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# Bank Financing to Small- and Medium-Sized Enterprises (SMEs) in Colombia

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## COLOMBIA - GOVERNMENT FISCAL YEAR

January 1 – December 31

### CURRENCY EQUIVALENT

(Exchange Rate Effective as of December 31, 2007)

Currency Unit                      Peso

2,014.76 Pesos = US\$1

### WEIGHTS AND MEASURES

Metric System

### SELECTED ABBREVIATIONS AND ACRONYMS

ACOI	<i>Asociación Colombiana de Medianas y Pequeñas Industrias</i> (Colombian Association of Small and Medium-Sized Industrial Firms)	Findeter	<i>Financiera de Desarrollo Territorial</i> (Municipal Financing Bank)
AI	<i>Agenda Interna para la Productividad y Competitividad</i> (Internal Agenda for Productivity and Competitiveness)	FNG	<i>Fondo Nacional de Garantías</i> (National Guarantees Fund)
ANIF	<i>Asociación Nacional de Instituciones Financieras</i> (National Association of Financial Institutions)	GDP	<i>Gross Domestic Product</i>
Asobancaria	<i>Asociación Bancaria y de Entidades Financieras de Colombia</i> (Banking and Financial Entities Association)	LIBOR	<i>London Interbank Offered Rate</i> (interbank rate)
Bancóldex	<i>Banco de Comercio Exterior de Colombia</i> (State Foreign Trade Export Bank)	LGD	<i>Loss Given Default</i>
BdR	<i>Banco de la Republica</i> (Central Bank)	MHCP	<i>Ministerio de Hacienda y Crédito Público</i> (Ministry of Finance and Public Credit)
CAF	<i>Corporación Andina de Fomento</i> (Andean Development Corporation)	Mipymes	<i>Micro, Pequeñas y Medianas Empresas</i> (Micro, Small and Medium-Sized Enterprises)
Confecámaras	<i>Confederación Colombiana de Cámaras de Comercio</i> (Colombian Confederation of Chambers of Commerce)	MCIT	<i>Ministerio de Comercio, Industria y Turismo</i> (Ministry of Industry, Trade, and Tourism)
CONPES	<i>Consejo Nacional de Política Económica y Social</i> (National Council for Economic and Social Policy)	PD	<i>Probability of Default</i>
DANE	<i>Departamento Administrativo Nacional de Estadística</i> (National Administrative Department of Statistics)	RM	<i>Relationship Manager</i>
DNP	<i>Departamento Nacional de Planeación</i> (National Planning Department)	SARC	<i>Sistema de Administración de Riesgo Crediticio</i> (Credit Risk Management System)
DTF	<i>Depósito a Termino Fijo</i> (Bank Deposit Certificate)	SEAF	<i>Small Enterprise Assistance Funds</i> (private investment firm)
FAG	<i>Fondo Agropecuario de Garantías</i> (Agricultural Guarantees Fund)	SENA	<i>Servicio Nacional de Aprendizaje</i> (National Training Service)
Fedesarrollo	<i>Fundación para la Educación Superior y el Desarrollo</i> (research and policy think tank)	SF	<i>Superintendencia Financiera</i> (Financial Superintendency)
Finagro	<i>Fondo para el Financiamiento del Sector Agropecuario</i> (Agricultural Financing Bank)	SME	<i>Small and Medium-Sized Enterprise</i>

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## Executive Summary

The purpose of this study, which forms part of a broader World Bank regional project, is to shed light on current trends and policy challenges in the financing of small- and medium-sized enterprises (SMEs) by banks in Colombia. The study is motivated by the well-documented financing gap for SMEs, whose causes are complex and multi-dimensional. The topic is particularly pertinent for Colombia, since access to credit has been cited as one of the most important constraints for SMEs.

In terms of approach, the study is primarily based on data collection and interviews with a representative sample of Colombian credit institutions and other relevant entities. The focus is on banks – the largest suppliers of external finance to SMEs – by analyzing the business and risk management models they use in this market segment, as well as the factors constraining their ability to provide more financing. Since the same exercise had already been undertaken for Argentina and Chile as part of the regional project, these countries serve as a benchmark with which to compare Colombia. While other important dimensions of SME financing – such as the demand side and broader non-financial sector considerations – are not analyzed in detail, the study should only be considered as part of a broader effort to ‘crack the multi-dimensional nut’ of SME financing.

SMEs represent an important part of the Colombian economy, although they are not well documented in official statistics. In particular, there does not exist sufficient periodic data as to their characteristics, evolution, or overall contribution to the economy – in most cases, SMEs tend to be bundled together with micro enterprises in official statistics. The true size of the market is understated due to informality. Lack of access to finance has been cited as an important problem in recent surveys. However, there are significant differences in perceptions as to the size and causes of the financing gap. While there is strong evidence to support its existence following the 1999 crisis, the significant growth of this market in recent years raises some questions as to whether such perceptions remain valid.

Public policy towards SMEs is coordinated by the *Sistema Nacional de Apoyo y Promoción de las Mipyme*. Government programs to support SME financing include long-term development funds (rediscounting lines at below-market rates) and partial credit guarantees by state-owned, second-tier credit institutions, especially Bancóldex and FNG. A recently-approved government document (CONPES 3484, August 2007) identifies some of the deficiencies in the micro-enterprise and SME segments and describes policy measures to promote these sectors. In addition, the authorities have recently embarked on the so-called ‘*banca de las oportunidades*’ initiative to improve financial access, including for SMEs.

The SME definition used by credit institutions is generally based on annual sales, but differs substantially between domestic and foreign banks. The former define SMEs within a much narrower annual sales range of around US\$0.1-5 million with differences largely determined by their respective target market, while the latter have adopted a common (and rather broad) definition across their global operations. Banking market practice does not therefore correspond with the legal definition of SMEs in Colombia, which is based on a firm’s assets and number of employees.

Credit institutions' exposure to SMEs has grown significantly in recent years (albeit from a low base) and currently comprises an important part of their loan portfolio. Asobancaria estimates that SME exposure had reached almost COP 17 trillion (around US\$8.5 billion, or 5 percent of GDP) as of March 2007, which is equivalent to more than one-fourth of the total commercial loan and lease portfolio of credit institutions. As much as one-fourth of all SME credits is supported by government programs, particularly FNG guarantees and Bancóldex rediscounting. Although data on non-performing SME loans is not available for these institutions, existing evidence suggests that they are relatively low.

SMEs represent a sizeable portion of the lending business of most credit institutions, particularly leasing companies; however, there are virtually no banks that currently specialize exclusively (or even predominantly) in SME lending. Market concentration is moderately high, with the market shares for the largest, top 3 and top 5 credit institutions in SME financing (23, 46 and 60 percent respectively) being only marginally higher than those for other credit market segments. However, given the high concentration in the leasing market segment, the provision of leasing services to SMEs is dominated by very few companies, virtually all of which are bank-owned.

The analysis of available background information and of the questionnaires indicates that bank financing to SMEs is becoming a strategic segment for Colombian credit institutions. In particular, growth (perceived profitability, stemming primarily from high loan spreads) is a decisive factor in their decision to target this segment. Cross-selling opportunities, diversification and market saturation were also cited as important drivers for SME involvement. This finding challenges the common belief that there is no interest in lending to SMEs. All interviewed credit institutions believe that the market's prospects are good and they expect it to continue growing, albeit at a slower pace than recently.

The business and risk management models for SME lending are still relatively underdeveloped, but greater sophistication is expected as the market matures. Banks are adapting their business practices by creating dedicated SME units, typically as part of the Retail Vice Presidency. Branches continue to dominate as distribution channels and specialized SME relationship managers are a relatively recent phenomenon. On-site visits and interaction with the SME owner remain crucial, while credit institutions do a fair amount of reaching out to potential clients by relying primarily on public databases and leveraging cross-selling opportunities. Loan products remain quite standardized and mostly short-term in nature. Leasing is a particularly popular financing product, while the use of factoring is still incipient. There is little differentiation in the treatment of SMEs by size or sector, while few banks have developed niche strategies or products to target specific client types. SME borrowers are analyzed on a case-by-case basis using traditional rating techniques based on both quantitative and qualitative factors; credit institutions have not yet begun to use automated credit scoring models in this market segment. Banks typically require collateral (mostly real estate) in order to lend to SMEs, and guarantees from firm owners ("*aval*") and government programs play a significant role; only a few banks have begun to collect default information that would allow them to measure loss-given-default parameters for SME loans. As a result, Colombia lags behind Argentina and Chile, where more sophisticated business models and practices have been adopted. However, as the SME financing market matures and becomes more competitive, it is expected that Colombian banks will increasingly start to catch up to regional peers.

Important institutional and policy constraints to SME lending remain but are not yet binding. Interviewed credit institutions highlighted several obstacles to further expanding lending: inherent SME characteristics (informality, availability/reliability of financial statements, management skills, family-owned structures), regulations (especially the interest rate ceiling on loans), the legal and contractual environment (particularly with respect to secured credit), as well as recent policy measures to cool the economy that provide conflicting signals to financial markets as to the government’s intentions. These constraints are not yet binding because of Colombia’s strong macroeconomic performance (which has led to relatively low NPL levels for SME exposures) and the lack of SME market saturation. In addition, banks have developed coping mechanisms by structuring their SME financing products – in terms of maturities, rates and use of collateral – to deal with some of these obstacles. However, unless relevant policy measures are taken, these constraints will increasingly ‘begin to bite’. In order to address them, a proposed policy agenda (see Table below) by main area and relevant stakeholder is identified below and discussed in detail in the study.

Policy Area	Relevant Stakeholders*	Policy Action
Macroeconomic Policy	<ul style="list-style-type: none"> <li>▪ BdIR</li> <li>▪ MHCP, SF</li> </ul>	<ul style="list-style-type: none"> <li>▪ Ensure positive macroeconomic environment, as well as a stable and consistent financial sector policy regime</li> </ul>
Legal & Contractual Framework	<ul style="list-style-type: none"> <li>▪ MHCP</li> <li>▪ Private sector (Chambers of Commerce, Asobancaria etc.)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Review and reform the legal framework for secured lending by consolidating diverse and overlapping legislation to enhance the ability of SMEs to pledge moveable property as collateral</li> <li>▪ Continue to improve the general framework for creditor rights and insolvency proceedings by strengthening enforcement procedures and registry systems</li> </ul>
Financial Sector Regulations	<ul style="list-style-type: none"> <li>▪ MHCP, SF</li> <li>▪ BdIR</li> <li>▪ Asobancaria</li> </ul>	<ul style="list-style-type: none"> <li>▪ Assess the effects of the interest rate ceiling (<i>tasa de usura</i>) on access to credit by SMEs and as a source of legal and regulatory uncertainty for credit institutions</li> </ul>
Government Support Programs for SMEs	<ul style="list-style-type: none"> <li>▪ MCIT, MHCP, DNP</li> <li>▪ FNG, Bancóldex</li> <li>▪ SENA</li> <li>▪ Private sector (Chambers of Commerce, Asobancaria etc.)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Evaluate government support programs, especially those of FNG and Bancóldex, to determine their additionality and to fine-tune them in order to better attain their intended objectives</li> <li>▪ Assess how such programs could support capacity-building activities for SMEs (i.e. financial literacy, business skill training etc.) and promote the development of new SME financing instruments (i.e. factoring, risk capital etc.)</li> <li>▪ Design incentives for SMEs to formalize (e.g. simplification of tax policy/administration, relevant labor and social security regulations, procedures/cost of inscription in commercial registries etc.)</li> <li>▪ Analyze and further streamline existing inter-institutional coordination of policies geared towards the SME market</li> </ul>
Statistics & Data Collection on SMEs	<ul style="list-style-type: none"> <li>▪ MCIT, MHCP, DNP</li> <li>▪ DANE</li> <li>▪ Private sector (Chambers of Commerce, Asobancaria etc.)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Unbundle SMEs from micro enterprises in official statistics</li> <li>▪ Improve periodic data collection on SMEs in order to identify their characteristics (size, economic sector, region, financial performance, contribution to employment and GDP, informality etc.) and to better understand the demand-side perspective</li> <li>▪ Expand SME definition to include annual turnover as a criterion</li> </ul>

\* The list of relevant stakeholders is not exhaustive, and other agencies would likely need to be involved for specific policy actions.

## 1. Introduction

1. **The purpose of this study is to shed light on current trends and policy challenges in the financing of small- and medium-sized enterprises (SMEs) by banks in Colombia.** In particular, the study, which forms part of a broader World Bank regional project on this topic (Box 1), has the following two objectives:

- to describe the evolution and characteristics of bank financing to SMEs in Colombia in recent years
- to identify remaining constraints that impede further growth of this market, and to develop relevant policy implications.

2. **The study is motivated by the well-documented financing gap for SMEs in many countries, whose causes are complex and multi-dimensional.** A number of studies have highlighted the importance of SMEs in overall employment and economic growth, as well as their financial constraints and perceived lack of access to finance<sup>1</sup>. Conventional wisdom, exemplified by an apparent U-shape in financing patterns, is that lending is easier for retail customers and large corporates. By contrast, lending to SMEs is complicated by a variety of factors that are identified and discussed in the relevant literature. The nature and complexity of these factors have often left policymakers and practitioners with few guidelines on how to best address them in a market-friendly and sustainable fashion, or on what the priorities (binding constraints) should be.

3. **The topic is particularly pertinent for Colombia, since the authorities have recently embarked on initiatives to promote SMEs and to expand financial access.** As described in section 2 of the study, access to credit has been cited as one of the most important constraints for Colombian firms. Given the importance of the micro and SME sectors to the economy, there have been several initiatives in recent years to promote their development using financial and non-financial policy instruments. In fact, the National Council for Economic and Social Policy (*Consejo Nacional de Política Económica y Social* or CONPES) has recently prepared a document on this topic, which includes strategies to expand access to financial services for SMEs as one of its components. In addition, and in response to the low level of financial penetration in Colombia, the authorities are currently adopting regulatory reforms in the context of the ‘*banca de las oportunidades*’ initiative (which includes a component to promote SME financing) in order to stimulate financial access.

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<sup>1</sup> See, for example Angeli and Generale (2005), Cull, Davis, Lamoreaux, and Rosenthal (2005), Beck, Demirguc-Kunt, and Maksimovic (2005), Beck, Demirguc-Kunt, Laeven, and Maksimovic (2006), Beck and Demirguc-Kunt (2006), OECD (2006), and Aghion, Fally and Scarpetta (2007).

## Box 1: World Bank's Latin American Regional Study on Bank Financing to SMEs

### **I. Motivation**

The purpose of the regional study, launched by the World Bank's Financial Policy Development (FPD) unit in the Latin American and Caribbean Region, is to better understand the nature and causes of the financing gap for SMEs in order to assist policymakers in thinking about ways to tackle this problem in a market-friendly and sustainable fashion. In particular, the study aims to bridge the gap between policy and research by providing an in-depth look at the specificities of the SME lending market, its determinants and evolution, for a selected group of Latin American countries. The results of the study are intended to enhance the Bank's policy dialogue with country authorities, improve the quality of future diagnostics in this area, and strengthen related technical assistance and policy advice.

### **II. Approach**

The approach of the study is to focus, mainly via on-site interviews of banks, on a key dimension of the problem, namely the bank lending supply side. Banks are the largest financial institutions that can potentially grant credit to SMEs, and are a better defined group to analyze and for which to obtain data. This approach is promising not just because of the dearth of studies of this type, but also because it sheds considerable light on the policy discussion regarding SME finance. Such a discussion has remained at too general a level largely because of insufficient understanding of the specificities of the SME lending technology and its interaction with the "environment", as characterized by – among other things – the degree of contestability in different credit markets, the quality of contract enforcement, as well as certain features of the prudential oversight framework.

