



# SME BANKING

## KEY PRINCIPLES FOR SUCCESSFUL IMPLEMENTATION

*Developing a successful SME banking business is always difficult, especially in Emerging Markets. Lack of reliable market and company information, and the difficulty of building a sound SME loan portfolio, pose serious challenges. However the rewards of better SME banking are potentially huge, not just for banks and the SMEs themselves, but for the economy as a whole. GBRW Consulting has practical experience in providing pragmatic solutions to some of the problems facing banks in this market, to help them build strong and profitable SME banking businesses.*

*In most countries Small and Medium Sized Enterprises (SMEs) represent a substantial proportion of all economic activity, and typically account for well in excess of 50 per cent of total employment. Governments therefore regard the growth of the SME segment as essential to the balanced development of the economy. Likewise banks and financial institutions compete to capture a share of this potentially lucrative market.*

***“...developing a successful SME banking business means adopting novel approaches to overcome unexpected challenges.”***

*However the experience of many banks, both in developed and emerging markets, is that developing a successful SME banking business means adopting novel approaches to overcome unexpected challenges. We have assimilated the key challenges into six broad themes below.*

MARKET PLANNING INHIBITED BY POOR QUALITY DATA

EXISTING ORGANISATION STRUCTURE AND OPERATING MODEL NOT WELL SUITED TO SME MARKET

SME DEFAULT RATES AND LOAN LOSSES TEND TO BE HIGHER THAN CORPORATE CUSTOMERS

RELATIVELY LOW LOAN SIZE MEANS INTEREST INCOME ALONE NOT SUFFICIENTLY PROFITABLE

RELATIONSHIP MANAGERS AND RISK MANAGERS UNFAMILIAR WITH CULTURE OF BANKING SMES

“FIRST MOVER” ADVANTAGE OFFSET BY UNEXPECTED LOAN LOSSES OR REPLICATION BY COMPETITORS

## WHY TARGET THE SME MARKET?

Whilst there are problems to be solved, investment in developing a strong SME banking business remains a priority strategy for most banks for the following reasons.

### Large Market Size

In any economy, SMEs account for a significant proportion of economic activity, employment, and financial transactions. The potential profit pool for banks is therefore large.

### Lower Price-Sensitivity

Compared with larger corporates, SMEs are far less price-sensitive. They tend to be more concerned with access to financial services, and are willing to pay a premium for good service and the right products, delivered through convenient channels.

### Strong Customer Loyalty

Once they have been won as customers, SMEs are typically reluctant to move to another bank, and will provide stable income for many years. This contrasts with the behaviour of larger corporates who are usually multi-banked and will award transactions to different banks based on very fine price differentials.

### Lucrative Relationships

SMEs are often owned by high-net worth individuals. Many are also suppliers to larger corporates. By understanding these ownership structures and supply chains, and offering related products, banks can indirectly strengthen their private banking and corporate businesses.

### High Growth Potential

Most large corporations start out as SMEs. Banks that can identify and support good quality small enterprises may find that these grow into substantial corporate customers.

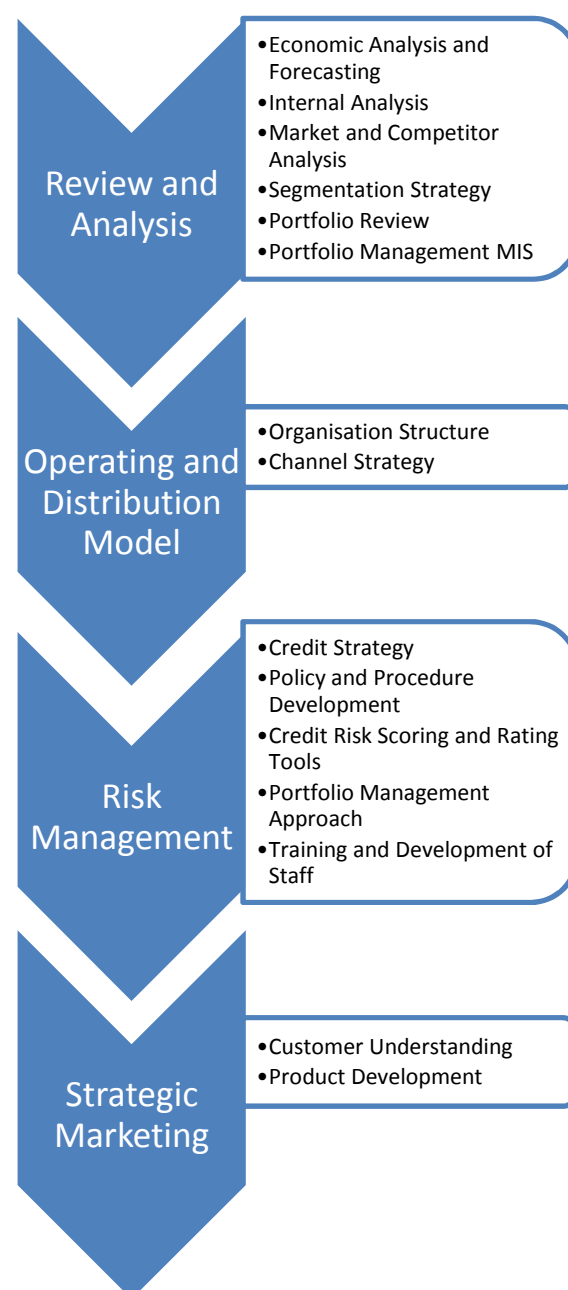
*GBRW can help your bank realise the benefits of investing in developing an SME banking franchise, through the extensive practical and consulting experience of the GBRW team throughout the world.*

