

Banking SMEs around the world: Lending practices, business models, drivers and obstacles

Thorsten Beck (World Bank)

Asli Demirgüç-Kunt (World Bank)

Maria Soledad Martínez Pería (World Bank)

Presentation for the World Bank Conference

“Small Business Finance: What Works and What Doesn’t”

Washington, D.C., May 5-6, 2008

Motivation

- SMEs account for a large share of employment
 - Ayyagari, Beck, and Demirgüç-Kunt (2007)
- Firm-level studies have shown that SMEs perceive access to finance and cost of credit as significant obstacles to their operations and growth.
 - Schiffer and Weder 2001, IADB 2004, Beck, Demirgüç-Kunt, and Maksimovic 2005, and Beck, Demirgüç-Kunt, Laeven, and Maksimovic 2006.
- Outside the U.S. and a handful of case studies, little data exist on the supply side of bank financing to SMEs across countries.

What is this paper about?

- Using data from 91 banks in 45 countries around the world, this paper documents the state of financing to SMEs by large banks around the world.
- Characterizes the extent, type, and pricing of SME financing and wherever possible, compares it to bank financing of large firms.
- Describes banks' business models, lending practices, and risk management set-ups used to serve SMEs.
- Examines the factors driving and impeding bank lending to SMEs across countries (including analyzing the role of government programs).

Main findings

1. Banks see the SME segment as an attractive one, with good prospects, and offer SMEs a wide range of financial products.
2. Though a higher share of bank loans is directed to large firms relative to SMEs, there are surprisingly small differences in the share of applications approved, the type and pricing of bank loans across firm size. Rather, we observe significant differences in these variables across developed and developing countries.
3. Banks have set up separate departments to serve SMEs and have decentralized the sale of financial products to the branches, but the loan approval, risk management, and loan recovery functions remain centralized.
4. Though scoring models are used by most banks in the sample, especially in small business lending, they are only one input in the loan approval process.

Main findings

5. There are differences in the lending criteria and collateral used by banks operating in developing vis-à-vis developed countries.
 - Banks in developing countries are more likely to make lending decisions based on a firm's credit history with the bank and the firm owner's characteristics, while banks in developed countries focus more on factors like the size and purpose of the loan.
 - While real estate is the most important collateral for SME loans around the world, it is less so in developing countries where liquid assets and personal and bank guarantees are also commonly used.
6. Banks in developing countries perceive macroeconomic factors as the most important obstacle to SME financing, while competition is the main obstacle among banks in developed countries. SME specific factors are not perceived as obstacles.
7. Government programs to promote SME finance are perceived positively and bank prudential regulations and documentation requirements are not deemed by banks to be a hurdle to SME financing.

Related studies

- US studies on SME bank finance
 - see Berger, Rosen, and Udell (2006) for a recent review.
 - Focus on behavior of large vs small banks and on impact of consolidation on lending to SMEs.
- IFC and World Bank case studies
 - IFC (2007)
 - Seeks to identify “best practices” in SME banking
 - World Bank (2007a,b) and Rodriguez and Stephanou (2008)
 - Document the state of bank financing in Argentina, Chile, Colombia and Serbia.
 - De la Torre, Martinez Peria, and Schmukler (2008)
 - Examine the conventional wisdom that SME banking is done through relationship lending.

The survey

- 56 questions, 3 parts
- Part I - Extent, type, and pricing of financing to SMEs.
 - Extent: share of lending to SMEs vis-à-vis total loans, % of loan applications approved.
 - Type of financing: share of loans devoted to investment purposes and the ratio of loans that are collateralized or secured.
 - Pricing: data on the fees and interest rates charged on loans.
 - Compare to large firm financing.

The survey

- Part II - Business models and risk management set-ups
 - Whether banks have separate specialized departments to manage their business with SMEs.
 - Whether sales decisions are separate from risk management,
 - Whether SME loans are processed at the branches or at headquarters.
 - Whether credit scoring is used to approve SME loans.
 - What types of criteria are most important when evaluating SME loans.
 - What type of collateral is most frequently used in SME lending.

The survey

- Part III – Drivers and obstacles of bank involvement
 - Rank the importance of factors related to the macroeconomic, regulatory, legal, and institutional frameworks, as well as the significance of factors such as the demand for financing, the degree of competition in the banking sector, the level of taxes in the economy, bank organizational issues, and SME specific factors (like opacity and informality).
 - Questions on the role and importance of government programs and of regulations in facilitating bank financing to SMEs.

The survey

- Targets the 5 largest banks in each country.
 - These have the most extensive branch networks and, hence, are the most accessible to SMEs, at least in terms of location.
 - These are the banks with the largest lending capabilities.
- Responses so far – 91 banks, 45 countries
 - 38 developing, 7 are developed
 - On average, banks that responded account for 32 percent of banking system loans.