While providing focus and a common thread to the policy discussion, the study remains limited in scope and excludes other important dimensions such as the demand side and financial structure of SMEs. However, it is only a first step in obtaining a better understanding of the relevant issues and additional work would be required.

### **III. Results To-Date: Argentina and Chile Case Studies<sup>2</sup>**

As part of this project, a detailed questionnaire was developed and used to interview banks from Argentina (14 banks; 75 percent of system assets) and Chile (8 banks, 79 percent of system assets). Responses from the questionnaire highlight the fact that the SME segment is a strategic sector for most banks, because they perceive it as highly profitable and large. To engage in this segment, banks are developing coping mechanisms that overcome the obstacles in SME financing. However, they have not yet fully adapted their business and risk models to reflect the complexity of SME lending; knowing the client is still crucial. SME financing is therefore in the midst of a structural change, and there seems to be an ongoing learning process through which banks are developing the necessary structure and mechanisms to reduce the high costs and improve risk management in this segment. Overall, it is expected that lending practices and risk management will change substantially in the years to come, as banks' involvement with SMEs matures.

4. **In terms of approach, the study is primarily based on data collection and interviews with a representative sample of Colombian credit institutions and other relevant entities.** The focus is primarily on bank financing to SMEs by analyzing why, how, and to what extent banks lend to this segment, the business and risk management models they use, and the factors constraining their ability to provide more financing. The reason for focusing only on banks – as opposed to considering other financial providers (e.g. capital markets) – is that banks are by far the largest suppliers of external (formal) finance to SMEs and they tend to dominate the domestic financial system in most countries, including Colombia. A detailed questionnaire was prepared in order to

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<sup>2</sup> See World Bank (July 2007) for the case studies of Argentina and Chile.

facilitate the analysis and collect – on a confidential basis – bank-level information on SME financing. Seven private banks and one leasing company, accounting for around two-thirds of the total system’s assets, participated in the interviews and data collection process<sup>3</sup>. In each bank, the team carried out separate interviews with the general manager, the SME business manager, and the credit risk manager, in order to bring together their perspectives on this market. This was complemented by data collection and on-site interviews with the authorities<sup>4</sup>, publicly-owned second-tier credit institutions<sup>5</sup> and other relevant organizations<sup>6</sup> to better understand the broader context and characteristics of the SME financing market in Colombia. Since the same exercise had already been undertaken for Argentina and Chile as part of the regional project, these two countries serve as a benchmark with which to compare Colombia in this study.

**5. It is important to recognize upfront the inherent limitations of the study’s scope and approach.** SME financing can be addressed from many different dimensions, and the paper only aims to provide a bank/supply-side perspective. Other dimensions – such as the demand side (e.g. structure and characteristics of SMEs) and broader non-financial sector considerations (e.g. informality, taxation, business environment etc.) – are mentioned but are not analyzed. The study also does not describe the Colombian financial system’s characteristics or evolution in detail<sup>7</sup>. Prior analytical work and evidence from other sources is used to complement the questionnaire responses in order to arrive at suitable policy implications. Some of these implications are at a high level either due to data unavailability or because they reflect issues that are outside the study’s scope, meaning that further analysis would be required in order to convert them into specific policy recommendations. The study should therefore be considered as only part of a broader effort to ‘crack the multi-dimensional nut’ of SME financing, although it provides useful suggestions for potential follow-up work in several related areas.

**6. The rest of the study is organized in five sections.** Section 2 provides an overview of SMEs and their financing patterns in Colombia, and briefly discusses public policy towards this sector. Section 3 presents some stylized facts about the evolution and type of bank involvement in SME financing, while section 4 identifies and analyzes the drivers underlying these stylized facts based on bank responses to the questionnaires. Section 5 describes in detail the business and risk management model that banks use in order to engage in SME lending, while Section 6 concludes and presents some policy implications.

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<sup>3</sup> Since leasing is an important financing instrument for SMEs in Colombia but it cannot currently be provided directly by banks, the interviews have included a major leasing company as well. It is worth noting that virtually all leasing companies belong to banks.

<sup>4</sup> These included the Ministry of Finance (*Ministerio de Hacienda y Crédito Público* or MHCP), the National Planning Department (*Departamento Nacional de Planeación* or DNP), and the Financial Superintendency (*Superintendencia Financiera* or SF).

<sup>5</sup> These included Bancóldex (*Banco de Comercio Exterior de Colombia*) and FNG (*Fondo Nacional de Garantías*).

<sup>6</sup> These included Fundes, ANIF (*Asociación Nacional de Instituciones Financieras*), Fedesarrollo (*Fundación para la Educación Superior y el Desarrollo*), Asobancaria (*Asociación Bancaria y de Entidades Financieras de Colombia*), ACOPI (*Asociación Colombiana de Medianas y Pequeñas Industrias*), SEAF (*Small Enterprise Assistance Funds*) Colombia, and Marulanda Consultores.

<sup>7</sup> See Stephanou and de la Cruz (September 2006) for a description of the Colombian financial system.

## 2. SMEs and their Financing in Colombia

### 2.1 What is an SME?

7. **The legal definition of SMEs in Colombia is based on a firm's assets and number of employees.** According to the so-called *Ley Mipyme* (Law 590/2000) as amended by Law 905/2004, small firms are defined as those with assets of 501-5,000 legal minimum monthly salaries (around US\$0.1-1.1 million) and 11-50 employees, while medium-sized firms are those with assets of 5,001-30,000 legal minimum monthly salaries (around US\$1.1-6.7 million) and 51-200 employees. As discussed below, this definition does not correspond to actual banking market practice that is based on firms' turnover, an indicator that often represents a better proxy of an SME's level of business activity and prospects than its assets or employees. However, according to article 84 of the recently-approved national development plan (*Plan Nacional de Desarrollo*) for 2006-2010, the government has the authority to introduce sales as an additional classification criterion and to change the relevant size ranges as deemed necessary.

8. **SMEs represent an important part of the Colombian economy, although they are not well documented in official statistics.** The main official source of information on SMEs is Colombia's statistical agency DANE (*Departamento Administrativo Nacional de Estadística*). Although the Superintendency of Companies (*Superintendencia de Sociedades*) also collects detailed financial information on firms, it does not gather data below a minimum threshold size that excludes the vast majority of SMEs. According to DANE's 2005 census, SMEs represented around 3.5 percent of all Colombian firms, employed around 30 percent of the labor force, and were divided in the ratio of 19-22-59 percent between the industry, commerce and service sectors respectively. By contrast, 2004 data of the Colombian confederation of chambers of commerce (*Confederación Colombiana de Cámaras de Comercio* or Confecámaras) shows that around 57,000 registered firms could be classified as SMEs based on their asset size (small firms represented 81 percent of that total); these accounted for 7 percent of the total number of firms and assets, and were divided 7-22-33-38 percent between the agricultural, industry, commerce and service sectors respectively<sup>8</sup>. The difference in results potentially stems from the fact that the DANE census covers a larger sample of companies including informal ones, but this hypothesis has not been tested. While DANE collects data by economic sector in addition to the census, it is difficult to compile this information by firm classification. As a result and in spite of the *Ley Mipyme* and the existence of government programs to support this segment, there does not exist sufficient periodic data as to SME characteristics, evolution, or overall contribution to the Colombian economy – in most cases, SMEs tend to be bundled together with micro enterprises in official statistics. The issue of insufficient information on SMEs has been discussed for some time but has not yet been resolved<sup>9</sup>.

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<sup>8</sup> Based on 2001 Confecámaras data, Rodríguez (2003) finds that one-half of all SMEs were based in Bogota and that their median age was around fifteen years.

<sup>9</sup> In response to the perceived information gap, ANIF, in collaboration with CAF (*Corporación Andina de Fomento*), the Colombian central bank (*Banco de la República* or BdIR) and Bancóldex, began a bi-annual

9. **The true size of the SME market is understated due to informality.** The aforementioned number of SMEs that are inscribed in the commercial registry of the chambers of commerce should be thought of as a lower bound estimate since they comply with the minimum requirement for being formal. Although both the definition and measurement of informality are complex issues, existing studies have estimated the size of the informal economy in Colombia between 35 and 44 percent of GDP, a figure that has apparently grown over the past decade<sup>10</sup>. This implies that a large proportion of firms (mostly micro enterprises, but also SMEs) is not captured in the official statistics<sup>11</sup>. While informality may confer firms with some advantages such as the ability to avoid paying taxes and social security contributions, it limits their possibility of receiving credit or accessing government support programs.

## 2.2 SME Financing Patterns

10. **Lack of access to finance has been cited as an important problem for SMEs.** While information on the financial performance and capital structure of SMEs is generally unavailable, existing surveys by Fundes, Fedesarrollo and ANIF indicate that supplier credit and bank borrowing (including leasing) are the main sources of external SME financing. Based on a 2003 Fundes survey of 687 SMEs whose results are summarized in Rodriguez (2003), access to finance was ranked the second most important constraint (particularly for smaller, industrial and younger firms) in the creation, development or diversification of their economic activities<sup>12</sup>. Within the access to finance category, credit conditions – relating primarily to interest rate, maturity, collateral requirements and lending procedures – were perceived to be the most important limiting factors. The perception of an inferior access to credit by small firms is also documented in surveys on credit conditions that were organized by BdlR between 2001 and 2005<sup>13</sup>. According to a recent government document on this sector (CONPES 3484 of August 2007 – see below), SMEs cannot access sufficient long-term borrowing to allow them to modernize their operations, while they lack alternative non-bank financing sources. Partly as a result, some SMEs resort to the use of informal lending sources – either the owner’s family or the so-called “*mercado extrabancario*” – to finance their activities; according to ACOPI’s survey, the latter financing mechanism is used by around one-fourth of SMEs.

11. **There are significant differences in perceptions as to the size and causes of the SME financing gap nowadays.** While there is strong evidence to support the

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survey in 2006 of the SME market – based on phone interviews with around 1,600 firms involved in industry, commerce and services – entitled “*La Gran Encuesta Pyme*”.

<sup>10</sup> See Cárdenas and Mejía (March 2007) for an overview in the case of Colombia, and Perry *et al.* (May 2007) for a regional perspective on the causes and implications of informality.

<sup>11</sup> According to the micro enterprise survey (“*Encuesta Microestablecimientos*”) regularly undertaken by DANE, around 40 percent of such firms are not inscribed in the commercial registry of the chambers of commerce, have not paid taxes, and report no financial statements, while two-thirds of such firms have not contributed to the social security system on behalf of their employees.

<sup>12</sup> In fact, individuals surveyed from the “supply side” (i.e. government, academia, associations and non-governmental organizations) ranked access to finance as the most important constraint for SMEs.

<sup>13</sup> See Murcia and Piñeros (March 2006) for more details.

existence of an SME financing gap following the 1999 crisis, the significant growth of this market in recent years raises some questions as to whether such perceptions remain valid. According to the 2007H1 *Gran Encuesta Pyme* by ANIF, 36-51 percent (depending on the sector) of surveyed SMEs had applied for banking credit (mostly for working capital purposes) in the last semester. Of those, 95-97 percent (depending on the sector) were approved, while 83-91 percent (depending on the sector) of those that had not applied stated that they did not need it. At face value, such a result would appear to contradict the aforementioned surveys that reported insufficient access to SME finance<sup>14</sup>. One explanatory factor could be that those SMEs complaining about access to finance are simply not sufficiently creditworthy to receive financing under normal circumstances. Of course, reasons underlying their lack of creditworthiness are diverse and could still represent a legitimate public policy objective – for example, their inability to pledge movable property as collateral. Another potential factor might be the choice of sample<sup>15</sup>: the ANIF survey covers SMEs that are registered with the chambers of commerce and are presumably formal (as can be seen in section 5, these are also the target customers of banks). The sample therefore excludes a potentially large universe of informal/semi-formal SMEs that cannot (or choose not to) tap the banking system. This hypothesis is supported by the reportedly large informality in the Colombian corporate sector, as well as by the responses of interviewed credit institutions (see section 4.4).

### 2.3 Public Policy Regarding Financing to SMEs

12. **Public policy towards SMEs is described in two recent CONPES documents.** Following the *Ley Mipyme* and in response to the objectives set in the previous national development plan for 2002-2006, CONPES document 3280 (April 2004) describes the authorities' strategy and policy measures for promoting domestic business development. The micro and SME sectors are highlighted as priorities given their importance to the economy, and several instruments of support are described. Non-financial instruments include training programs to increase competitiveness and promote technological development and exports, while financial instruments include programs to support development financing (see below). In terms of SME policy coordination, the Ministry of Commerce, Industry and Tourism (*Ministerio de Comercio, Industria y Turismo*, or MCIT) presides over the National System for the Support and Promotion of Micro Enterprises and SMEs (*Sistema Nacional de Apoyo y Promoción de las Mipyme*), which comprises a range of public and private, financial and non-financial, entities. The recently-approved CONPES document 3484 (August 2007) identifies some of the deficiencies in the micro- and SME segments<sup>16</sup> and describes policy measures to promote

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<sup>14</sup> Another potentially contradictory finding comes from the World Bank Group's 2006 Business Enterprise Survey for Colombia (<http://www.enterprisesurveys.org>), in which a sample of 1,000 firms (mostly micro enterprises and SMEs) rank access to finance as the fifth most important constraint, behind unfair competition from the informal sector, crime, taxation, and inadequate educational skills.

<sup>15</sup> See Claessens and Tzioumis (May 2006) for a broader discussion of the difficulties involved in surveying firms on their ease of access to finance. These include potential problems of endogeneity (e.g. self-selection in survey participation, simultaneity bias etc.) and definition ambiguity (e.g. on what constitutes reasonable cost or quality of service, access versus usage of finance etc.).

<sup>16</sup> In the case of SMEs, these include low innovation capacity, low use of information technology and communications, limited access to adequate finance, problems in commercializing products, and limited participation in public sector procurement.

these sectors as part of the authorities' national competitiveness strategy ("*Política Nacional de Competitividad*"). One of its components aims to increase financial access for SMEs by further expanding existing government programs (see below) and by promoting the development of alternative financing instruments (investment funds, factoring/supplier financing, fiduciary structures etc.).

**13. Government programs to support SME financing include long-term development funds and partial credit guarantees.** Longer-term development funding is mainly provided in the form of rediscounting lines at below-market rates by the state-owned, second-tier credit institutions Bancóldex<sup>17</sup>, Finagro<sup>18</sup> (*Fondo para el Financiamiento del Sector Agropecuario*) and Findeter (*Financiera de Desarrollo Territorial*)<sup>19</sup>. Partial credit guarantees – typically around 50 percent loan loss coverage – are provided by FNG<sup>20</sup>, as well as by FAG<sup>21</sup> (*Fondo Agropecuario de Garantías*) for the agricultural sector. As will be seen in sections 3 and 4 below, the role of these institutions – particularly Bancóldex and FNG – has been cited as instrumental in promoting access to credit for SMEs.