## SUCCESS FACTORS FOR SME BANKING

1. **Superior Economic and Industry Sector Analysis:** Understand the market to identify and develop high growth/ high profitability segments.
2. **Market Leadership in Chosen Segments:** Carefully define your customer segments and be a leader in your chosen market rather than trying to win the whole of the SME segment.
3. **Cost Control:** Take advantage of opportunities for standardisation, process re-engineering, and adoption of new technology to improve efficiency and reduce costs.
4. **Separation of SMEs from Mid-Caps:** Mid-Caps differ from true SMEs not just in size but in the appropriate treatment strategy. In our view Mid-Caps are almost always better served within the Corporate banking segment, rather than diluting the focus on SMEs.
5. **Cross-Selling:** Maximise cross-sell opportunities to capture all the fee income and liability-side business you can, and also the lucrative personal business of directors and owners.
6. **Credit Scoring and Rating:** Adopt credit risk scoring and rating tools to radically improve the consistency of credit decisions, enhance portfolio management, improve customer service, and lower the costs of lending.
7. **Cash Flow Analysis:** Develop basic cash flow forecasting and analysis skills for both customers and staff, to overcome some of the challenges of misleading or missing financial statements.
8. **Risk-Based Pricing:** Improve loan loss forecasting and adopt risk-based pricing at sub-segment or customer level to maximise portfolio profitability.
9. **Business Culture:** Keep in mind the major changes in the business culture required to make SME banking a success. Adjust reward and incentivisation, performance management, and training and development to assist the transition.

10. **Leadership:** Make sure the SME business is sponsored at the most senior level, and the business has a Board-level profile.

**Fig. 1: GBRW Process Flow for Building a Successful SME Banking Business**



## **GBRW APPROACH TO SME BANKING**

GBRW is a leader in working with banks around the world, and particularly in emerging markets. We develop and deliver viable and profitable SME banking models through practical consulting. In a world of imperfect information, we have the experience to help banks achieve realistic solutions to addressing the SME market sustainably.

Our clients particularly value our focus on implementation, rather than just strategy development. GBRW is a consulting firm which understands these business challenges and we can assist across a wide range of SME banking issues. If you find some of these ideas and approaches useful or interesting, we would be happy to discuss with you the unique challenges of your own organisation, and how we might be able to assist.



### **MARKET UNDERSTANDING**

The SME market is not homogeneous, but covers a huge variety of different types of enterprise with widely varying financial needs. Identifying which segments of the market are most attractive to a bank, and how best to address their needs, will help ensure the success of the business. GBRW emphasises the following elements when working with banks:

#### **Economic Analysis and Forecasting**

We can undertake macro-economic and industry sector analysis to help identify the sectors and segments with the best growth and profit profiles. We assimilate the best high-level economic research and form a view about the trajectory of the economy over the next five years. The data is used to develop industry risk and sensitivity profiles with which to undertake scenario analysis against the SME portfolio. As well as individual customers, successful SME banking is about strategic exposure to the right areas of the economy.

#### **Internal Analysis**

We consider the bank's own portfolio. Using this more detailed portfolio data will add colour to the analysis and projections, and help target industry sectors and sub-segments with most attractive risk/reward ratios.

#### **Market and Competitor Analysis**

We use available data to estimate the size and composition of the broader SME market, and potential market share metrics. Also, we review competitor offerings and market positioning. As well as the potential attractiveness of a segment, we consider where your bank has competitive advantage in terms of skills, knowledge, or brand.