Reporting the data

- Quantitative data:
 - Country-level data shown for countries where more than one bank responded and the market share > 30 percent.
 - Country-level figures reported for those countries where the market shares < 30 percent, but the largest bank responded.
 - Average for all banks operating in developing countries and, separately, in developed countries.
- Qualitative data
 - Percentage of banks that chose each option in each question, separating among banks operating in developed and developing countries.

The extent, type, and pricing of SME bank finance

What is an SME?

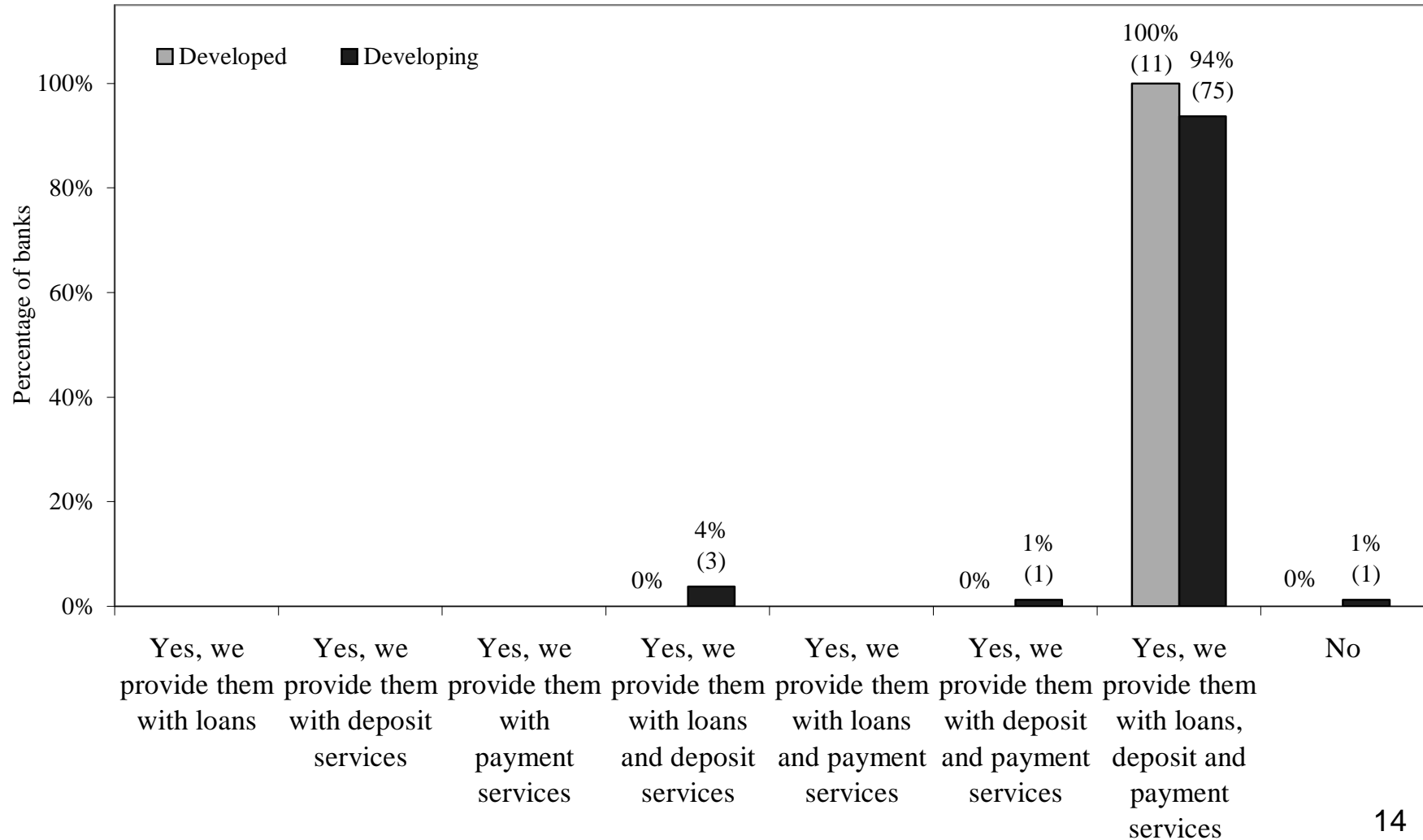
- Most banks define SMEs in terms of sales.
 - 85 % of banks operating in developing countries
 - 71 % of banks operating in developed countries

Definition of SMEs in terms of sales

Countries	Small firms	Medium-sized firms
Developing	Up to US\$ 4 million	Up to US\$ 14.5 million
Developed	Up to US\$ 5.5 million	Up to US\$ 28 million

