non-lending products, are already providing useful input into IFC’s technical assistance operations. In addition, the benchmarking work will be complemented by IFC’s SME banking CHECK methodology. These two tools will help establish IFC’s leadership role in promoting SME banking in emerging markets.

**IFC SME Banking CHECK: a tool for technical assistance appraisal of SME banking operations**

To conduct the Benchmarking SME Banking Practices initiative, IFC used as a conceptual framework its recently developed IFC SME Banking CHECK methodology (CHECK). CHECK consists of a diagnostic toolkit which is used to assess the SME banking operations of IFC’s clients before designing a tailored action plan and technical assistance program to strengthen those operations.

CHECK offers a method for assessing the different business areas specific to SME banking: strategy and SME focus, products, sales approach, risk management, technology, and financial management. This formalized approach guides analysts through an organized and exhaustive framework, which can also be used by bank staff to perform their own self-evaluation. Based on SME best practices, the methodology helps banks quickly compare themselves to state-of-the-art (SOTA) practices (see graphic left). The tool consists of interview guides, questionnaires, an evaluation methodology, and a template report format.
Summarizing the IFC SME Banking CHECK

Banks are assessed in five different areas, each of which is divided into several sub-areas. These sub-areas are scored from 0 (most formative practice) to 8 (most developed practice, or “State-Of-The-Art (SOTA)”).

Stellar graphs, such as the one opposite for the “sales culture and delivery channels” area, summarize the bank’s performance and compare it to a SOTA bank.

The notes attributed are qualitative, yet not subjective as they are based on pre-established benchmarking tables, as illustrated by the example below.

Sample Benchmarking Table

The evaluation methodology is based on qualitative benchmarking tables (see samples opposite). These tables draw on IFC’s long track-record of providing financial and technical support to emerging markets financial institutions to set out descriptions of banking practices at the different stages of banking sector development.
Partnering with IFC

Examples of Assignments
- Conduct detailed diagnostic and gap analysis
- Organize strategic workshops for senior management
- Design and implement separate SME banking operations
- Design profitability analysis models
- Undertake customer segmentation
- Assist in new product design
- Re-engineer front-office/back-office balance and branch organization
- Design and implement credit scoring for the retail and small business segments
- Implement internal rating systems
- Re-engineer workout processes
- Train credit and risk staff
- Assist in selection of new MIS
- Design appropriate MIS reports

Selected References
Central and Eastern Europe
- TBC, Georgia
East Asia
- ADEDA Bank, Cambodia
- Sacombank, Vietnam
Latin America and the Caribbean
- FINDESA, Nicaragua
- COMPARTAMOS, Mexico
Middle East & North Africa
- CIB, EDIB, Egypt
- Attijariwafa Bank, Crédit Populaire du Maroc, Morocco
- Riyad Bank, Saudi-Arabia
South Asia
- BRAC Bank, City Bank Ltd, Islami Bank, Bangladesh
- Bank Of Bhutan, Bhutan National Bank
- Hatton National Bank, Commercial Bank, Sri Lanka

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