**14. The authorities have recently embarked on an initiative to improve financial access, including for SMEs.** The low level of financial penetration in Colombia, both in response to pre-crisis levels and compared to other regional peers, has prompted the authorities to take measures to expand access to credit and other financial services (Figures 2.1 and 2.2). Both demand- and supply-side barriers have been identified and will be tackled via regulatory reforms and the '*banca de las oportunidades*' initiative. Recent policy measures have included the introduction of correspondent banking arrangements<sup>22</sup>, changes in the definition of the interest rate ceiling, passage of legislation on credit reporting ("*Ley de habeas data*"), and strengthening of creditor rights via a new bankruptcy law (see section 4 for a discussion)<sup>23</sup>. Additional proposed reforms include changes to the civil code on enforcement procedures and to the financial system structure, as well as plans for the introduction of a special savings account for low-income households. In addition, the '*banca de las oportunidades*' initiative aims to design and propose measures to stimulate financial access, particularly for low-income

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<sup>17</sup> Bancóldex is an affiliate of the MCIT, and its main aim is to provide low-interest lines of credit via first-tier credit institutions for exporters and SMEs. It took on the discount portfolio and functions of another, currently defunct, second-tier credit institution (*Instituto de Fomento Industrial*) in 2002, and has in recent years reoriented itself towards becoming an "entrepreneurial development and foreign trade bank".

<sup>18</sup> Finagro was created in 1990 as part of the legislation that established the *Sistema Nacional de Crédito Agropecuario*. It is an affiliate of the Ministry of Agriculture, and its main aim is to provide low-interest financing for agriculture, livestock, forestry and related rural projects.

<sup>19</sup> Findeter is an affiliate of MHCP, and it was set up in 1989 in order to lend (via first-tier banks) to sub-national entities for infrastructure and other development projects.

<sup>20</sup> FNG was created in 1982 and is an affiliate of the MHCP. It is a guarantee fund that 'backs' credits to all economic sectors (except agriculture) with the primary objective of facilitating access to credit for micro enterprises and SMEs.

<sup>21</sup> FAG is a guarantee fund housed within Finagro that 'backs' working capital and investment loans for the agricultural sector that are financed either with Finagro discounting or with a credit institution's own funds.

<sup>22</sup> Correspondent banking arrangements refer to bank partnerships with typically non-bank commercial outlets in order to provide a range of banking services, such as payments and transactions.

<sup>23</sup> See World Bank (November 2006) for more details. The World Bank has contributed substantially to the definition of this agenda via non-lending technical assistance on some of these topics.

households. The initiative includes a component to promote SME financing that is being drafted.

Figure 2.1: Colombia – Evolution of Domestic Credit to Private Sector (1960-2006)

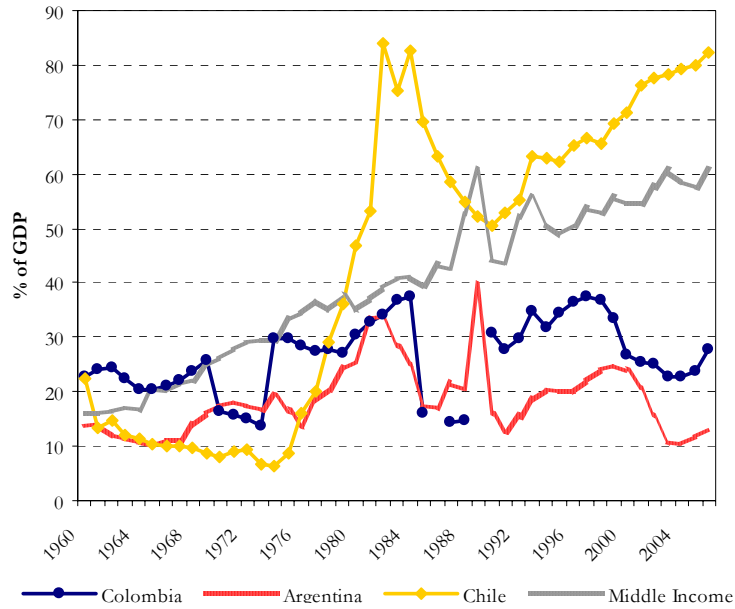
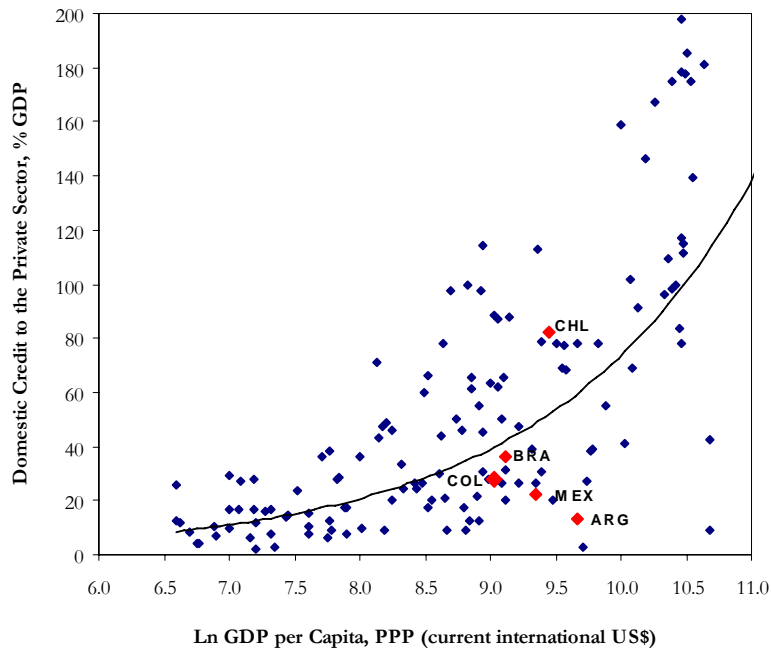


Figure 2.2: Cross-Country Comparisons of Domestic Credit to Private Sector (2006)



Source: The World Bank (World Development Indicators).  
 Note: CHL = Chile, COL = Colombia, BRA = Brazil, MEX = Mexico, ARG = Argentina.

### 3. Stylized Facts on Banks' Involvement with SMEs

#### 3.1 Banks' Definition of SMEs

15. **The SME definition used by credit institutions is generally based on annual sales, but differs substantially between domestic and foreign banks.** In particular, all interviewed credit institutions are using annual turnover in their classification of borrower type, while only one bank also used total assets. This drives a wedge between the SME universe based on the legal definition and the one that is attended by the banking system. As can be seen in Table 3.1, the range for Colombia appears relatively large, but this can be attributed to the inclusion of international banks that have adopted a common (and rather broad) SME definition across their global operations. By contrast, most domestic Colombian banks define SMEs within a much narrower annual sales range of around US\$0.1-5 million, with differences largely determined by their respective target market. This range is quite narrow compared to the one used by banks in Argentina and Chile, particularly with regards to the definition of a medium-sized firm.

Table 3.1: SME Definition Used by Credit Institutions

	Lower Bound of Sales to Define a SE (US\$ Million)			Upper Bound of Sales to Define a SE (US\$ Million)		
	Average	Min	Max	Average	Min	Max
	Argentina	\$ 0.3	0	\$ 1.3	\$ 4.6	\$ 0.8
Colombia	\$ 0.4	0	\$ 2.5	\$ 2.5	\$ 0.5	\$ 10.0
Chile	\$ 0.1	0	\$ 0.2	\$ 1.6	\$ 0.9	\$ 2.3

	Lower Bound of Sales to Define a ME (US\$ Million)			Upper Bound of Sales to Define a ME (US\$ Million)		
	Average	Min	Max	Average	Min	Max
	Argentina	\$ 4.6	\$ 0.8	\$ 12.0	\$ 30.0	\$ 10.0
Colombia	\$ 2.5	\$ 0.5	\$ 10.0	\$ 12.8	\$ 3.1	\$ 50.0
Chile	\$ 1.6	\$ 0.9	\$ 2.3	\$ 23.8	\$ 2.0	\$ 50.0

Source: Authors' analysis of bank questionnaires, World Bank (July 2007).

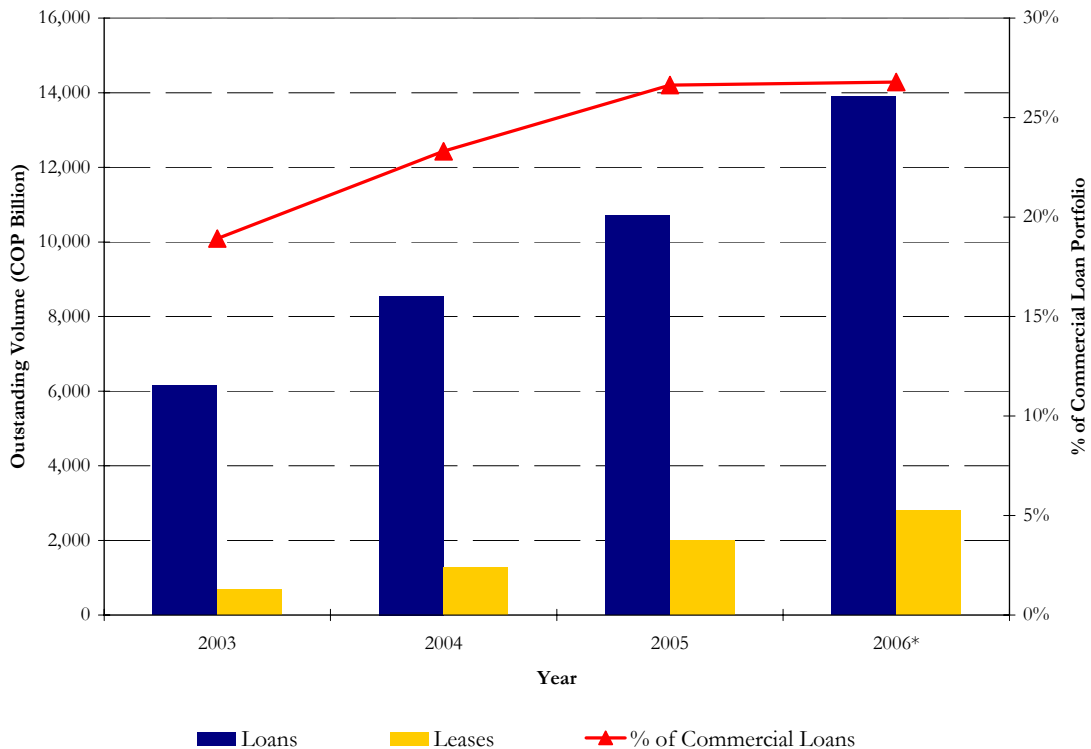
Note: SE and ME refers to Small- and Medium-Sized Enterprise respectively. Simple averages are used in the above estimation.

#### 3.2 Extent of SME Lending

16. **Credit institutions' exposure to SMEs has grown significantly in recent years and currently comprises an important part of their commercial loan portfolio.** An exercise by Asobancaria on the size of the SME credit market (both loans and leases) based on the legal definition of SMEs shows a rapid increase from a low base in 2003 (Figure 3.1). According to this exercise, the share of SME exposure had almost doubled in less than 4 years and had reached almost COP 17 trillion (around US\$8.5 billion, or 5 percent of GDP) as of March 2007, which is equivalent to more than one-fourth of the total commercial loan and lease portfolio of Colombian credit institutions. In fact, this figure is likely to underestimate the true size of the market given the methodology that is

used<sup>24</sup>; for example, a similar exercise recently undertaken by the SF estimates the size of this market at COP 22 trillion as of end-2006<sup>25</sup>. It is interesting to note that, while interviewed credit institutions reported different SME portfolio volumes depending on whether the legal or business definition of SMEs was used, the combined total SME exposure across all interviewed credit institutions was fairly similar for both definitions. Finally, it is worth highlighting the significant growth of leasing in recent years, which represents an important source of longer-term SME funding (see section 5 below).

Figure 3.1: Evolution of SME Loan and Lease Portfolio by Credit Institutions (2003-2006)



Source: Asobancaria. \* Figures for 2006 are for November.

Note: The legal (as opposed to the business) definition of SMEs is used in the above Figure.

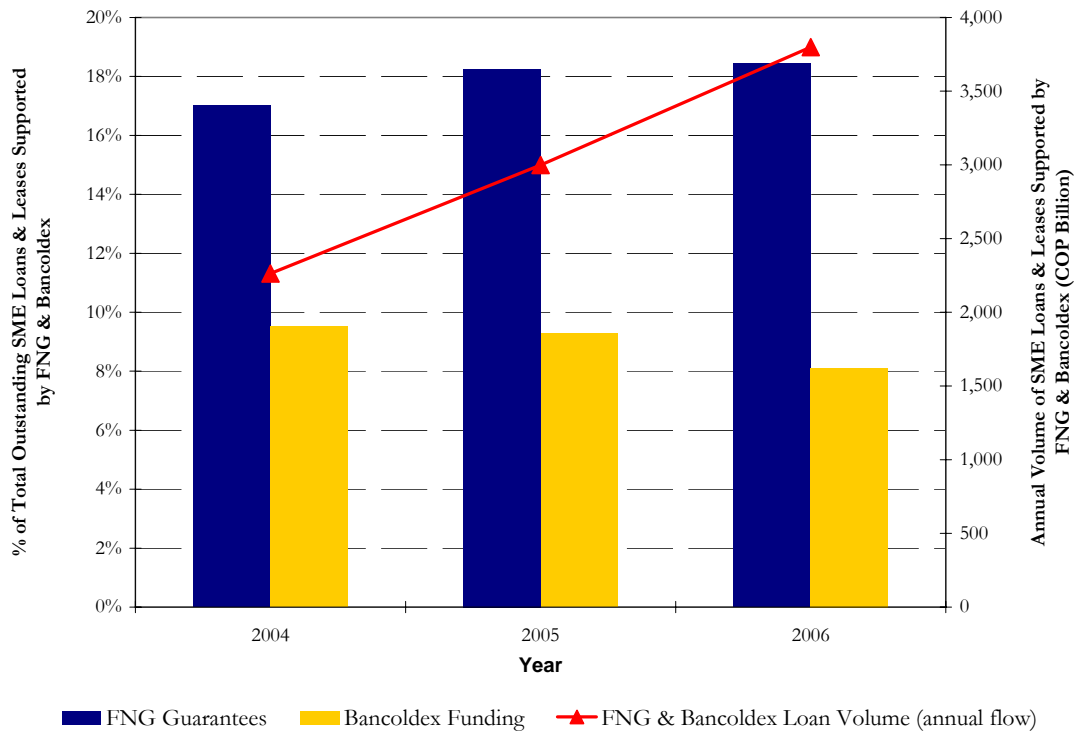
17. **A substantial proportion of all SME credits is supported by government programs.** In particular, as can be seen in Figure 3.2, it is estimated that FNG guarantees and Bancóldex rediscounting had ‘mobilized’ SME loans and leases amounting to COP 4.5 trillion as of end-2006, which represented around one-fourth of outstanding SME exposures based on Asobancaria’s figures. Both institutions have significantly expanded their operations in recent years (see section 4.3), although their contribution has remained relatively unchanged since 2004 given the growth in this market. Although data on non-performing loan rates is not available on a disaggregated basis (e.g. by program type or loan size) for these institutions, existing evidence suggests that these remain relatively

<sup>24</sup> Asobancaria has compared the tax identification numbers of 45,000 borrowers in its credit bureau (CIFIN) against those found in the database of Confecámaras. Only credits to those firms identified as SMEs (based on reported asset size, per the legal definition) were included in the total market size. This excludes the possibility that other borrowers that are not captured in the database (e.g. because their tax identification numbers could not be matched) are, in fact, SMEs.

<sup>25</sup> This figure excludes personal loans to SME owners that are actually used to fund their business activities.

low<sup>26</sup>. It should be noted that the share of government support – which is among the highest in Latin America – is likely to be marginally greater than shown below due to the existence of financing programs in the agricultural sector via Finagro and FAG that also cover SMEs, although specific figures are unavailable<sup>27</sup>.