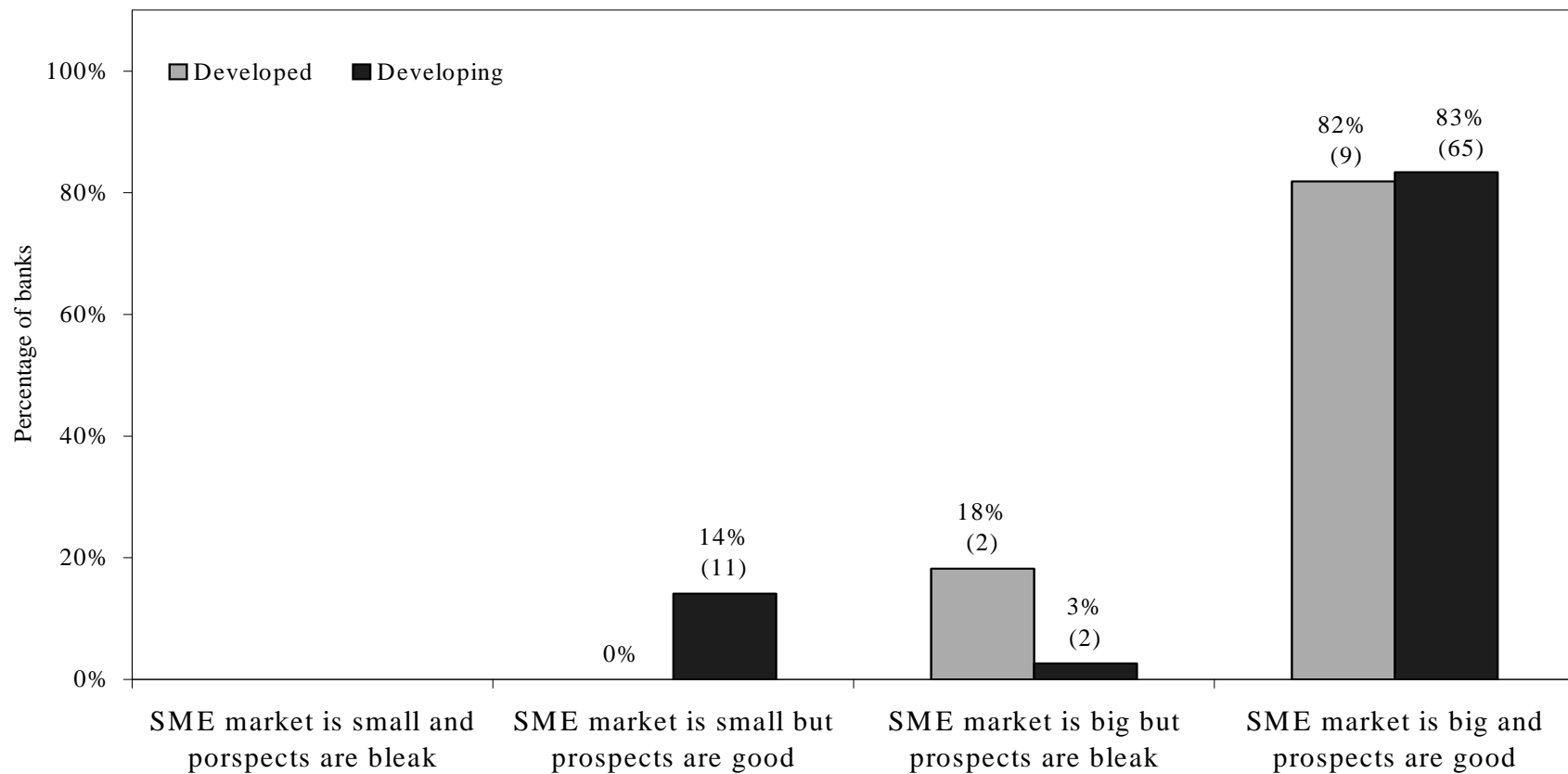
Almost all banks have SME clients and offer them multiple services

Do banks have SME clients?



Most banks perceive the SME segment as large with good prospects

What are banks' views on the size and prospects of the SME market?



Exposure to SMEs lower than to large firms but the type and pricing of bank finance is similar

Variable	Income group	Mean for SME loans	Mean for large firms loans	t-test	p-value
Share of total loans	Developed	17.93%	27.88%	1.18	0.26
	Developing	22.99%	32.80%	2.33	0.02**
Share of applications approved	Developed	82.75%	86.94%	0.29	0.80
	Developing	78.11%	80.76%	0.52	0.61
Share of loans for investment	Developed	68.04%	72.93%	0.35	0.74
	Developing	46.18%	49.82%	0.74	0.46
Share of secured loans	Developed	49.27%	42.80%	-0.45	0.67
	Developing	81.48%	74.85%	-1.36	0.18
Loan fees	Developed	0.37%	0.22%	-0.68	0.51
	Developing	0.96%	0.83%	-0.73	0.47
Interest rates on best clients	Developed	4.66%	4.00%	-0.59	0.57
	Developing	11.16%	10.22%	-0.74	0.46
Interest rates on worst clients	Developed	8.79%	7.30%	-0.86	0.41
	Developing	15.65%	14.09%	-0.98	0.33
Share of non-performing loans	Developed	6.93%	2.54%	-1.46	0.19
	Developing	6.49%	4.13%	-1.68	0.10*

