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 Technical Notes and Resource kits that are being developed out of work with the ARPs. These provide detailed information about the best practices and are intended for use by financial service providers and those supporting such institutions which are entering the SME market.

Abstract
This Technical Note introduces Banking SME Codes of Conduct that are designed to improve the relationship between financial institutions and SMEs.

ECONOMIC BACKGROUND AND CONTEXT

It is universally accepted that a vibrant, robust and growing SME sector is a vital component of any healthy economy. Primarily, SMEs create employment and income opportunities; but they also underpin an economy that is resilient during downturn, foster innovation, support the equitable distribution of wealth and help to maintain civil society. In developing economies, SMEs provide a link between the formal and informal markets. This broad acceptance of the economic imperative of SMEs applies strongly to Kenya, where best estimates peg the MSME market at approximately 7.5 million enterprises contributing ~4-4% to the Kenyan GDP (in 2008, up from estimates of 13.8% in 1993), 80% of the country’s total employment and 92% of all new jobs.

In parallel, success in the SME segment is considered to be critical for future profit growth within banks. The ‘Small Business River of Gold Report’ published by Macquarie Research suggested that “the quality of the bank : SME relationship has become the key determining factor in terms of gaining and maintaining profitable market share in the crucial but highly competitive SME market.” Subsequently, the ‘Diamonds in the Rough – SME Banking Report’ published by the Boston Consulting Group re-enforced this view and stated that “Clear instructional commitment to servicing the SME market that is endorsed fully by senior management is essential”. Further endorsement is provided in the IFC Kenya SME Study 2005 that suggests “evidence from other parts of the World suggests that the Kenyan banks need to become more innovative and aggressive in the formal SME market as opportunities to generate returns from Government securities and consumer lending continue to decline”.

1 SMEs are an important element of the Kenyan economy, however establishing accurate and up to date numbers of Kenyan small businesses is difficult. The estimate given here is likely to be high encompassing as it does micro and informal enterprises. Building a better picture of the number and nature of SMEs in Kenya is something that FSDK is currently working on with its partners.


By Tim Atterton

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THE NATURE OF THE BANK: SME RELATIONSHIP

Clearly, banks and SMEs have a symbiotic relationship and are mutually dependent upon one another for profitability, growth and sustained success. The banks need a strong and well-managed SME customer portfolio that underpins profitability and provides diversity and spreads risk. SMEs, both collectively and individually, require willing and empathetic suppliers of financial products and services that complement their entrepreneurial endeavours and help to build net worth within their enterprises. In an ideal world, the banks should regard SMEs as a primary target market that demands respect and exemplary support service; whilst, the SME should embrace its bank and its officers as “trusted strategic partners in their business development process”. However, reality is far removed from this panacea. On the whole, it is an unfortunate truism that SMEs do not entirely trust their banks, which they often believe “do not understand them”, and are fearful of the fact that banks can wield a disproportionate influence over their operations and hold unpredictable licence to affect their future. On the other side of the ledger, banks all-too-often adopt a mass market approach to managing their SME customers driven by the need to reduce the opportunity cost of doing business in this sector. Consequently, SMEs feel that they lack a ‘voice and influence’ within the relationship. Although, collectively, SMEs represent a strong constituency that should carry gravitas; individually, they are powerless and impotent in the face of larger and often impenetrable banking corporations.

Evidence in support of this lack of understanding and trust between the parties in the Kenyan market is provided by the strong preference of Kenyan SMEs to multi-bank, in part, as a risk management practice. It is likely that banks in Kenya can significantly improve their profitability from the SME market by increasing their ‘share of wallet’ from an existing customer base.

A STRATEGIC RESPONSE: INTRODUCING SME CODES OF CONDUCT OR COMPACTS

Over the past decade or more, many countries and individual banks have pioneered ‘Banking SME Codes of Conduct’ in response to the above. On occasions, these codes have been stimulated by soft discussions promoted by government organisations. For example, the European Commission’s Directorate-General for Enterprise and Industry Financing SME entrepreneurs and innovators have convened a regular series of round table discussions between banks and SMEs to facilitate transparency and dialogue. In other circumstances, national APEX bodies like central banks have imposed mandatory statutory frameworks on regulated entities lending to SMEs. Perhaps, the best example of this being the Central Bank of Ireland’s Code of Conduct for Business Lending to Small and Medium Enterprises launched in 2012 (which replaced...
an earlier code promoted in 2009). Interestingly, this Code includes specific mechanisms and provisions for managing SME accounts in default.