### **PORTFOLIO MANAGEMENT**

Underpinning almost all elements of a successful approach to SME banking is the concept of active portfolio management. At its simplest, this means that management has the necessary quality and quantity of timely information on the Bank's SME customers to understand how they are performing on an aggregated basis, and to forecast performance under different scenarios. More sophisticated approaches support even more granular and effective marketing and risk management strategies which can yield excellent financial performance. Whilst the portfolio management capacity will evolve over time, we suggest early thought is given to some of the fundamentals including:

## Internal Definition of SME Segment

We can advise on the most appropriate definition of SME customers from the bank's perspective, by size of the business, form of ownership, and current relationship. Care will be needed as branches may be reluctant to lose their best customers, while the corporate business may be eager to transfer their smaller problem customers. Although there may be a regulatory or national policy definition of SMEs, the bank should approach the definition from its own perspective. SMEs are valuable customers, not simply a demographic segment.

***“...create your own definitions for the SME market... they are valued customers, not just an economic demographic...”***

## Portfolio Review

GBRW can help you undertake a review of the existing SME portfolio, by first centralising all the SME account information. If this proves impractical an alternative is undertake a sampling exercise.

## Portfolio Management MIS

We can advise on the how the bank can best monitor its sector, client and product profitability, and to measure performance against budgets and business plans. For that the SME Unit is likely to need a customised Management Information System (MIS) Because customers will usually be managed by the branches, it is essential that customer and account level data is centrally warehoused. The on-going portfolio and market analyses can be integrated with the MIS to produce Probability of Default measures. Combined with the calculation of estimated losses on individual products, this will help drive decisions on pricing, credit analysis and marketing.

## SEGMENTATION STRATEGY

It is important to select carefully which parts of the SME market you wish to target with your SME banking proposition. GBRW can help you develop your segmentation strategy starting from the following principles:

### Aim for Leadership in Chosen Markets

In our experience, aiming for market leadership in closely targeted segments is usually more effective than seeking to capture a certain share of the overall SME market.

### Identify 20 High Potential Sectors

Identify the most promising 20 business sectors in terms of growth and/or consistently strong profitability e.g. medical, broadcasting, software development, transport, tourism. Also consider in which of those segments the bank may already have some momentum.

### Define Your Customers

It is important for management and sales staff to have a clear understanding of the typical profile of your preferred customer, using criteria such as ownership and management structure, size and type, links in the value chain, and maturity, amongst others. Consider the use of hypothetical customer profiles and/or case studies to bring this exercise to life.

### Consider Geographic and Demographic Factors

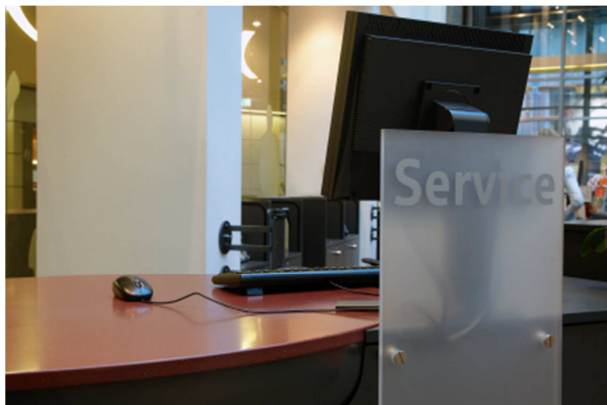
Economies can vary markedly from region to region. Your bank should make decisions about where its SME business is best concentrated. Try to select at least 10 preferred areas to develop the SME business in the initial phases. Naturally this should feed into your distribution strategy (which may be expanded once the strategy is shown to be working).

### Remember Your Existing Customers

You should be in a position now to clearly define and identify your current SME portfolio, which is most likely split between the Retail and Corporate businesses. Give early thought to identifying and tracking them, and pay attention to the migration strategy.

## DISTRIBUTION CHANNELS AND OPERATING MODEL

When establishing an SME business unit, the structure and business model will be quite different to either Retail or Corporate banking. There is no perfect solution but the goal is to develop and build a model which gives SME customers convenient access to the bank's services, while facilitating the cross-selling of a broad range of products, and ensuring that relationship managers are incentivised to maximise customer profitability. At the same time it will need to lower costs, ensure effective risk management and control, and maintain expected levels of service to the customer. Whilst this is a complex operational and business challenge, GBRW has found that adopting the following principles tends to result in more successful outcomes:



### Carefully Position the SME Unit

The positioning of an SME banking business within the organisation chart has often been a cause for contention, with competing arguments from Corporate and Retail. Neither is usually an ideal fit, and most banks with successful SME businesses position them independently, and ranked equally with other major business divisions. And remember that you do not have to use the term "SME" in the unit's title; on the contrary, it can make customer feel that they are considered less important than their large corporate counterparts. Use a name which will appeal to customers and staff, for example 'business banking', 'commercial banking', or "independent enterprise".