Figure 3.2: FNG and Bancoldex Support for SME Loans and Leases (2004-2006)



Source: Authors' analysis based on figures provided by Asobancaria, FNG and Bancóldex.

Note: The legal (as opposed to the business) definition of SMEs is used in the above Figure. Since the average FNG guarantee is around 50 percent of a loan's value, only one-half of the 'mobilized' FNG-related loan volume shown above is actually backed up by an FNG guarantee. In order to convert annual flows to end-of-year stocks, the average duration of an FNG-guaranteed SME loan and of a Bancóldex-funded SME loan are assumed to be 1.1 and 1.5 years respectively. A few SME credits funded by Bancóldex are also supported by an FNG guarantee, but this potential double-counting issue is not significant in size.

18. **SMEs represent a sizeable portion of the lending business of most Colombian credit institutions, particularly leasing companies.** As can be seen in Figures 3.3 and 3.4 below, SME exposures (using the legal definition of SMEs that is based on assets) represent around 23 percent of the total loan and lease portfolio across all Colombian credit institutions. This market segment is particularly important for a few finance companies and almost all leasing companies, although there are virtually no banks that currently specialize exclusively, or even predominantly, in SME lending.

<sup>26</sup> The average net-of-recoveries loss rate on FNG's guarantees portfolio has averaged around 2 percent in the last few years, while the exposure of Bancóldex in its rediscounting facilities is to the credit institutions themselves and not to the ultimate borrowers; both institutions have been profitable in recent years.

<sup>27</sup> Finagro's total outstanding credit portfolio amounted to COP 3.3 trillion as of end-2006. Around COP 0.3 trillion and COP 1.6 trillion were disbursed during 2006 – via credit institutions (primarily *Banco Agrario*) – to small/medium-sized agricultural companies and to individual and 'associative' producers respectively, some of which can be classified as SME credits. FAG reports outstanding guarantees on agricultural loans totaling COP 1.7 trillion that were mostly funded by Finagro.

Figure 3.3: SME Exposure as % of Net Loans and Leases of Banks (2006)

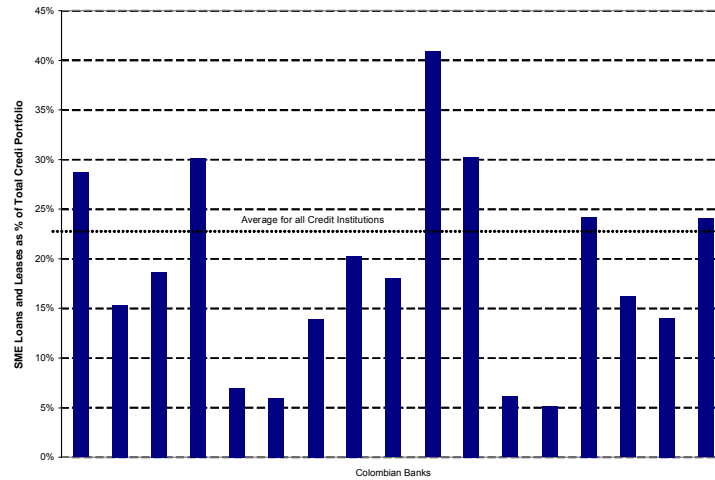
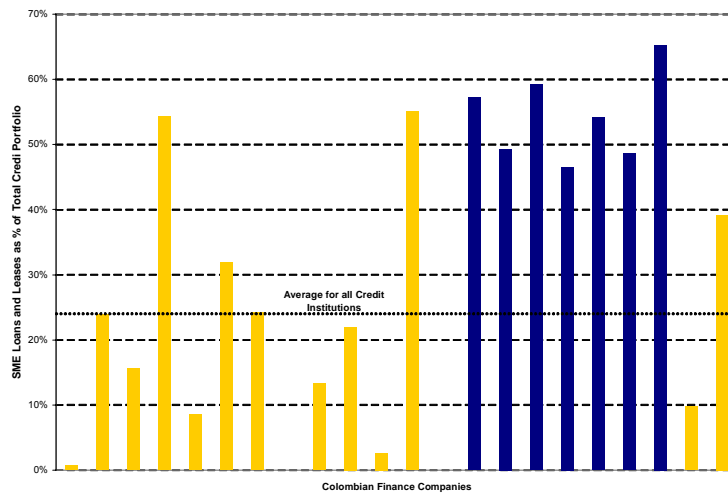


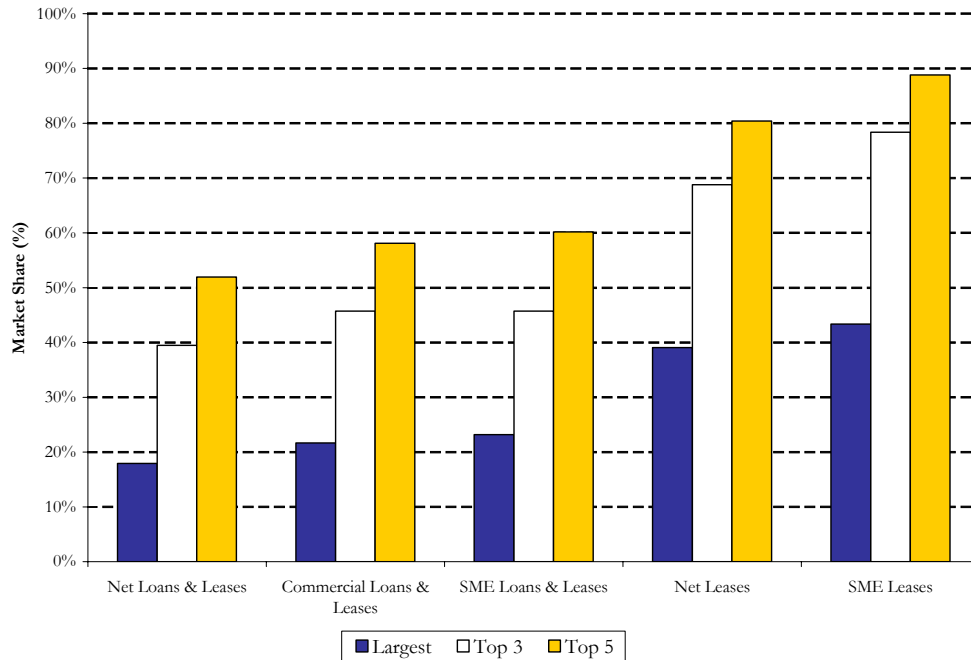
Figure 3.4: SME Exposure as % of Net Loans and Leases of Finance Companies (2006)



Source: Authors' analysis based on figures provided by SF.  
 Note: The legal (as opposed to the business) definition of SMEs is used in the above Figures. Finance companies shown in Figure 3.4 include both general commercial finance companies (shown in light bars) and specialized leasing companies (shown in dark bars).

19. **The provision of SME financing by credit institutions is not significantly more concentrated than other credit market segments.** As can be seen in Figure 3.5, the market shares for the largest, top 3 and top 5 credit institutions in SME financing (23, 46 and 60 percent respectively) are only marginally higher than those for other credit market segments. However, given the high concentration in the leasing market segment, the provision of leasing services to SMEs is dominated by very few companies.

Figure 3.5: Concentration of Loan and Lease Market (2006)



Source: Authors' analysis based on figures provided by SF.

Note: The legal (as opposed to the business) definition of SMEs is used. The largest, top 3 and top 5 (by market share) credit institutions for each loan market segment – not necessarily the same entities across all segments – are shown in the above Figure.

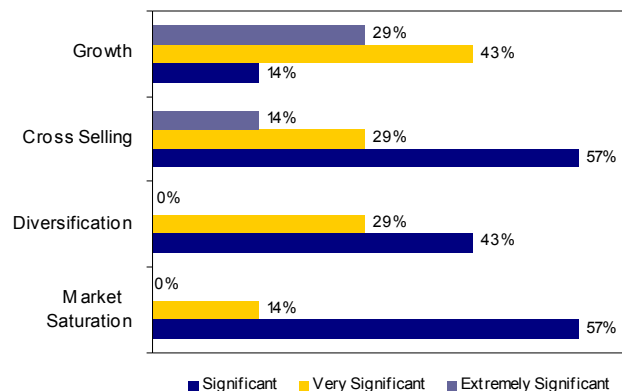
20. **A favorable macroeconomic conjecture has led to relatively low non-performing loan (NPL) levels for SME exposures until now.** After a long period of shrinkage due to the 1999 crisis, financial intermediation begun to recover in 2004 and has accelerated since then across most market segments. According to the SF, the proportion of riskiest SME loans and leases (i.e. those classified C, D and E) was only around 3.2 percent as of end-2006, compared to 2.6 percent for large firms. This represents a substantial improvement in loan quality since 2000, when the commercial loan portfolio's NPL rate had exceeded 14 percent. As will be discussed later in the study, the combination of benign external and strong domestic macroeconomic conditions has boosted liquidity and helped to maintain SME credit growth in spite of important institutional deficiencies. However, this favorable NPL performance might not continue going forward as the macroeconomic cycle turns and as credit institutions increasingly move down the credit risk curve in search of new SME clients.

## 4. What is Behind these Stylized Facts?

### 4.1 Drivers

21. **The SME market is becoming a strategic sector for Colombian credit institutions, primarily due to its perceived profitability and growth potential.** All interviewed banks have SMEs among their clients, although their degree of involvement and the sophistication of their business models differ substantially. As can be seen in Figure 4.1, growth (perceived profitability) is a decisive factor in banks' decision to target this segment, as they believe that the potential profits – which stem primarily from high loan spreads – more than compensate for the elevated costs and risks associated with this business. In addition, a few banks that had not previously focused on this market segment are discovering the cross-selling opportunities available to them in having a large number of SMEs as depositors but not as borrowers. Diversification (for banks heavily concentrated in other business lines) and market saturation (for banks focused on mature and less profitable market segments, e.g. corporate banking) were also cited as important drivers for increased SME involvement.

Figure 4.1: Drivers of Banks' Involvement with SMEs



Source: Authors' analysis of bank questionnaires.

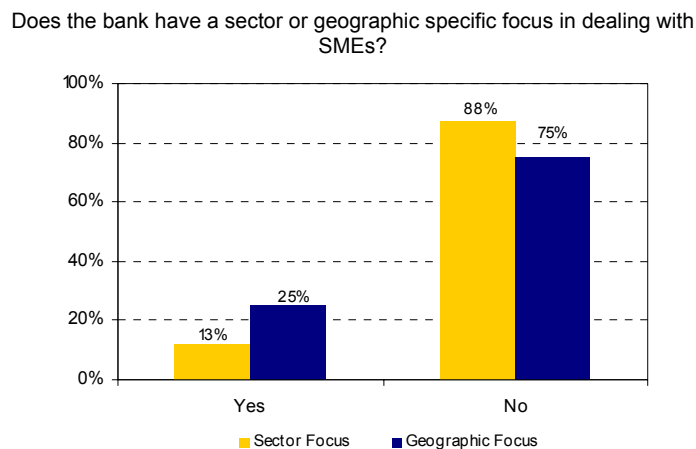
Note: The Figures do not add up to 100 percent because credit institutions provided more than one responses.

### 4.2 Market Environment

22. **Banks are optimistic about the prospects of this market segment, as it is still relatively immature and not saturated.** Virtually all interviewed credit institutions believe that the SME financing market is big and its growth prospects are good. They expect the market to continue growing, albeit at a slower pace than recently since it is becoming increasingly competitive. In spite of its growth in recent years, there have been no significant changes in market structure with a few large domestic banks and leasing companies being the main players, although international banks and smaller domestic credit institutions have also been growing their operations. Most interviewed banks perceive that there is a first mover advantage, as SMEs tend to use fewer banks (1-3 on average), exhibit greater loyalty, and do less switching and shopping around than

corporate clients. Another indicator of the lack of market saturation is the fact that most banks have not yet developed niche strategies to target SMEs (Figure 4.2).

Figure 4.2: Sector-Specific and Geographic Focus in Dealing with SMEs



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

### 4.3 Government Programs

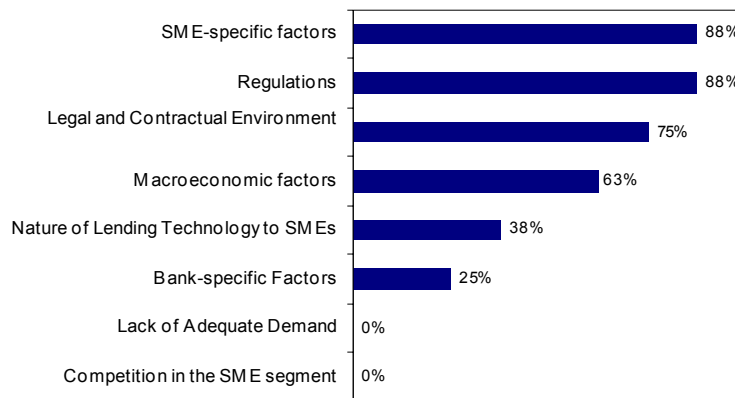
23. **Although banks stressed the overall positive role of government programs, particularly FNG and Bancóldex, a rigorous assessment of their impact on the SME market has not yet been made.** Virtually all interviewed banks agreed on the positive role played by FNG and Bancóldex in helping them mobilize financial resources to SMEs. In particular, a number of policy actions in recent years<sup>28</sup> have enabled FNG to significantly expand its operations, while banks have expanded their use of Bancóldex discounting facilities in order to increase the maturity of SME financing. In addition, special Bancóldex credit lines – such as the “*aPrograssar*” program – and regional alliances/partnerships provide assistance and long-term funding for entrepreneurial training, technological innovation, and research and development related to SMEs. However, in spite these positive developments, banks consider that more government assistance is required in areas such as capacity-building (e.g. financial literacy to improve the overall quality of financial statements/business plan proposals, business skill training for SME owners etc.) and providing incentives for SMEs to formalize (see below). In addition, it is important to note that the effective contribution of government-sponsored SME financing programs in terms of enhancing access and other key objectives compared to a suitable baseline has not yet been assessed. This is an important consideration, especially in light of the scaling up in the operations of Bancóldex and FNG activities going forward, as affirmed by their respective business plans and as mentioned in the CONPES document 3484 (August 2007).

<sup>28</sup> These include the admissibility of its guarantees for loan loss provision purposes (1999), an increase in its capitalization (2000), its inclusion as a financial institution subject to SF oversight (2004), as well as the development of new products and operational improvements that automated the granting of guarantees. See Llisteri et al. (2006) for a description.

#### 4.4 Obstacles

24. **Important institutional and policy constraints remain, although they are not currently binding.** As can be seen in Figure 4.3, interviewed banks cited SME-specific factors, regulations, the legal and contractual environment, and macroeconomic factors as the most pressing obstacles to further expanding credit to SMEs (see below for a description of each factor). The nature of lending technology to SMEs (e.g. cost of applying traditional credit assessment techniques) and bank-specific factors (e.g. limited geographic coverage, inflexibility in lending procedures) were mentioned in a few cases by banks as pressing obstacles in mobilizing SME finance, while the lack of adequate demand and excessive competition in the SME segment were not considered as important constraints.

