SME BANKING MODELS

By Mary Miller and Duncan Oyaro

INTRODUCTION

Banks that have decided to pursue the SME customer segment will have come to the understanding that SME banking is a different line of business from retail/consumer and corporate banking, and as such has its own best practices and strategic choices to follow. While this will be a revelatory moment for a lot of banks, it does not necessarily follow that practices to operationalise SME banking will immediately fall into place. Furthermore—there is no one single operational model to follow, and each bank that wants to serve the SME market will have to make decisions about what to offer, what customers comprise its target market, how products will be delivered and how business will be managed.

Most SME banking consultants have had the experience of trying to talk through choices with a bank, only to be asked to "please provide policies, procedures, and forms" used elsewhere with a view that the bank will then adopt these ‘good practice’ approaches wholesale. Needless to say this approach is strongly discouraged. The appropriate way to provide profitable, scalable SME banking services is to carry out a thorough evaluation of the bank's strengths and weaknesses, advantages and constraints, interests and attitude, in order to make choices that will work effectively for the bank in the long run. The most successful SME banking operations are planned in detail and executed well.

What types of decisions will the bank be making? There is no single approach to SME banking, because the only feature that is common to all choices is that the SME clients should be served effectively. Even the delivery of credit is not unique: there are banks that do not offer credit to SMEs (or at least not to start-ups) but have built a portfolio of clients by offering comprehensive current account and fee-based services. Credit itself comes in lots of shapes and sizes.

Consider the SME banking offer of two world class SME banks, ICICI Bank of India and Wells Fargo Bank of the United States. ICICI is known for its corporate leverage approach, offering value chain-tied financing to SMEs.
suppliers of its corporate clients and to other large corporates in the market; Wells Fargo has a high volume of credit scored loans to SMEs which were applied for over the internet. These markedly different approaches reflect different strengths (corporate relationships that could be linked; sophisticated IT capacity plus access to sophisticated credit bureau databases) which have been exploited. Interestingly both banks offer extensive web-based information services for SMEs, perhaps reflecting their broad banking footprints in India and the USA respectively.

This Technical Note will review and compare the SME banking model choices available to banks, with commentary on how well they work and in what circumstances.

**SME BANKING MODELS – BASIC CONSIDERATIONS**

It is useful to first look at basic characteristics, to understand how a bank should look to leverage its strengths and characteristics in developing an SME strategy. These factors include:

**Target customer base** – SME is a broad segment and virtually no bank will serve businesses of all sizes and sectors or subsectors, but will already be specialising

**Legacy business** – what has been the traditional business of the bank, for instance a bank with a strong retail base may want to focus on very high volume, standardised business

**Current bank SWOT** – what is the bank known for, what does it already do well (or not), what is current cost structure; what opportunities exist

**Branch network** – if the bank has an extensive branch network it makes sense to leverage this and offer SME banking services using this existing infrastructure

**IT/MIS system** – best practice volume SME banking today is heavily information-driven, and a strong system can be used for this. By contrast, a weak or low capacity system suggests that the approach should be more staff-oriented

**Human resources capacity** – what are current staff capabilities, and what are the bank’s training capabilities — even if a whole new staff cadre is recruited, SME banking capacity building calls for extensive basic and refresher training, delivered to many personnel

**Competitor strengths and weaknesses** – are there dominant SME-serving banks in the market, and if so, does the bank want to compete head to head, or does it want to find market niches that are unserved, including growing small enterprises or particular sub-sectors

**Capital position** – what resources does the bank have to commit to the new line of business

**Risk appetite** – how much risk, real and perceived, is the bank willing to undertake

**Leadership** – what organisational commitment does the bank have to SME banking, is there a champion; the bank needs to commit to SME banking (or any new line of business) for the long run

**Availability of external support** – are there government schemes for supporting SME development such as credit guarantee mechanisms and training programmes

A self-assessment that considers these points is the first step in developing an SME strategy and in making decisions about how to go about doing SME business. A good approach to this is to conduct a workshop planning meeting to discuss this involving representatives of all bank departments. This is because introducing SME banking will affect all departments, and because
this type of decision-making process in a workshop context builds consensus and commitment for SME banking.