### Consider the use of SME Centres

Often the needs of customers can better be supported by creating designated and separate "SME Centres", even if they are located close to existing branches. These can act as a locus for expertise and improvement for SME banking in the area, enhancing the relationship with customers whilst also propagating best practice.

### Enable Electronic Channels

SME owner/managers often work under pressure, and welcome any service that facilitates day-to-day financial management and avoids time-consuming visits to the bank. Owners of young SMEs may themselves also be young, and very open to using electronic channels (internet banking, mobile phone banking etc.) to meet their core transactional needs. It is therefore important to incorporate a range of online services in the overall SME channel proposition.

## RISK MANAGEMENT

The GBRW team, comprising experienced former senior bankers, is exceptionally well placed to advise on risk management issues. We are experts in identifying the credit, market and operational risks inherent in the SME business and putting in place the appropriate processes, controls and mitigations to manage those risks. Our approach emphasises:

### Even Balance Sheet Growth

Whilst many SMEs are credit hungry, it is important that asset growth is balanced by deposit growth. Capturing liability-side business (i.e. current and savings deposit accounts) and generating an SME portfolio which is largely self-funding is a good guiding principle.

### Risk-Based Pricing

The benefit of good portfolio management and analysis is the ability to apply risk-based pricing at segment or even customer level. This makes sure that potential loan losses are well covered by profits and that good credits are retained through competitive pricing.

## SME BANKING: KEY PRINCIPLES

### **Risk Scoring and Rating Models**

These improve the consistency, predictability, speed, and cost of credit decision-making through the expert use of data and technology. GBRW has expertise in SME scoring and rating – *please contact us for more detailed information on our SME Credit Risk Scoring and Rating Tools and Models.*

### **Use of Cash Flow Forecasting and Judgemental Analysis**

We understand that good customer financial data is not always available for SMEs in emerging markets. However, we can help relationship managers to use simple cash flow forecasting tools, and to apply non-financial analytical approaches, to reach sound credit decisions.

### **Sensible Use of Collateral**

Collateral is not an excuse for poor lending decisions, but it is a useful tool to manage risk. But over collateralisation can make a bank uncompetitive. We can help reduce the dependency of the lending process on collateral by using credit scoring and rating data to introduce a 'sliding scale' of requirements.

### **Policies and Procedures**

We help develop standardised credit policies and procedures for staff, reducing cost, improving efficiency, and enhancing customer service.

### **Non-Performing Loans**

Any growing SME loan portfolio will include some problem loans, though if the business is based on a sound strategy and strong risk management, these will be within the budgeted parameters. Nevertheless the bank can minimise losses, and maximise potential returns, by quickly identifying customers who are experiencing difficulty and dealing with them through a well-structured process. This could include remedial measures, recovery, or write-off, depending on the position of the customer.



## **MARKETING STRATEGY**

GBRW has experience in developing marketing strategies for the Corporate, SME, and Retail segments. A marketing strategy for SMEs in particular, might need to consider some or all of the following elements:

### **Branding**

The SME business may need its own image and brand in order to differentiate its approach and what it does from the rest of the bank. It will also make SME customers feel that they are dealing with specialists who understand their particular needs.

### **Differentiating the Offer**

The bank will also need to differentiate its SME offering from those of its competitors. The most successful banks achieve that through their product and service range, their sub-segment focus, their marketing, and their delivery and branding. Price also has to be competitive, but concentrating on price competition is not a viable long-term strategy.

### **Watching the Competition**

Whilst innovation and differentiation pay dividends, it is also essential to monitor market developments and what the competition is doing. There is nothing wrong with replicating a competitor's product or approach if they are working successfully and can benefit your franchise.

## Sales Approach

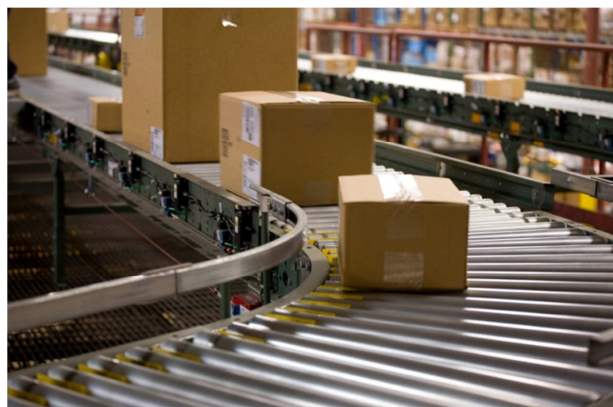
A different sales approach will be required by business developers and relationship managers to make the most of SME customers. You will need to develop appropriate marketing tools and distribution methods, and train front-line staff to identify customers' product needs and win their business using "consultative selling" techniques.