Figure 4.3: Obstacles to Banks' Involvement with SMEs



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

25. **Inherent SME features represent some of the main obstacles to lending.** As stated in the relevant literature<sup>29</sup>, some of the intrinsic characteristics of SMEs – heterogeneity in their activities, informality, unavailability and unreliability of financial statements<sup>30</sup>, low managerial capacity of owners, and their family-owned nature – complicate their assessment of creditworthiness and increase transaction costs<sup>31</sup>. In addition to the results of this questionnaire, this finding seems to be corroborated by a recent Asobancaria survey of 5 major banks that stresses the importance of SME-specific

<sup>29</sup> For example, see the Latin-American Shadow Financial Regulatory Committee (September 2004), OECD (2006), and Beck and Demirguc-Kunt (2006).

<sup>30</sup> The quality of financial reporting is not solely an SME issue; see World Bank (July 2003) for an assessment of the accounting and auditing standards for Colombia.

<sup>31</sup> This is also stated in CONPES document 3280 (April 2004) on government programs to support business development: “*las barreras de acceso al crédito de las MIPYMES, en la mayoría de los casos, no tienen relación directa con la oferta de la banca de desarrollo, sino con aspectos como la baja calidad de la información que reportan las MIPYMES para la evaluación de riesgo por parte de los intermediarios financieros, la insuficiencia de garantías y el deficiente cumplimiento de las obligaciones de crédito reflejado en la historia crediticia de algunas de estas empresas*”. See also Felaban, CII and FOMIN/BID (January 2007) for a recent survey of the main barriers for accessing SME credit according to banks in several Latin American and Caribbean countries.

features (Table 4.1)<sup>32</sup>. In fact, several of the interviewed credit institutions had partnered up with other organizations (e.g. universities, Fundes, ANIF, the National Training Service SENA etc.) in order to provide free/low-cost non-lending technical assistance to their SME clients on issues such as financial statements preparation, business plan design, registration procedures, tax policy etc. Although these problems lie beyond the realm of the financial sector per se, these institutions perceive the need to deal with them in order to expand their SME borrower base.

Table 4.1: Main Obstacles Cited by Banks for SME Financing (February 2007)

<b>Obstacle</b>	<b>Importance*</b>
Quality of financial information	1.4
Informality of company	1.4
Lack of payment history	1.8
Low capacity to pay	2.4
Weak financial structure of project	2.4
Quality of management	2.6
Lack of guarantees	2.8
Internal bank risk policies	3.4
Lack of specialization in market segment	3.8
Government regulations	4
Low profitability for this type of loan	4.2

*Source: Encuesta Pymes Asobancaria.*

*\* Importance is ranked from 1 to 5, with 1 being the most important.*

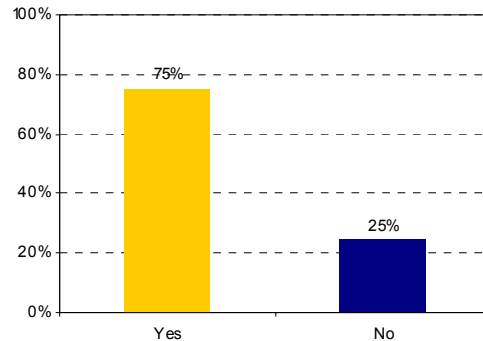
26. **Credit institutions perceive the interest rate ceiling as a significant source of legal and regulatory uncertainty.** The ceiling, whose violation represents a penal code offense, applies to all loans granted by supervised financial institutions. Its technical method of calculation has been frequently modified in recent years in order to achieve specific policy objectives, but often in a non-transparent manner<sup>33</sup>. The existence and continuous re-interpretation of the ceiling (as well as the manner in which it is modified) also creates legal uncertainty for credit institutions – for example, with respect to whether the current ceiling applies only to newly-originated loans or to the outstanding credit stock as well.

<sup>32</sup> However, the Asobancaria survey results need to be treated with caution. Other important SME financing obstacles are either not mentioned (e.g. legal and contractual environment, macroeconomic stability) or are not deemed to be very important (e.g. lack of guarantees, government regulations), which is a surprising result in light of credit institutions' responses to the questionnaire in this study.

<sup>33</sup> See Asobancaria (2007) for a description. The methodology for estimating the interest rate ceiling is now publicly available from the website of the SF ([www.superfinanciera.gov.co](http://www.superfinanciera.gov.co)).

Figure 4.4: Interest Rate Ceiling as Obstacle to SME Lending

If there are maximum regulatory lending rates, do they prevent you from expanding SME lending?



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

27. **Although not as binding due to recent policy measures, the ceiling appears to hinder access to credit for riskier SMEs.** Both the method of calculation and periodicity of the ceiling were recently changed<sup>34</sup>, effectively raising the maximum interest rate that can be charged for commercial (including SME) loans. However, as can be seen in Figures 4.5 and 4.6 below, there is a relatively large number of SME borrowers whose interest rates lie just below the ceiling. This is an indication, albeit one that has to be validated in more detail, that access to credit by the official banking system might be restricted for some firms – presumably smaller and younger ones – forcing them to use alternative sources of financing, including the “*mercado extrabancario*”<sup>35</sup>. The problem is particularly acute for those firms transitioning from micro enterprise to SME status based on the legal definition, because the effective interest rate ceiling for the former is much higher than for the latter. Not only is the legal ceiling for microcredit (currently 33.9 percent) higher than for SME loans (currently 28.5 percent), but an additional 4.5-7.5 percent commission (depending on loan size) can also be charged by credit institutions in the case of microcredit. The extent of the problem depends on each credit institution’s target market, with those focusing on smaller firms (primarily domestic banks) being the ones that are most exposed (Figure 4.4).

<sup>34</sup> The ceiling had traditionally been calculated on a monthly basis as 1.5 times the average current interest rate across all types of loans (except mortgages, whose ceiling is estimated separately). Decrees 4090/2006 and 519/2007 introduced sector-based interest rate ceilings (a common ceiling for commercial and consumer credit was adopted), changed their re-setting frequency from monthly to quarterly, and excluded loans at preferential rates (“*créditos de tesorería*”) from their calculation.

<sup>35</sup> An alternative hypothesis would be that credit institutions have sufficient market power to maintain interest rates for certain SME borrowers to the highest possible level, so the interest rate ceiling helps to control predatory pricing. This hypothesis can only be validated empirically via borrower/loan-level analysis, but available evidence – for example, on SME market concentration and on the use of multiple banks by most SMEs – seems to cast doubt on its validity.

Figure 4.5: Distribution of New Loans to Small Firms by Interest Rate (2006Q4)

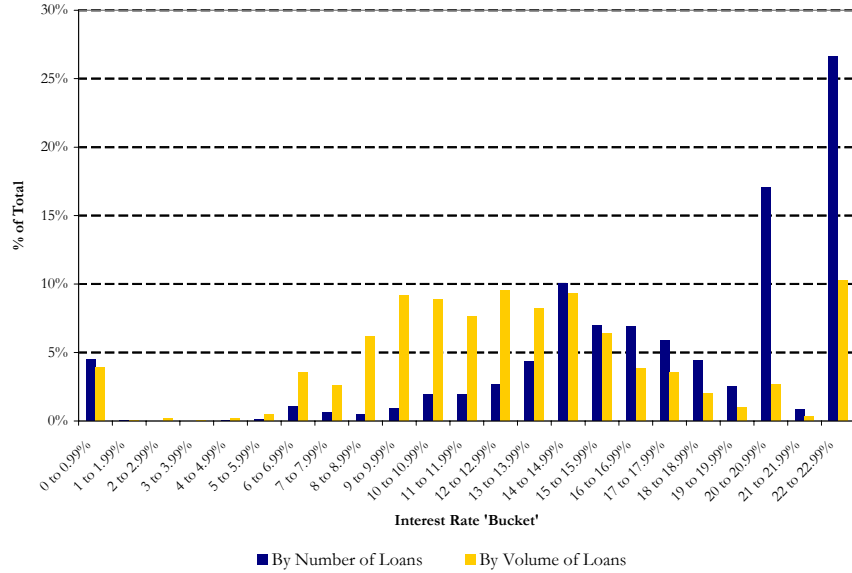
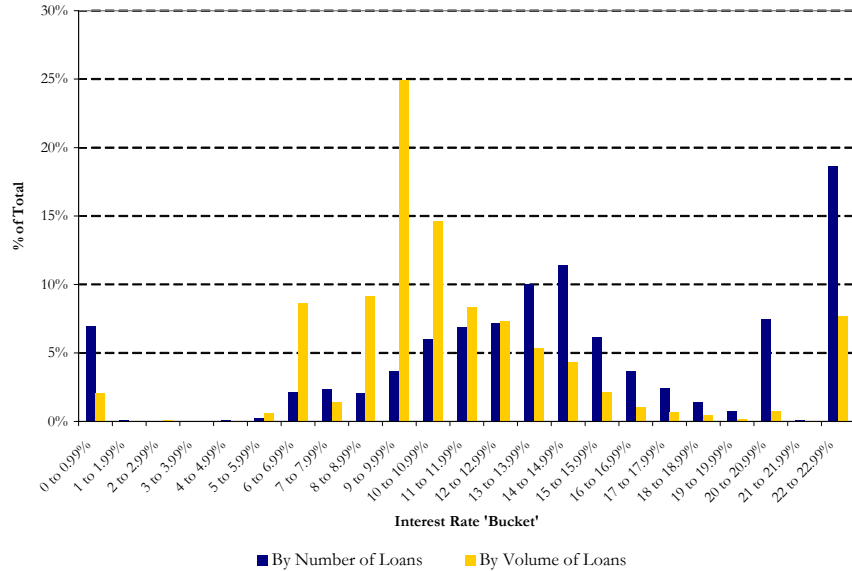


Figure 4.6: Distribution of New Loans to Medium-Sized Firms by Interest Rate (2006Q4)



Source: Authors' analysis based on figures provided by SF.  
 Note: The above figures show the distribution of SME loans by interest rate 'bucket' that were originated in the fourth quarter of 2006. The relevant interest rate ceiling during that period was 22.6 percent.

28. **A few banks mentioned the loan loss provisioning regime as another example of regulations that reduce the supply of SME credit.** According to the credit risk management system (*Sistema de Administración de Riesgo Crediticio* or SARC) developed by the SF in recent years, provisioning should be based on a loan's probability of default (PD) and loss-given default (LGD) estimates. PD estimates by rating classification and market segment may be derived either using banks' own internal credit risk models (after the SF validates them), or using segment-specific 'standard' reference

models built by the SF based on 1994-2006 default data that it has collected. In the case of the commercial loan portfolio – which includes the small firm and medium-sized firm market segments – these rules came into effect in July 2007. Since no internal credit risk model has yet been approved by the SF, all credit institutions have to use the same reference model and thus the same provisioning levels by rating category for their commercial loan portfolio exposures. In addition, the SF has adopted a counter-cyclical provisioning regime under which excess provisions are built during ‘good times’ to act as a shock absorber/cushion during ‘bad times’. Given that historical default data include the 1999 crisis, the PD rates currently used for provisioning purposes are much higher than actual defaults; such an effect is particularly pronounced for SME loans, whose performance is highly cycle-sensitive. For example, according to the reference model, the highest-rated (AA) loan to a small firm is assumed to have a PD rate of 7.52 percent, while the actual default rate currently is less than half that level. The confluence of these factors has recently led to a built-up of loan loss provisions by some banks in order to comply with these regulations, which could raise the cost of (and therefore access to) credit for the relevant market segments. Although this might simply reflect the authorities’ intention to raise average provisioning levels across the entire banking system, the use of the same default parameters stemming from the SF’s reference model across all credit institutions is problematic because it penalizes those entities that are better managed (and vice versa). However, once the SF begins to validate banks’ internal credit risk models, it is expected that performance differences across credit institutions (which should be reflected in their provisioning levels) will become more apparent.

29. **The legal and contractual environment in Colombia was also highlighted by credit institutions as a major constraint for SME credit.** The problems that were mentioned relating to creditor rights and insolvency proceedings have already been identified and described extensively in the relevant literature<sup>36</sup>. In particular, notwithstanding the use of collateral, the loss given default incurred by credit institutions is not adequately reduced due to inefficient enforcement and collection mechanisms (e.g. limited use of private enforcement or mechanisms with minimum judicial intervention, long processes and abusive use of procedural defense mechanisms) and the bias against creditor rights in insolvency proceedings. The rigidity of the security interest regime, the diminished priority attached to mortgaged debts or pledges by civil law, and certain weaknesses in the registry systems (lack of electronic interconnection, geographic fragmentation, and slow procedures) contribute to the low regard in which collateral is held. In response, credit institutions have structured their products to cope with this risk (see section 5.1 below) and have reduced their reliance on collateral as a source of repayment in the event of borrower default. The recently-approved new bankruptcy law 1116/2006 and forthcoming changes to the civil code on enforcement procedures improve, but will not fully resolve, some of the aforementioned problems<sup>37</sup>.

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<sup>36</sup> See CEAL (July 2005) and Rouillon (May 2006) for a description. According to the World Bank Group’s *Doing Business* 2008 report, Colombia is ranked low (147<sup>th</sup> globally) in terms of the efficiency of its judicial system in enforcing a commercial dispute.

<sup>37</sup> See Rouillon (May 2006) for more details. Changes in the new law include the possibility of judicial validation of out-of-court reorganization agreements, the simplification of procedures for an accelerated recognition of controversial claims in insolvency proceedings, the establishment of provisions to streamline and encourage actions seeking personal liability against directors and officers of the insolvent company, the

30. **Since SMEs tend to rely more on the use of collateral than larger firms, what constitutes acceptable collateral (“*garantía idónea*”) is an important issue for them.** In practice, most SMEs have few real estate assets and can only pledge moveable property – such as equipment, inventories, receivables or fixtures – as guarantee (“*prenda*”). Besides the ineffectiveness of foreclosure and liquidation procedures that diminish the value of such guarantees, there also exist legal and regulatory impediments to their acceptability as collateral by credit institutions (Figures 4.7 and 4.8)<sup>38</sup>. An important impediment is the requirement for an excessively detailed description of the asset operating as collateral for the guarantee to be valid, which limits the possibility of pledging assets that cannot be fully identified or of settling pledges separately from the SME itself<sup>39</sup>. In addition, the absence of a comprehensive property registry limits the types of moveable collateral that can be acceptable by credit institutions. As a result, with the exception of motor vehicles and durable goods stored in warehouses, other forms of moveable collateral cannot easily be pledged and represent ‘dead capital’ for SMEs.

Figure 4.7: Regulatory Treatment of Collateral as Obstacle to SME Lending

Do you consider that the regulatory treatment of collateral inhibits SME lending?

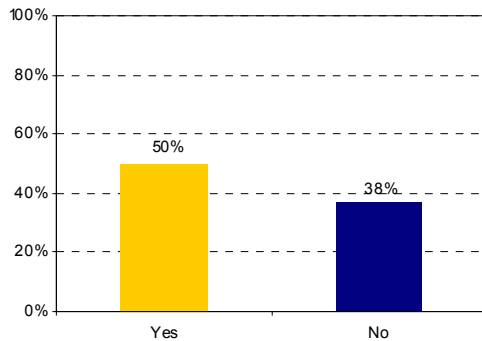
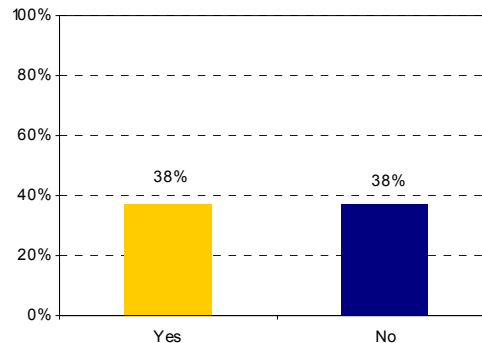


Figure 4.8: Registering Collateral as Obstacle to SME Lending

Are there issues in registering collateral that inhibit SME secured lending?