**BANKING MODEL CHOICES**

Much of the challenge of SME banking comes from the myriad choices that an institution faces in developing its SME line of business. By contrast, corporate banking is largely relationship banking, and service to consumers is either high volume retail products and/or relationship banking for high net worth individuals. Best practices in SME banking are not settled or established, as different banks around the world and competitors in the same market have shown that differing approaches may be successful in their own way.

3.1 **Organisation**

A major decision for a bank will be where to house the SME banking department. Effectively there are three choices:

- **Under corporate** — this is common because SME banking often starts from going downmarket from corporate banking. Major concerns, however, are that SME banking is considered second best, and that the best staff and most desirable jobs are dealing with larger rather than smaller customers. There is also an issue that the bank may not be able to break a preconceived notion that SME is “corporate, only smaller”.

- **Under retail** — given that most SME banking has the volume characteristics of retail banking and that banks typically expect to leverage their branch networks to serve SME clients, this placement can make a lot of sense. Trends in SME banking, are however, to handle SME credit approvals centrally and exclude them from the branch approval/reporting structure, which can generate change management issues because credit approval authority is generally considered a mark of management significance.

- **Own division** — on paper this may be the most desirable structure so that SME banking can establish its own practices and procedures, but this is an expensive choice because it will require its own overhead staff and systems. Establishing SME banking as its own operation increases its prestige. Chinese bank regulations, for example, now require that any SME division have an equal footing with corporate and retail banking, an effort to direct more attention to the banking needs of SMEs in the country.

Another variation is to split SME into small and medium, with medium-sized businesses housed with corporate and small businesses housed with retail. The expectation here is that the medium-sized businesses will have relationship managers (RMs), and the small businesses will be served by branches with highly standardised products.

Finally, it is fairly common that the lending relationship is housed per one of the choices above, but the deposit relationship is handled in the retail division by the local branch. Often the SME RM does not have easy access to deposit information on the customer because accounts are not coded to the RM. This is an informational problem that inhibits relationship management and cross-selling. The solution is not easy or obvious, as accounts may be in a name other than that of the SME, and because the branch understandably wants attribution for the accounts that it is servicing.

3.2 **Segmentation**

SME by itself is too large a category to be very useful, so a segmentation of the potential target market is recommended. This should be done with the understanding that the segments should not be too small, or the volume approach that is mostly needed for SME banking will be lost. There are several ways to segment the SME market, including:

- **Business size** — usually measured by annual sales or total assets; total number of employees is also used. This is the basis of the breakdown of the category that is typically used by governments and donors, most commonly needed to categorise businesses for eligibility for government programmes or certain tax treatment. While a bank should be cognisant of these definitions and may follow them to some extent (e.g., reporting loans and deposits to the central bank, or qualifying borrowers to participate in donor-funded loan programs) a bank is not required to use these breakdowns for its own planning purposes.

- **Sectors or sub-sectors** — these will be gross categories,
SME banking models

such as manufacturing, wholesale, retail, or service business, or will specify sub-sectors such as food processing, furniture manufacturing, trucking services. The Central Bank of Kenya does require reporting with categorisation by eleven major sectors, including agriculture, manufacturing, energy and water, and real estate. Most of these are applicable to SMEs, although some are outliers, i.e., financial services and personal household.

- **Business linkages** – this segmentation may be used if a bank takes a value chain approach to developing its SME business. In this case it would segment all the SME suppliers or buyers from its corporate clients or from nationally known companies and segregate these from SME clients and prospects who do not have these linkages. The distinction here often comes from how the business is being sourced, and the “linked” clients are typically found through referrals from the corporate customer.

- **Need for particular financial products** – this approach is often tied to business age, e.g., start up packages, credit for high growth firms, investment products for mature firms. The segmentation may also be tied to specific need such as invoice discounting or import/export transactions.

- **Customer profitability or potential profitability** – on paper this is perhaps the most attractive way to segment clients because the bank can give the most attention to the clients that are the most profitable to them. In practice this is difficult to implement because of weaknesses of customer relationship management (CRM) systems in collecting customer data or because the bank does not know much about its own pricing and costing practices.