## Value Chains

The bank's major corporate relationships can be used as a means of identifying good customers in their supply chain. Products can be developed which deepen these relationships, such as supply chain finance (receivables and stock financing). Both your SME and corporate customers can benefit from an enhanced cash-flow whilst the risk profile of the credit is improved.

## Family Banking

Many SMEs are family-owned businesses, and are also often part of a larger network of individuals and enterprises linked by strong family and community bonds. To maximise the bank's business potential requires a well-coordinated approach between the SME and Retail banking businesses, e.g. to attract high-net worth personal accounts, or investment business.



***'...keeping relationship managers on the road and visiting clients in their own premises is a key factor in good sales as well as effective risk management.'***

## CUSTOMER UNDERSTANDING

Customer understanding is much more than just asking what your customer wants. More than likely they will tell you they simply want more credit at lower cost, which is usually unacceptable to the bank! Good customer understanding, however, gives the bank an advantage in negotiating a favourable compromise with the customer that is ultimately mutually beneficial. The GBRW approach emphasises:

### Focus Groups

For a variety of reasons, formal surveys of SMEs can be a disappointing in the quality or usefulness of information that they provide. Focus groups of SME customers are an extremely valuable, and relatively cheap, source of qualitative information on purchasing preferences, values, and behaviour.

### Benchmarking the Competition

Valuable ideas can be generated, and important lessons learned, by encouraging comparisons with the competition. Send your staff on a discreet mystery shopping exercise to see for themselves what the competition is doing well, and in what areas you have the advantage.

### Staff Insights

Front-line staff, who are dealing with customers and with the bank's products and processes all the time, can have great insight into customer needs and how the bank's service delivery can be improved. Encourage your product development, marketing, and sales teams to suggest new ideas, and remember to also look at regional and international banks for inspiration.

### Maximising 'Share of Wallet'

Unlike large Corporates, SMEs show greater loyalty to banks that support them. We believe that providing an SME with credit entitles you to EXPECT that customer to use you as a sole financial services provider – provided you offer adequate products and levels of service. Remember that profitable SME banking means aiming for 100% of a customer's "share of wallet".

### Service as well as Products

The overall customer experience encompasses products, service quality, channel and price. The bank can use its knowledge of customer preferences to guide customers towards more cost-effective solutions (e.g. internet banking, mobile banking, deposit/cash points). The staff resources freed from the branches can then be directed towards the sales force. Keeping relationship managers 'on the road' and visiting clients at their own premises is a key factor in effective selling as well as good risk management.

### Enterprise Development Services

Most SMEs do not have enough practical business support, and many fail needlessly. Many countries have schemes and institutions providing non-financial assistance to SMEs on a commercial basis or often free of charge basis. These "enterprise development" services typically include strategic or financial planning advice, legal, regulatory, and tax advice, and consulting and training across a wide range of skills. Banks can add value to their SME customers by linking up with existing Enterprise Development Services, or can even consider offering them directly through the bank.

## PRODUCT DEVELOPMENT

Good product development means mastering the art of keeping costs down whilst simultaneously meeting the full financial services needs of customers in a way that makes them feel valued. Through our extensive experience in customer and product development consulting for the SME market, GBRW can offer support in the following areas:

### Product Range

Banks can boost the profitability of SME customers by having a range of products which truly responds to customer needs, including liability-side, cash management, trade finance, and shorter-term secured asset finance. SMEs can markedly improve profit retention and capitalisation through a well-structured cash flow solution, which is ideal for both the customer and their bankers.

*'...promote value chain and trade finance products, and shorter-term secured asset finance, to improve cash-flow...'*

### Customer Segment Solutions

One way of quickly and efficiently gaining sales momentum in a desirable segment is through customer "offers" (products and product bundles, delivery mechanisms, pricing model etc.) tailored to the requirements and preferences of the identified target sub-segments. This makes customers feel that the bank is providing them with a solution that matches their exact needs, not just a generic SME proposition.

### Product Development Process

Getting new and innovative products on the market quickly and effectively is a core competence of any successful bank. Banks need to review regularly the existing product portfolio, design and launch new products to fill the gaps, and also put in place methodologies to design, test and launch products, profitably and with a minimum of risk.

## CONTACT DETAILS

To discuss your bank's needs in more detail, or to find out more, please contact one of the GBRW team.

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