Source: Authors’ analysis of bank questionnaires (simple averages across all banks).

Note: The Figures may not add up to 100 percent because some credit institutions did not answer the question.

31. **The recently-approved Credit Information Law could further increase the supply of credit to SMEs, although its ‘amnesty’ provision was cited by banks as being problematic.** A well-functioning credit reporting industry allows lenders to more accurately measure credit risk based on a borrower’s payment behavior and other relevant information, thereby enabling them to expand credit and/or reduce its price. While credit reporting has been extensively used in Colombia, the absence of an effective legal and

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adoption of modern rules for the treatment of the international aspects of insolvencies with cross-border impact, and the suppression of “consensual priorities” and of “internal creditors”.

<sup>38</sup> For example, as part of SARC, standard LGD rates are currently applied across all banks depending on the type of collateral backing a loan; the large difference in LGD rates between loans with no (or non-acceptable) collateral and those loans that have an FNG guarantee provides a strong incentive for banks to seek the latter type in order to reduce their loan loss provisions.

<sup>39</sup> See the World Bank (November 2003) and Fleisig and de la Peña (September 2005) for more details.

regulatory framework until recently hampered its development<sup>40</sup>. The adoption of the *Ley de Habeas Data* by Congress in June 2007, which has not yet been adopted pending its revision by Colombia's Constitutional Court, addresses many of the key issues and would further promote credit growth, including to SMEs. However, the law includes an 'amnesty' provision that allows negative information on borrowers to be erased from their credit reports after only one year, as long as those borrowers pay or otherwise settle their obligations within six months from the date of entry of this law; subsequently to this period, such information will remain on credit records for four years. Although the omission of data from the report is only activated after a borrower's overdue debt has been paid or otherwise settled (as opposed to when the loan goes into irregular status), the provision is overly lenient and not in line with good international practice. The interviewed banks have highlighted it as a factor that would inhibit the expansion of access to credit for those borrower segments where delinquent behavior is more common (e.g. certain types of agricultural lending), although its overall effect remains unclear.

**32. Historical macroeconomic volatility and recent policy measures that provide conflicting signals were also mentioned as important obstacles to further expanding SME credit.** A booming economy in the last few years has strongly benefited SMEs, which tend to be more susceptible to macroeconomic conditions than large corporates. However, a combination of an appreciating currency and accelerating inflation in recent months has led to concerns about possible overheating of the economy<sup>41</sup>. The gradual tightening of monetary policy by the central bank (the policy rate was raised from 6 percent in April 2006 to 9.25 percent in July 2007) has thus far been ineffective in limiting the growth of aggregate demand. In response, the authorities adopted a series of policy measures in May and June 2007 in order to directly limit credit growth and the appreciation of the peso<sup>42</sup>. Interviewed banks expressed some concern about a possible return of macroeconomic volatility and with the choice of measures to combat inflation, since they would directly result in an increase in banks' funding cost that would have knock-on effects to the cost and availability of credit, including for SMEs. In fact, anecdotal evidence suggests that lending rates have already increased by 3 to 4 percentage points since these policy measures were enacted. In addition, banks pointed out the inconsistency between those measures and the stated government objectives to increase financial access (e.g. via the "*Banca de las Oportunidades*" initiative), which sent unclear and conflicting policy signals to financial markets.

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<sup>40</sup> See Center for Latin American Monetary Studies – The World Bank – FIRST Initiative (January 2005), and Miller and Guadamillas (May 2006) for more details.

<sup>41</sup> In particular, the Colombian peso had appreciated (in spite of sizeable exchange market intervention by the central bank) from around 2,400 COP per US dollar in August 2006 to below 2,000 by June 2007, inflation has broken above the official 2007 target range of 3.5-4.5 percent over the last few months, while the annualized real GDP growth for the first semester of 2007 has been 7.6 percent.

<sup>42</sup> These included an increase in non-remunerated marginal reserve requirements on domestic bank deposit accounts, the imposition of non-remunerated reserve requirements on external borrowing and short-term portfolio inflows ("*encaje*"), and limits on the amount of leverage that can be used by financial intermediaries in forward foreign exchange transactions.

## 5. How do Banks Engage in Lending to SMEs?

### 5.1 Business Model

#### 5.1.1 Structure

33. **Stand-alone SME units are increasingly being created by Colombian credit institutions, typically as part of the Retail Vice Presidency (VP).** Almost half of all interviewed banks had fully operational and dedicated SME units to service this market segment, while the rest are moving in this direction but their operational structure is still incipient. For the former, SME units are typically part of the Retail VP since most client outreach and product delivery still takes place through bank branches (see below). SME units are usually involved in determining the product portfolio and in designing strategies to target new SMEs and cross-sell products to existing SME clients. Since banks perceive this segment as both costlier and riskier to operate, SME units also aim to improve operational efficiencies (e.g. by standardizing products and leveraging information technology) and reduce lending risks (e.g. by working with the risk management function to streamline the credit assessment process and to design credit ‘filters’ for RMs).

34. **Branches continue to dominate as distribution channels, and very few banks have moved to a business center concept.** All interviewed banks use branches as the most common distribution channel for the SME segment, while some banks offer electronic and phone banking as complementary means to reach clients (Figure 5.1). Some banks are moving towards hybrid branch models where clearly separated space, personnel, and back office operations are destined solely to service SMEs within a branch – an SME ‘branch within a branch’ model – while others service SMEs as part of a branch’s regular functions alongside retail clients. The concept of dedicated SME business centers is quite novel, and a few interviewed credit institutions have recently begun to move in this direction.

Figure 5.1: Distribution Channels Used for SME Lending

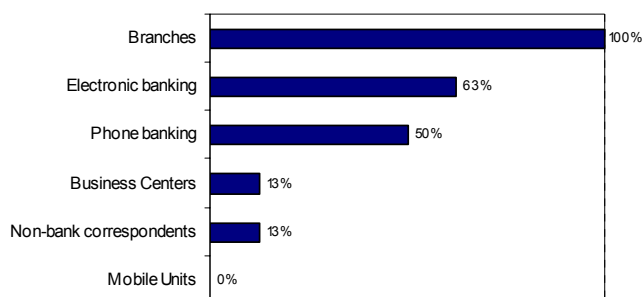
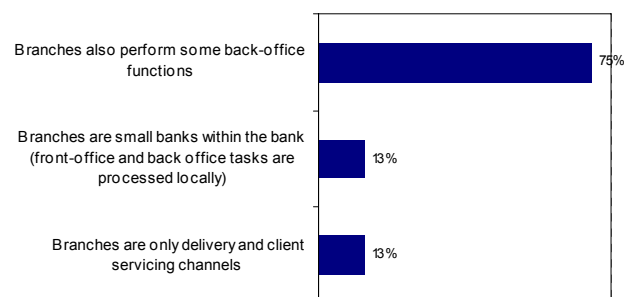


Figure 5.2: Role of Branches



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

Note: Figure 5.1 does not add up to 100 percent because some credit institutions cited multiple distribution channels.

35. **Headquarters are mostly involved in the later stages of granting a loan, while branches and sales personnel complement a number of centralized functions.** Most credit institutions acknowledged that branches are not merely delivery and client

servicing channels, but also perform some back-office functions when dealing with SMEs (Figure 5.2). While the initial stages of granting a loan are usually decentralized, functions such as loan approval (either for all loans or above a minimum loan size), risk analysis, monitoring of credit exposure, and loan recovery are centralized. However, it is common practice among banks to pull in their commercial area into loan processing tasks or credit exposure monitoring, as these functions are not yet automated or standardized, and still require considerable manual input to operate. As further explained below, these features are additional indicators of a business model in transition and of a market that is still underdeveloped. Another indicator of the relative immaturity of this market is the fact that the large majority of interviewed credit institutions is not yet able to quantify the contribution of the SME segment in terms of income (from loans, deposits and fee-based services), costs and risks to overall financial performance.

**36. Specialized SME Relationship Managers (RMs) are a recent phenomenon, while on-site visits and interaction with the SME owner remain crucial business practices.** The more traditional banking model based on on-site visits and direct interaction with the company owner dominates in most banks, given some of the inherent features associated with this segment (informality, lack of reliable financial information etc.). While banks are adopting the figure of specialized RMs for SME clients, the practice of assigning them to specific SMEs varies widely; some banks do not have dedicated SME RMs, others only assign them to specific clients (e.g. larger or more profitable SMEs), while a few banks assign all their clients to a RM (even if it means that each RM is responsible for hundreds of SMEs). In contrast to Colombia, the RM model is more advanced in Argentina and Chile, where RMs are crucial for new client development and coordination between headquarters and branches<sup>43</sup>. In terms of incentives to sales personnel, most interviewed credit institutions mentioned a variable element component in RM compensation based on criteria such as client profitability, loan volume and cross-selling business (Figure 5.3).

Figure 5.3: Incentives to Sales Personnel

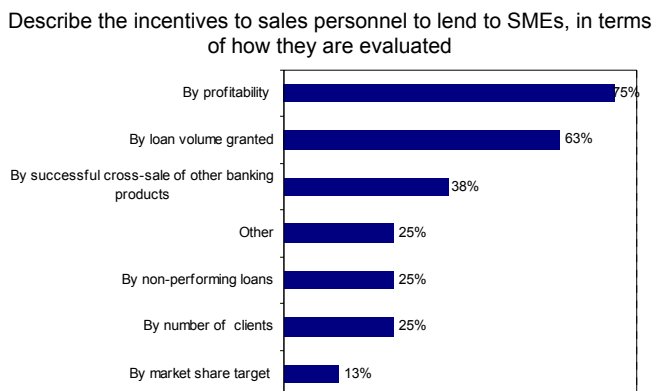
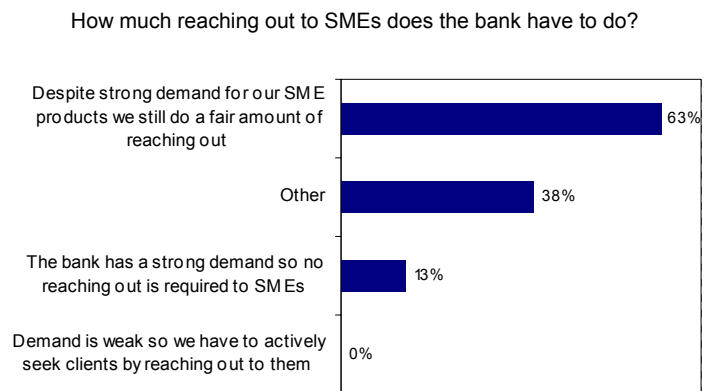


Figure 5.4: Reaching out to SME Clients



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

Note: Figure 5.3 does not add up to 100 percent because some credit institutions provided more than one response. 'Other' in Figure 5.3 means that sales personnel are evaluated in terms of other metrics, such as deposits and fees generated. 'Other' in Figure 5.4 means that the credit institution leverages cross-selling opportunities from existing clients in addition to reaching out for new clients.

<sup>43</sup> In both Argentina and Chile, RMs look for new clients and prepare SME credit applications. In Chile, for instance, RMs are being trained in risk management so as to perform an initial filtering of the SME pool and to have credit approved more expeditiously. See The World Bank (July 2007) for more details.

37. **Credit institutions still need to do a fair amount of reaching out to potential SME clients, primarily by relying on public databases and leveraging cross-selling opportunities.** A majority of interviewed banks actively seek out SME clients (Figure 5.4) by consulting and cross-referencing information obtained from public databases such as those of DANE, *Superintendencia de Supersociedades*, Confecámaras and credit bureaus. Such information serves as a first filter to target potential SME clients based on parameters set by each bank and to allocate resources and responsibilities to branches and sales personnel (Figure 5.5). A few banks also try to leverage their depositor base in order to cross-sell credit products to existing SME clients. The sequencing of product offerings to a new SME client varies across banks depending on their business strategy and perceived comparative advantage (Figure 5.6). With few exceptions (e.g. focus on family-owned SMEs or on suppliers of large multinational firms), most Colombian banks have yet to develop sophisticated targeting strategies (Figure 5.7).

Figure 5.5: Sources Used by Banks to Identify New Clients

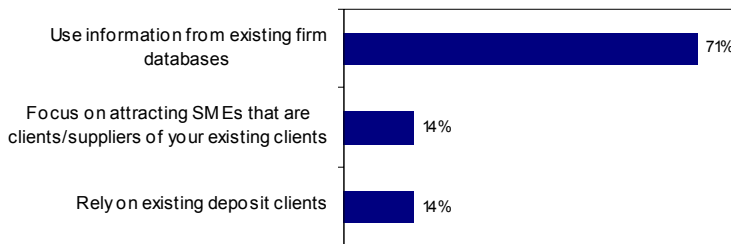
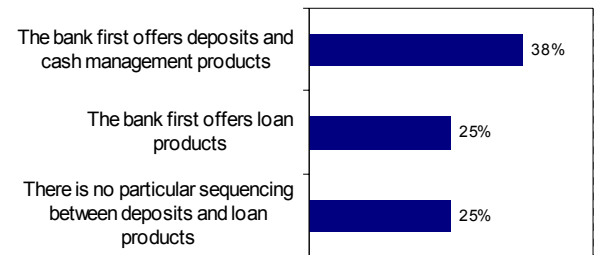


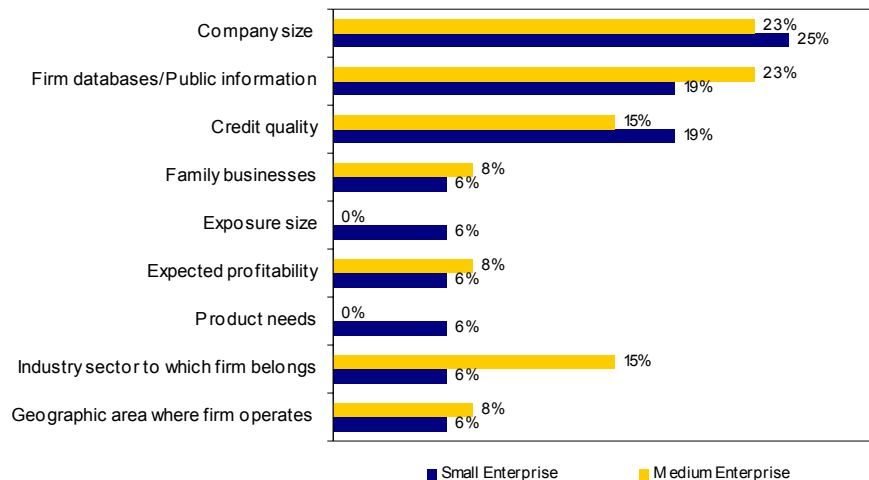
Figure 5.6: Sequencing in Product Offerings to Target New Clients



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

Note: Figure 5.6 does not add up to 100 percent because some credit institutions did not provide a response.

Figure 5.7: Criteria to Target New SME Clients



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

Note: Figure 5.7 does not add up to 100 percent because some credit institutions provided more than one response.

### 5.1.2 Products

**38. Banks are currently offering a range of deposit and loan products and other banking services to SMEs.** In general, banks are offering a fairly standard menu of products to SMEs that include checking/savings/time deposit accounts and loans for working capital or investment (sometimes with pre-approved limits). Business credit cards are also quite popular, and banks appear to be targeting this segment aggressively as a natural extension of the consumer credit card market. Other banking services such as cash management as well as payroll and social security payment services are also important for SMEs, as they prefer to manage most transactions with a single credit institution in order to minimize payment of the financial transactions tax (*gravamen a los movimientos financieros* or GMF).