Other possibilities include geographic region and gender. The choice of segmentation approach will depend on the bank’s current portfolio, the market, and the bank’s goals. The segmentation is most commonly used to develop distinctive value propositions for each segment, and also to prioritise outreach to clients. If a bank is in a market where SMEs are already widely banked, a segmentation that targets niche sub-sectors that are not well-served may be the best strategy. If a bank is in a market where SMEs are already widely banked, a segmentation that targets niche sub-sectors that are not well-served may be the best strategy.

The amount of capital that a bank is willing to devote to its SME line of business may also play a role in the segmentation strategy. While a bank would attempt to serve any business that comes through the door, it will only launch calling and product development efforts on particular target segments that are chosen on the basis of potential return.

**APPROACHES TO SME BANKING**

The following are some fundamental approaches to offering SME banking, which indicate the focus of the bank, how it expects to offer products and services, and how it expects to make money. While isolated here, there are overlaps in the approaches outlined below.

- **Full service banking** for the SME business is the most common bank approach, typically with standardised products for SMEs and a focus on cross-selling products to capture as much of a share of wallet as possible. This is a relationship-based approach, although a bank ordinarily will only assign an actual RM to the largest or most profitable customers (smaller customers may be assigned to a branch or not have any single “owner” in the bank).

- **Total customer approach** – while the full service banking approach described above sounds comprehensive, it does not include the sales and associated with the business client, including providing financial services to employees and sister businesses, and most important, to the owner himself or herself. It would seem elementary to include these related parties in the SME banking relationship, but in practice business owners complain that the bank has sidelined the business away from the owner. This shortcoming is likely due to weak management information systems, and argues for a strong CRM system that can capture data relevant to an entire relationship.

- **Asset-based (loan-based) approach** – here the financial institution (FI) is only selling credit products to SME customers; this approach is taken both by non-deposit-taking FIs and by banks, the latter particularly in emerging markets in which credit is the hurdle product to bring clients into the bank. The focus may be solely on loans because smaller customers in particular otherwise transact all business in cash and make little use of deposit accounts or fee-based services.

- **Liability-based (deposit-based) approach** – in this case the bank is only selling deposit and fee-based services to clients. This is common in western countries in
which businesses tend to be fully banked, thus financial institutions mostly get new customers at startup, when they will not qualify for credit. Much of the approach here is to encourage the business to establish a track record of performance in handling a current account well.

- **Segment-based approach** — here bank is only pursuing serving certain segments of the SME market, for example small professional firms (law, accounting, medical, etc.). This choice may reflect a credit risk aversion on the part of the bank (e.g., the small professional firms segment would be regarded as low risk in all markets) or a particular sector knowledge and expertise.

- **Value chain or supply chain approach** — this approach is to provide for the credit needs of the SME suppliers to the bank’s major corporate clients, and loans are typically made by discounting invoices billed to the corporate client. This approach also tends to reflect a credit conservatism on the part of the bank, because outreach to these customers rarely goes beyond lending against accounts receivable for the large firm buyer.

- **Single product approach** — banks occasionally will strongly promote a single product or line of products to SMEs, such as foreign exchange or foreign trade services, although they may also have an unpromoted line of products that are available. However, this approach is mostly used by factoring and leasing companies which are only selling a single product. Some banks have used their SME banking platform to strongly promote sales of insurance products issued by an affiliate company.

### DELIVERY SYSTEMS — WHAT ELSE BESIDES BRANCHES?

While a range of delivery systems is available, in practice a bank’s branch system is the most important delivery mechanism for SME banking. This reflects the need for a physical repository for cash, particularly for retail businesses, but likely also shows the desire of most small business owners to have some relationship with bank staff.

Services may also be delivered directly by an RM or account officer, but these staff are typically tied to a branch or to an SME service centre, with costs comparable to a branch.

Keys to selection of alternative delivery systems are the desire for a low-cost, volume approach, balanced by SME customer willingness to use the delivery system and convenience to the customer. On the whole the best way to assure acceptance of these systems has been to offer them on the basis of convenience to the customer, with the assurance that the branch or RM is there, but may not be as accessible (i.e., branch is not available after hours), rather than by insisting that customers shift to the lower-cost delivery systems or explicitly charging them to use higher cost services. For new outreach initiatives the low-cost delivery system may be intrinsic to the product or service, as in credit cards, debit cards, and stored value cards.