One of the most popular innovations has been the incidence of banks world-wide voluntarily introducing their own “SMEs Codes of Conduct” or compacts (a compact being an agreement between two or more parties designed to improve the relationship for mutual advantage) as a means of establishing trust in the market place and building market share. Such voluntary codes provide assurances that extend well beyond statutory or regulatory requirements most often entrenched in consumer protection legislation. Many would argue cynically that these measures are superficial and often introduced to head-off pending regulatory control. However, whatever the initial motivation, there is a growing body of evidence that a well-drafted and fully committed SME Banking Code of Conduct can be a very powerful tool in terms of attracting and retaining good SME customers, capturing all their banking requirements and establishing sustainable competitive advantage in an increasingly crowded market place.

POSSIBLE ITEMS FOR INCLUSION IN AN ‘SME CODE OF CONDUCT’:

- Aspire to build long-term relationships with its SME customers;
- Act with appropriate skill, care and diligence in the best interests of its SME customers at all times;
- Behave honestly, fairly and professionally at all times;
- Resist the short-term temptation to sell financial products in favour of adopting a longer-term business development approach;
- Only seek collateral when absolutely necessary; and be prepared to release security when no longer required;
- Where possible, seek charges over business assets rather than personal assets;
- Be open and seek to maintain a relationship that is founded upon the full disclosure of information;
- Seek and publish independent feedback and critical assessment of its performance in respect of its SME customer base, and respond accordingly;
- Maintain confidential relationships;
- Endeavour to understand the culture of the SME and the management practices adopted;
- Appreciate the reality of running a business and try to understand and take into account the business ‘pressures’ that influence SME decision-making;
- Endeavour to evaluate SME business performance from a long-term holistic perspective and not based purely upon available financial statements;
- Facilitate the SME’s interface with appropriate decision-making staff, and provide continuity of relationship;
- Make quick decisions;
The above is indicative and expansive. Individual banks would define their own ‘SME Code of Conduct’ relevant to their articulated SME strategy and associated value proposition and brand promise. It is likely that an actual ‘SME Code of Conduct’ would contain no more than ten or twelve of the above conditions. Ideally, any bank with a formal code would include mechanisms for monitoring compliance that include consequences for breach and performance below standard. Monitoring arrangements should include a 360° element that actively canvasses feedback from their SME customers. Organisational commitment to the concept of a Code would be re-enforced if a bank was willing to commission independent monitoring and review of compliance; and make public the results on a quarterly basis.

**BENEFITS TO THE PARTIES INVOLVED**

**Banks:** Endorsement of an ‘SME Banking Code of Conduct’ would serve to remove the ‘David & Goliath’ stereotype; whereby, the big bank is always perceived to be the guilty party in the relationship compared to the small, largely defenceless SME. An ‘SME code’ would elevate a Bank to a higher strategic purpose and demonstrates absolute organisational commitment to both the individual SME and the target market. From a commercial perspective any bank with an SME Code would, most likely, build a resilient and growing SME customer portfolio comprising a high (and expanding) percentage of loyal growth businesses that placed all their banking requirements with a single supplier.
**SMEs:** The main benefits that would accrue to the SME would be additional comfort and security within their banking relationship; based on the knowledge that their bank was an engaged strategic partner in their business and committed to their long-term success.

In due course, it may prove possible to elevate an ‘SME Banking Code of Conduct’ that is, essentially, a bi-partisan arrangement that defines the attitudes and behaviours of a bank into a ‘Bank-SME’ Compact that establishes a set of obligations and responsibilities that both parties pledge to observe as their commitment to establishing and maintaining a long-term relationship that leads to mutual benefit.

**SUMMARY**

This Technical Note is intended to stimulate discussion amongst the Banking Community in Kenya and, also, its various stakeholders; including but not exclusively: the Central Bank of Kenya; the Kenyan Institute of Bankers; the Kenya Institute of Monetary Studies; the Kenya College of Banking & Finance; and Strathmore University. GrowthCap has worked with its partners to draft SME Codes of Conduct but as yet none are promoted as such. It is hoped that this Note will stimulate critical debate and might lead to industry-defining innovation in the SME-Banking arena.

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.