**39. Loan products are still very standardized and mostly short-term in nature, reflecting banks' historical experience with SMEs.** The loan product variety offered by banks to SMEs is quite narrow and fairly standardized across banks (Figure 5.8). Working capital loans have an average maturity of 6-24 months and floating rates of DTF<sup>44</sup> + 8-12 percent<sup>45</sup>. Investment loans are mostly granted at slightly higher interest rates and with an average term of 3-5 years; some of these represent special Bancoldex-funded credit lines (*credito de fomento*). Most banks also have some sort of short-term overdraft accounts as well as foreign currency-denominated credit lines for trade finance purposes that are indexed to LIBOR. SME lending rates (or rate ranges) and terms are generally determined centrally by Headquarters, and sales personnel have very limited pricing flexibility (Figure 5.9). Current product features such as short maturities, floating rates, standardized pricing, and widespread use of real estate collateral and of personal guarantees (see below), are partly a 'coping mechanism' for credit institutions given historical volatility and their insufficient involvement in, or knowledge of, this segment. As the market matures and banks become more familiar with their clients' needs, greater product customization – as in Chile and, to a lesser extent, Argentina – are expected.

Figure 5.8: SME Product Customization

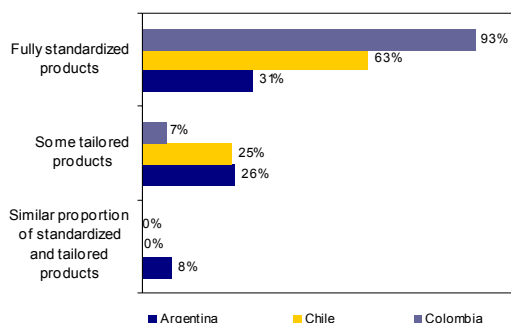
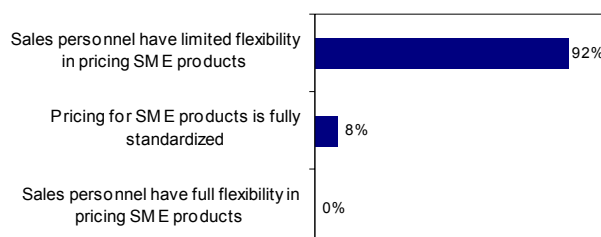


Figure 5.9: Flexibility in Product Pricing



Source: Authors' analysis of bank questionnaires (simple averages across all banks) and World Bank (July 2007).

Note: Figure 5.8 does not add up to 100 percent for each country because some credit institutions did not provide a response.

<sup>44</sup> The DTF (“*Depósito a Termino Fijo*”) is the 90-day deposit certificate, which is used as a benchmark reference rate for pricing most loans in Colombia. The current DTF rate is around 9 percent.

<sup>45</sup> Credit institutions focusing primarily on medium-sized firms report lower rates (e.g. DTF + 4-5 percent).

40. **Leasing is an extremely popular SME financing product in Colombia.** Asobancaria figures, which are based on the legal definition of SMEs, show that the use of financial leasing has more than quadrupled over the last four years and now accounts for almost one-fifth of SMEs' total credit and a much greater proportion of their long-term investment financing. In fact, according to Euromoney's *World Leasing Yearbook*, Colombia was the highest ranked Latin American country in 2005 in terms of annual leasing volume as a percentage of GDP (1.8 percent), ahead of Brazil (1.2 percent), Peru (0.9 percent), Chile (0.8 percent) and Argentina (0.2 percent). This can be attributed to the reactivation of the Colombian economy in recent years, leasing's favorable tax treatment, and the fact that enforcement procedures are easier since ownership of the asset remains with the leasing company until full repayment of the loan<sup>46</sup>.

41. **By contrast, the use of factoring is still incipient.** Factoring can represent one of the most important financing methods for higher-risk, informationally opaque SMEs, since the credit provided by a lender is explicitly linked to the value of an SME supplier's accounts receivable and not to the supplier's overall creditworthiness; this allows high-risk suppliers to transfer their credit risk to their high-quality buyers<sup>47</sup>. However, this instrument is rarely used in Colombia. According to CONPES 3484 of August 2007, factoring represented only around 0.5 percent of commercial bank lending<sup>48</sup> over the period 2003-06. Some banks extend collateralized loans against receivables as an alternative to factoring, although there is apparently a large invoice discounting market outside the official banking system. In an Asobancaria survey of 5 major banks in February 2007, factoring was mentioned as the least developed product that they were offering to SMEs. Several hypotheses were identified by credit institutions and other participants during the interview process, including legal problems (e.g. framework for secured lending), tax issues (e.g. treatment of interest payments on factoring services), the absence of a cost-effective technology, and business considerations (e.g. competition from the relatively efficient "*mercado extrabancario*", or the perceived unwillingness by major retailers to allow their invoices to be used for discounting purposes by their SME suppliers). However, there is no comprehensive study that analyzes the causes of this phenomenon in Colombia. The forthcoming introduction of a reverse factoring product ("*Liquidex Cadenas Productivas*") by Bancóldex will likely shed further light on the prospects and constraints of this instrument.

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<sup>46</sup> See Arbeláez et al. (October 2004) for more details.

<sup>47</sup> See Klapper (May 2005) for details, and Berger and Udell (2005) for a description of different transactions lending technologies for SMEs.

<sup>48</sup> In addition, the Center for Latin American Monetary Studies – The World Bank – FIRST Initiative (January 2005) reports that factoring is not a major source of financing and that there are few factoring companies in Colombia. Factors Chain International also reports a very low annual factoring turnover (EUR 100 million) for Colombia in 2006, compared to other Latin American countries such as Chile (EUR 11.3 billion), Argentina (EUR 333 million) and Peru (EUR 563 million).

## 5.2 Risk Management

### 5.2.1 Risk analysis

42. **SME loans are perceived to be riskier than corporate loans, but less risky than consumer loans or micro credit.** As can be seen in Figures 5.10 and 5.11, most interviewed credit institutions consider SME loans to be riskier (in terms of having a higher default probability – PD, and higher loss given default – LGD) than corporate loans, but less risky than either consumer loans or microcredit. This is not surprising, as SME loans in most countries tend to default more often than loans to large corporates, while the fact that they are usually collateralized reduces their LGD compared to unsecured consumer credit. Opinions differ substantially on the riskiness of SME loans vis-à-vis mortgages, which can be attributed to Colombia’s negative historical experience with housing credit following the 1999 crisis.

Figure 5.10: Riskiness of SME Loans (PD) Compared to Other Loan Types

Provide your assessment of the risk (in terms of default probability) of the average SME loan compared to other average loan types

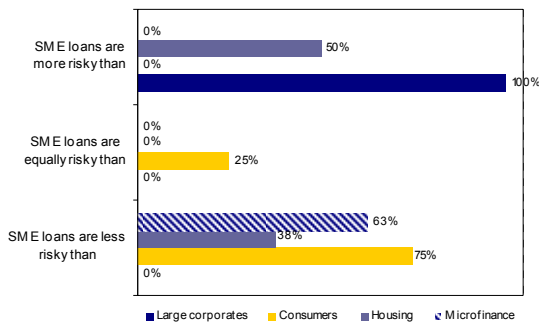
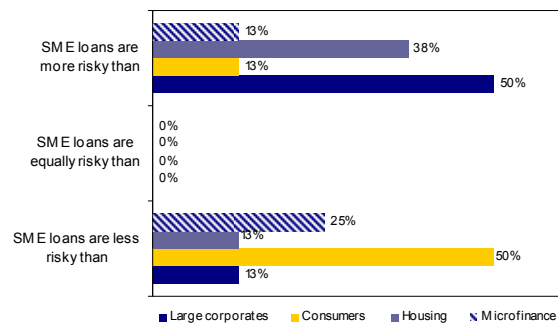


Figure 5.11: Riskiness of SME Loans (LGD) Compared to Other Loan Types

Provide your assessment of the risk (in terms of percentage loss given default-LGD) of the average SME loan compared to other average loan types



Source: Authors’ analysis of bank questionnaires (simple averages across all banks).

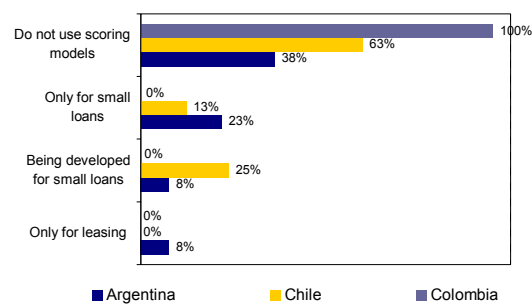
Note: Figures 5.10 and 5.11 do not add up to 100 percent because some credit institutions did not provide a response. PD and LGD refer to Probability of Default and Loss Given Default respectively.

43. **Credit scoring models are not yet used by banks to automate their lending decisions to SMEs.** None of the credit institutions interviewed in this study has developed automated scoring models for SMEs, although a few were in the process of constructing and/or validating them. Although credit scoring products are already available by external specialized providers, interviewed banks did not feel sufficiently confident in the use of such models for small firms. These models, which rely on technology developed for consumer lending, ensure consistency in risk assessment across the institution and help streamline the loan decision process, thereby reducing transaction costs and accelerating response times. However, there is a risk-cost trade-off: mechanistic decision rules and lack of human involvement tend to increase ‘type II errors’, namely that banks lend more to borrowers that default. The unavailability of sufficient historical data for validation purposes and the poor quality of financial information are important impediments that require additional due diligence for SME loans – in fact, several credit institutions believe that it is too early and risky to develop such models and prefer to rely

on traditional rating methods. By comparison, credit scoring models have already been broadly adopted in Argentina and Chile to evaluate smaller firms (Figure 5.12).

44. **In the absence of credit scoring, interviewed banks have adopted credit assessment methods for SMEs that are usually a streamlined variant of the rating process used in corporate lending.** Such methods tend to be more simplified than for corporate loans and adapted to reflect SME realities – for example, a greater weight placed on qualitative criteria in the rating itself. In Colombia, credit scoring models are expected to play a greater role in risk assessments as SME clients are better segmented/targeted, distinct financing products are designed based on their specific business needs, and historical data becomes available for model validation purposes.

Figure 5.12: Use of Scoring Models to Lend to SMEs



Source: Authors' analysis of bank questionnaires (simple averages across all banks) and World Bank (July 2007).

Note: Figure 5.12 does not add up to 100 percent because some credit institutions in other countries did not provide a response.

45. **SME clients are analyzed on a case-by-case basis using traditional rating techniques, and credit analysis is based on both quantitative and qualitative factors.** Credit risk management is separated from sales and centralized at headquarters. In the absence of scoring models, credit ratings are generated on the basis of quantitative and qualitative information. Qualitative data is at least as important as quantitative data, particularly for smaller firms; in fact, as much as 60 percent of the rating for an SME comes from qualitative factors according to some of the interviewed risk managers. Qualitative information includes an evaluation of business plans, the quality of SME management, SWOT (Strengths, Weaknesses, Opportunities, Threats) analysis of the SME, and an assessment of the prospects of the sector in which it operates. Most of this data is collected from information submitted by the SME client, and validated by on-site visits and references collected by bank staff. Quantitative assessments mostly derive from financial analysis and include variables such as cash flow generation, indebtedness, profitability and balance sheet structure. In some cases, these are complemented by analysis of the SME's projected sector trends and of its owners' financial standing. The latter factor is particularly important given the absence of reliable financial information and the family-owned nature of most SMEs. In fact, 50 percent of all interviewed banks state that information on the owner is as important as information on the firm, and both are included in the SME's overall quantitative assessment. Banks collect most of this information either from internal sources and the client, or from credit bureau data.

46. **Banks typically require collateral in order to lend to SMEs, and guarantees from firm owners and government programs play a significant role.** Collateral

(mostly real estate) is generally required for SME loans, particularly to smaller firms, while virtually all interviewed credit institutions state that guarantees are important because of the aforementioned factors that constrain SME creditworthiness<sup>49</sup>. In this realm, government guarantees (mostly FNG) are playing an important role, while use of personal guarantees (“*aval*”) from the SME owners is also common because they can be used to ‘blacklist’ those individuals in the credit bureau.

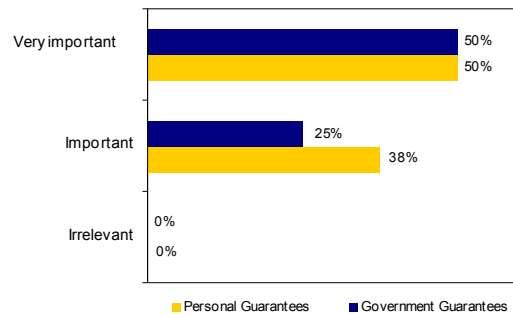
Figure 5.13: SME Collateral Requirements

If collateral requirements are higher for SMEs than for larger corporates, indicate which of the reasons below apply



Figure 5.14: Importance of Guarantees

How important are guarantees in minimizing loss given default (LGD) for SME loans?



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

Note: Figure 5.13 does not add up to 100 percent because some credit institutions provided more than one response. Figure 5.14 does not add up to 100 percent because some credit institutions did not answer the question.

## 5.2.2 Monitoring and risk exposure analysis

47. **Exposures are typically reviewed annually at individual SME borrower level.** In all interviewed credit institutions, senior management has an annual approval cycle for individual SME credit exposures, although some banks also review limits at portfolio and product levels. Other credit limits might also be applicable to the SME portfolio, such as global concentration limits by economic sector. The authorization for credit approval limits differs by loan size, so the business line might be involved in approving small SME loans for some banks, while this function is completely centralized in others.

48. **Both headquarters and RMs/credit analysts monitor risk exposures, primarily via a combination of traditional and automated techniques.** Banks' risk exposure is usually monitored via largely-automated indicators/triggers and on-site visits performed to oversee the client's health (Figure 5.15). Indicators such as repayment frequency, cash flow generation, and total outstanding debt, as well as reporting from the borrowers and information collected from regular on-site visits (mostly for larger firms), represent the most common means of monitoring SME exposures. However, more sophisticated monitoring techniques and early warning mechanisms, such as management of SME exposures based on a portfolio approach and the use of stress testing (Figure 5.16), have not yet been adopted by banks in Colombia.

<sup>49</sup> The value of having collateral does not necessarily stem from its seizure and liquidation. As one bank pointed out, collateral was “nice to have” but was primarily used to negotiate with borrowers in trouble.

Figure 5.15: Monitoring of Credit Risk Exposure

Which of the following characterize some of the ways the bank monitors credit risk outlook over time for each particular SME?

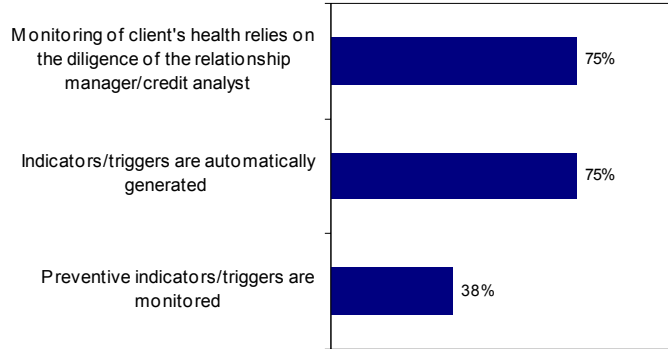
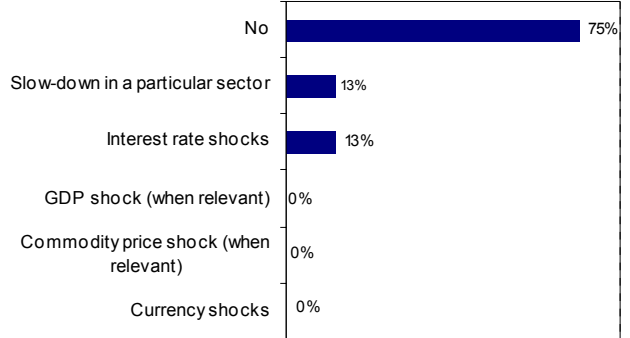


Figure 5.16: Stress Testing on SME Portfolio

Do you run any of the below mentioned stress test exercises on the SME portfolio?