Alternative delivery systems include:

- **Dedicated SME branches** — these tend to be located regionally, in areas with a lot of SME business. Two advantages of this approach are that the customer gets more dedicated service in a less-crowded facility, and for the account officers themselves there is an on-the-job training benefit by locating them together.

- **Call centres** — the advantage of call centres is that the service still has a human touch, but is generally available 24/7, unlike a branch. There may be dedicated lines for SME clients, which can handle all but the most complicated transactions. This is commonly the point of contact for small scale, high volume SME customers.

- **Internet-based services** — these are very common in the United States, e.g., Wells Fargo takes SME loan requests through web-based applications. While there has been some promotion of internet-based services in emerging markets the uptake has not been strong, with the few SME business owners who access bank accounts via the internet simply using the service to check account balances.

Most mainstream financial institutions in Kenya offer internet banking. The uptake of this channel however, has been very poor owing largely to limited access to internet, low literacy levels, as well as lack of trust by customers. This channel has immense potential especially for disseminating SME products such as supply chain financing as well as in reducing transaction costs.

- **Mobile banking** — in some emerging markets mobile banking has been hugely successful as a retail product, and is used by SMEs for some bill-paying as well as for payroll. Currently in Kenya mobile banking is being promoted as an alternative payment mode, *Lipa na Mpesa*, with SMEs avoiding the receipt of cash and transferring funds from the mobile wallet to the bank.
Agent networks - The rise of agent networks, recruitment of agents in remote areas to take in and pay out cash on behalf of a bank, has extended the reach of banks beyond their branch networks to serve small and very small businesses in rural areas.

According to the 2013 FinAccess survey, mobile banking and agency banking networks account for over 80% of financial access points in Kenya. These networks are mainly used for cash in and cash out transactions and seldom offer other financial and non-financial services to SMEs.

Plastic cards – Credit cards, debit cards, and stored value cards are becoming increasingly used for transactions in emerging markets. In the United States credit cards are by far the most common form of bank finance for small scale businesses.

Credit cards have not been very popular in Kenya. Lately financial institutions in Kenya have been offering credit cards as bundled products in a bid to increase their uptake.

Other delivery mechanisms include self service stores and kiosks.

Credit approval for SMEs requires a re-think by banks, which commonly will start with a corporate approval approach that may have been slimmed down (or dumb-downed) but which still does not reflect the ability, or lack of ability, of the SME to provide quality financial information. Perhaps equally important, it does not reflect the risk exposure of the bank from each individual loan. For a bank that offers corporate loans, the SME loans individually will never be a threat, because a loss on any individual loan will be too small to affect the bank’s capital stability.

The bank’s risk exposure from SMEs comes from the quality of the SME portfolio as a whole, thus the trick to SME lending is to have enough credit process to ensure that loans meet certain quality standards. Once that standard is met, or alternatively, once it is clear that the standard will not be met, the credit approval process for an individual loan should stop — any more analysis effort is not worth the cost.

The bank can control the quality more cost-effectively by setting and adjusting standards for the portfolio than by utilising an extensive approval process. For example, the bank may decide that certain industry sectors are becoming more risky — rather than spending more time scrutinising individual applications, the bank should set higher standards for these approvals, e.g., firms in business longer, signed contracts in place rather than manufacturing on spec, a lower debt to worth ratio, higher debt service coverage, etc.

Another overarching factor for speeding up the credit approval process is that SME clients are always looking for quick responses to credit requests, and will rate this speed factor as significant in evaluating banking relationships.

There are basically two models associated with a good SME loan approval process, and both of these need to be measured by the need for quick decisions that meet a threshold of quality:

- Credit scoring – the advantages here are a highly standardised approach to credit evaluation that can be done centrally, and information on the business and its owner can be collected by account officers who do not have a lot of experience with credit evaluation. The downside is that it can take time and money to set up a scoring system, whether statistically based or an expert model, or a combination of the two. Once established the system has to be maintained, and will require adjustments over time to retain its accuracy. Banks that are entering SME banking, by definition, will not have historical data available to call on for building a statistical model; even banks that have been doing SME credit for a while may not have data in a usable, accessible form. Banks that are heavily reliant on credit scoring are likely to have access to robust credit reference bureau information.

There has recently been an interest in psychometric scoring both to evaluate loan requests and to rate a poten-
tial borrower’s entrepreneurial skill. While the efficacy of psychometric scoring is being tested, it may have some benefit in rating customers who have passed through the bank’s minimum universal criteria.

- **Local decisions** — the more bank personnel who “touch” the credit the longer the decision-making process takes. Since financial information is largely unreliable, extensive analysis is equally unusable. There is a fondness for approving loans using credit committees, which makes sense for large loans and credit facilities (for which a wider discussion of financial results and projections is useful) but which take up too many person-hours for SME loans, particularly when the yes/no decision is really being made by one person at the table. A good local decision approach to credit approval will have appropriate checks and balances to avoid fraud and favouritism issues, but will be done quickly with no superficial reviews or signoffs.

### PERSONNEL – SME ACCOUNT OFFICERS

Historically the bank officers who deal with client requests have been credit-oriented, mostly because the banks have been dealing with corporate clients that have complex financial needs that require analysis and understanding. SME account officers initially were expected to have extensive financial skills, but this attitude and approach are changing. While credit skills are still significant for SME account officers, the trend is to de-emphasise these and to look for more customer management and sales ability.

**Relationship manager** has been a popular term for the SME account officer in recent years, as it serves to emphasise the role of the account officer in pro-actively cross-selling all bank products, rather than just promoting credit services. Despite this approach however, as long as the bank continues to recognise credit performance above all other activities (performance targets based on loan volume and quality rather than on relationship profitability to the bank) and recruits candidates based on financial analysis ability and aptitude, the SME account officers are not likely to focus on cross-selling, or have much skill for it.

Over time banks have started to see a shift in appropriate skills set, to recognise that SME credit is relatively simpler than corporate credit and fewer financial skills are needed, thus are now recruiting sales-oriented staff rather than financial types into SME account officer positions. The bank looks for outgoing, people-oriented candidates rather than analytical staff. Particularly as credit scoring is adopted and loan decisions are made centrally by a system there is less and less need for analysis at the account officer level, but more need for the sales person who can seek out and call on a high volume of customers. The loans will actually be package by a credit support structure.

The **hunter and farmer** approach has started to take hold in some banks, where there is the recognition that some staff are good at cold call selling, and other staff are good at cultivating relationships, but that the skill sets do not overlap much. Hunters are generally paid mostly on commission, with potentially huge compensation if performance is strong. These staff are responsible for the first recruitment of clients, but thereafter hand-off the client to others in the bank. For some financial institutions in India the “hunters” are not even employees but are independent agents, who may or may not be working exclusively for one institution.

The farmer in this structure is an RM who does not call on non-customers, but is responsible for cross-selling banking services to existing clients and related parties such as the business owner and his and her family and related businesses, and also refers employees to branch services.

There will be need to recruit more sales-oriented staff rather than financial types into SME account officer positions since loan decisions are made centrally by a system.
Best practice volume SME banking today is heavily information-driven.

**REFLECTIONS ON GOOD PRACTICE AND CHALLENGES**

It is hard to say what "good practice" is in choosing a banking model — the best practice for one bank may be very different than best practice for another bank, even in the same country, depending on staff and IT/MIS capacity, branch network, risk appetite, capital available to devote to SME banking, and competitive market position. There is also a question of what the bank wants to get out of its SME banking line of business — reasons for entering this market typically include the following:

- New untapped market, more market opportunities, profit for the bank
- Capital available and return on investment
- Diversification of risk away from corporate
- Social good

These imply different approaches and amounts of resources that will be devoted to SME banking. This again brings the bank back to evaluation of all the factors that were listed in the second section under ‘considerations’, and urges making a realistic assessment of the bank’s best choices.

**REFERENCES**


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