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

Note: Figure 5.15 does not add up to 100 percent because some credit institutions provided more than one response.

### 5.2.3 Management of NPLs

49. **Banks carry out similar actions once a loan is past due, while recovery efforts usually take place in-house.** Once a loan is past due, similar actions are undertaken by most banks. In the initial stage, the relevant commercial manager or RM attempts to contact the borrower in order to receive the late payment; if unsuccessful, this is followed by the initiation of a pre-judicial recovery process (administrative collection) and the account is transferred to a dedicated SME recovery unit. Most interviewed credit institutions have such a unit that manages past-due loans (Figure 5.17), while others delegate this task to the relevant branches or regional centers (but they maintain a central roster of lawyers). Finally, once the loan officially moves to non-accrual status, a judicial procedure against the borrower is initiated. Few banks outsource SME loan recovery operations (in the sense of selling these loans to private collectors), although several of them use external lawyers in the foreclosure process. Interviewed credit institutions also state that they do not have standardized loan restructuring policies, and most of them prefer to tailor solutions to the client's repayment capacity.

Figure 5.17: Existence of Dedicated SME Recovery Unit

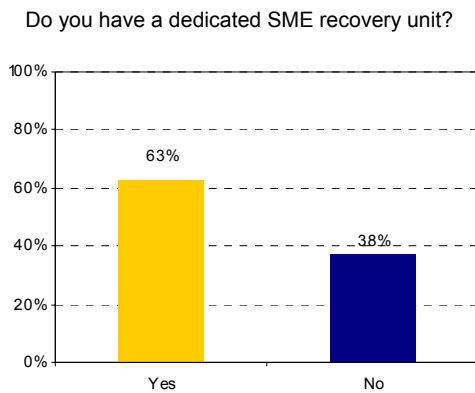
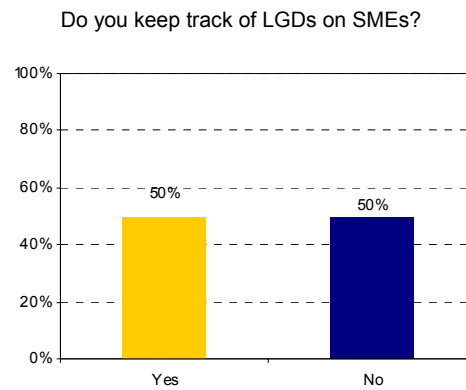


Figure 5.18: Tracking of LGDs on SMEs



Source: Authors' analysis of bank questionnaires (simple averages across all banks).

50. **A few banks have begun to collect default information in order to allow them to measure LGD for SME loans.** As most banks' involvement with SMEs is fairly recent, few of them have sufficient information on past default experiences such as average recovery time and cost, as well as the proportion of the loan that was recovered by type of collateral. Models to estimate LGD have been built by only half of the interviewed credit institutions (Figure 5.18), although others are currently in the process of developing them.

## 6. Conclusions and Policy Implications

51. **Bank financing to SMEs has grown significantly in recent years (albeit from a low base), and it is becoming a strategic segment for Colombian credit institutions.** Notwithstanding issues related to measuring the size of the SME lending market, the analysis of available background information and of the bank questionnaires clearly indicates the increased importance and growing opportunities in this segment. This challenges the common belief that there is no interest in lending to SMEs. On the contrary, credit institutions appear eager to better service this market segment given its perceived profitability and cross-selling opportunities. Government programs to support SME financing have also been cited as contributing to market growth. Virtually all interviewed credit institutions believe that the market's prospects are good and they expect it to continue growing, albeit at a slower pace than recently.

52. **The business model for SME lending is still relatively underdeveloped, but greater sophistication is expected as the market matures.** Banks are adapting their business and risk models by creating dedicated SME units, but loan products and risk management practices are still incipient. Branches continue to dominate as distribution channels, while specialized RMs are a relatively recent phenomenon. Loan products remain quite standardized and mostly short-term in nature. Leasing is a particularly popular financing product, while the use of factoring is still incipient. There is little differentiation in the treatment of SMEs by size or sector, while few banks have developed niche strategies or products to target specific client types. SME borrowers are analyzed on a case-by-case basis using variants of traditional credit rating techniques, and credit institutions have not yet begun to use automated credit scoring models. As a result, Colombia lags behind Argentina and Chile, where more sophisticated business models and practices have been adopted. This can be attributed to the fact that the SME segment is still immature and relatively new for most banks, so business models are still evolving<sup>50</sup>. However, as the market matures and becomes more competitive, it is expected that Colombian banks will increasingly start to catch up to regional peers.

53. **Important institutional and policy constraints to SME lending remain but are not yet binding.** Interviewed credit institutions highlighted several obstacles to further expanding SME lending: inherent SME characteristics (informality, availability/reliability of financial statements, management skills, family-owned structures), regulations (especially the interest rate ceiling on loans), the legal and contractual environment (particularly with respect to secured credit), as well as recent policy measures to cool the economy that provide conflicting signals to financial markets as to the government's intentions. These constraints are not yet binding because of Colombia's strong macroeconomic performance and the lack of SME market saturation. In addition, banks have developed coping mechanisms by structuring their SME financing products – in terms of maturities, rates and use of collateral – to deal with some of these obstacles. However, unless relevant policy measures are taken, these constraints will increasingly 'begin to bite'.

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<sup>50</sup> An additional potential contributing factor is the relatively low foreign bank presence in Colombia, which might have reduced the adoption of relevant SME lending technology from abroad.

54. **A policy agenda that addresses the aforementioned constraints is outlined and discussed below.** In particular, Table 6.1 summarizes potential next steps by main area, as well as relevant stakeholders from the public and private sectors. It is worth noting that several proposed policy actions would be beneficial for the broader lending environment in Colombia and not solely for SMEs. Moreover, as previously mentioned, some actions are at a high level either due to data unavailability or because they reflect issues that are outside this study’s scope, meaning that further analysis would be required in order to convert them into specific policy recommendations.

Table 6.1: Policy Agenda to Promote Bank Financing to SMEs

Policy Area	Relevant Stakeholders*	Policy Action
Macroeconomic Policy	<ul style="list-style-type: none"> <li>▪ BdIR</li> <li>▪ MHCP, SF</li> </ul>	<ul style="list-style-type: none"> <li>▪ Ensure positive macroeconomic environment, as well as a stable and consistent financial sector policy regime</li> </ul>
Legal & Contractual Framework	<ul style="list-style-type: none"> <li>▪ MHCP</li> <li>▪ Private sector (Chambers of Commerce, Asobancaria etc.)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Review and reform the legal framework for secured lending by consolidating diverse and overlapping legislation to enhance the ability of SMEs to pledge moveable property as collateral</li> <li>▪ Continue to improve the general framework for creditor rights and insolvency proceedings by strengthening enforcement procedures and registry systems</li> </ul>
Financial Sector Regulations	<ul style="list-style-type: none"> <li>▪ MHCP, SF</li> <li>▪ BdIR</li> <li>▪ Asobancaria</li> </ul>	<ul style="list-style-type: none"> <li>▪ Assess the effects of the interest rate ceiling (<i>tasa de usura</i>) on access to credit by SMEs and as a source of legal and regulatory uncertainty for credit institutions</li> </ul>
Government Support Programs for SMEs	<ul style="list-style-type: none"> <li>▪ MCIT, MHCP, DNP</li> <li>▪ FNG, Bancóldex</li> <li>▪ SENA</li> <li>▪ Private sector (Chambers of Commerce, Asobancaria etc.)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Evaluate government support programs, especially those of FNG and Bancóldex, to determine their additionality and to fine-tune them in order to better attain their intended objectives</li> <li>▪ Assess how such programs could support capacity-building activities for SMEs (i.e. financial literacy, business skill training etc.) and promote the development of new SME financing instruments (i.e. factoring, risk capital etc.)</li> <li>▪ Design incentives for SMEs to formalize (e.g. simplification of tax policy/administration, relevant labor and social security regulations, procedures/cost of inscription in commercial registries etc.)</li> <li>▪ Analyze and further streamline existing inter-institutional coordination of policies geared towards the SME market</li> </ul>
Statistics & Data Collection on SMEs	<ul style="list-style-type: none"> <li>▪ MCIT, MHCP, DNP</li> <li>▪ DANE</li> <li>▪ Private sector (Chambers of Commerce, Asobancaria etc.)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Unbundle SMEs from micro enterprises in official statistics</li> <li>▪ Improve periodic data collection on SMEs in order to identify their characteristics (size, economic sector, region, financial performance, contribution to employment and GDP, informality etc.) and to better understand the demand-side perspective</li> <li>▪ Expand SME definition to include annual turnover as a criterion</li> </ul>

\* The list of relevant stakeholders is not exhaustive, and other agencies would likely need to be involved for specific policy actions.

55. **A good macroeconomic environment and a stable policy regime are necessary for the sustainable growth of this market going forward.** One of the lessons of the last few years is that banks will expand SME lending on their own accord – in spite of the presence of important constraints – when they perceive the attractiveness of this market and have began to saturate ‘easier’ (in terms of business model) market segments such as corporate and consumer lending. However, in order to ensure the sustainable growth of this market, continued strong macroeconomic performance and a stable and consistent policy framework in the financial sector (clear ‘rules of the game’) have been identified as important considerations. These will permit the emergence of alternative

financing mechanisms and providers that will enhance competition and provide additional sources of financing for all firms, including SMEs.

**56. Reforming the legal framework for creditor rights and insolvency proceedings in general, and for secured lending in particular, would greatly enhance the ability of SMEs to access bank loans by pledging collateral.** It is important to note that existing government programs to support SME financing not only help credit institutions to address SME-specific issues, but also allow them to overcome broader credit infrastructure weaknesses such as the existing legal framework for creditor rights and insolvency proceedings<sup>51</sup>. The recently-approved new bankruptcy law and forthcoming changes to the civil code on enforcement procedures improve, but will not fully resolve, some of the problems that had been previously identified. In the specific case of SMEs, which tend to rely more on the use of collateral than larger firms, what constitutes acceptable collateral is an important issue. Reforming the legal framework for secured lending by consolidating diverse and overlapping legislation in all its dimensions – creation, perfection and enforcement of security interests – would facilitate SMEs to pledge moveable property and release what is currently ‘dead capital’ for them.

**57. The role of the interest rate ceiling in preventing riskier SMEs from accessing credit by the official banking system should be carefully analyzed.** Several interviewed credit institutions emphasized the importance of the interest rate ceiling as a constraint for expanding credit to riskier firms, which are typically the ones that are smaller, have less collateral to offer, and lack a long track record. As previously mentioned, the problem seems particularly acute for those firms transitioning from micro enterprise to SME status because the effective interest rate ceiling for the former is much higher than for the latter. Although recent efforts to raise the ceiling by tinkering with its method of calculation and periodicity have been positive, its existence is perceived to act as a binding constraint for some SMEs and as a source of legal and regulatory uncertainty for credit institutions. A careful analysis, based on available borrower/loan-level data, would shed light on the debate about the relative merits and potential costs (in terms of additional rent-seeking by banks) of abolishing this ceiling in Colombia.

**58. Existing government programs that support SME financing can be further optimized by focusing on additionality and on developing new lending instruments.** FNG and Bancóldex have been cited by banks as important in the development of SME financing (either via guarantees or rediscounting) and – as affirmed in their respective strategic plans and CONPES document 3484 (August 2007) – are expected to continue doing so in the future. However, their contribution in terms of additional financing, and other potential objectives compared to a suitable baseline has not yet been measured. Such an assessment would help the fine tuning of their products in order to maximize impact. This is becoming particularly important as the SME financing market continues to grow, which raises the question of whether these institutions can and should keep up (in terms of market share) or whether they should concentrate their scarce resources on the neediest SMEs. The latter alternative would imply the introduction of stricter SME

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<sup>51</sup> As another example, one could argue that FNG guarantees partly compensate for the inability of banks to charge riskier SME borrowers an interest rate above the legal ceiling. Although these guarantees are a valid contribution to SME financing, they represent a second-best solution to what is an inherent policy issue.

borrower profile selection criteria in order to ensure additionality<sup>52</sup>. In addition, Bancóldex could take the lead in supporting capacity-building programs and promoting the development of new SME financing instruments – such as factoring and risk capital – by analyzing existing constraints and proposing suitable policies to overcome them.

**59. A better understanding of SMEs and the design of measures to tackle some of their inherent weaknesses are important policy priorities.** In particular, SMEs need to be ‘unbundled’ from micro enterprises in the collection of statistics, and their characteristics (size, economic sector, region, financial performance, contribution to employment and GDP, informality etc.) analyzed in greater detail in order to better understand the demand side perspective. Given the importance accorded by credit institutions to constraints stemming from inherent SME characteristics, priority could be given to developing appropriate policy measures to tackle them. Such measures – which go beyond the realm of financial sector policy per se – could include the expansion of capacity-building programs and the design of incentives for SMEs to formalize (e.g. simplification of tax policy/administration, relevant labor and social security regulations, and of procedures/cost of inscription in commercial registries). In fact, some of these measures have been identified and adopted in CONPES 3484 (August 2007).

**60. Consideration should be given to the adoption of an SME definition that includes annual turnover as one of the criteria.** In particular, the use of an SME definition that is not compatible with actual banking market practice complicates the attainment of policy objectives in this area and raises questions as to whether the right type of firm is being targeted<sup>53</sup>. International practice in defining SMEs also supports the use of annual sales as an important criterion<sup>54</sup>. The recently-approved 2006-2010 national development plan, which permits the authorities to change the SME definition and relevant size ranges as deemed necessary, represents an opportunity to address this issue.

**61. The aforementioned policy measures necessitate a well-coordinated and comprehensive strategy to promote bank financing to SMEs.** As previously mentioned, the SME financing gap stems from complex and multi-dimensional causes. A suitable policy response, potentially encompassing some of the policy actions described above (many of which have been included in the recent CONPES document), requires coordination and information exchange across several parts of the Colombian government, including (but not limited to) MHCP, MCIT, DNP, DANE, second-tier credit institutions and the SF. It is therefore critical that efficient institutional mechanisms exist within the government in order to undertake this role. The implementation of the CONPES represents a good opportunity to further streamline these mechanisms and improve their functioning.

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<sup>52</sup> Examples would include the ‘screening out’ of loans to those SMEs that already have a satisfactory credit history with the banking system and/or can provide other forms of collateral.

<sup>53</sup> According to a recent exercise by Asobancaria and Comité Pymes (2007) using 2003 data from Confecámaras, a substantial number of micro enterprises would be classified as SMEs (and vice versa) if the classification was based on annual turnover as opposed to total assets.

<sup>54</sup> See Felaban and FOMIN/BID (December 2004) for an overview of the SME definitions used by banks in Latin America and the Caribbean, and Zevallos (2007) for the legal SME definition used in Latin American countries and by the European Union.

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