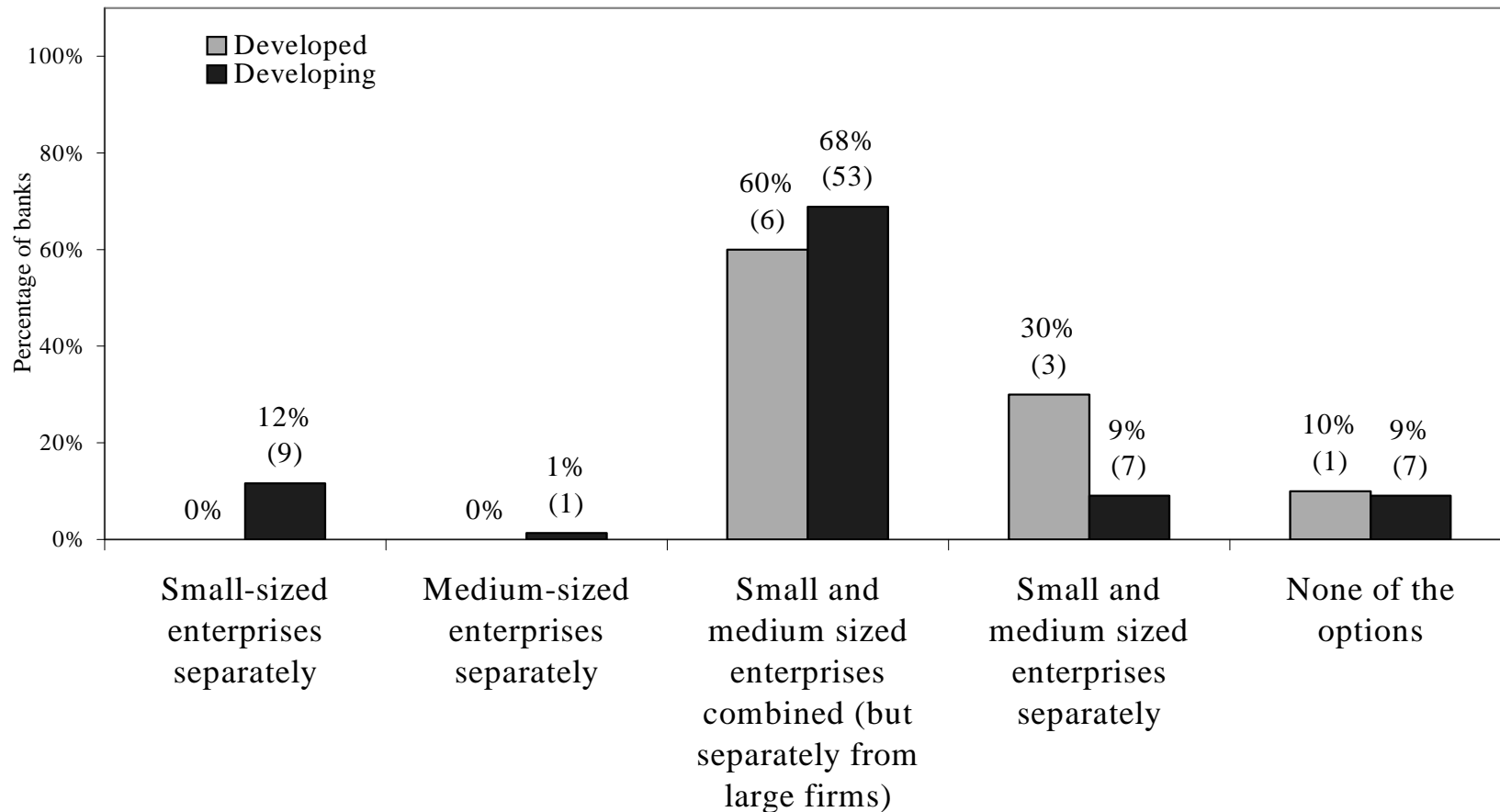
On the other hand, there are large and significant differences between banks in developed and developing countries

Variable	Firm Type	Mean for Developing Countries	Mean for Developed Countries	t-test	p-value
Share of total loans	SMEs	22.99%	17.93%	-1.03	0.32
	Large firms	32.80%	27.88%	-0.61	0.55
Share of applications approved	SMEs	78.11%	82.75%	0.57	0.59
	Large firms	80.76%	86.94%	0.47	0.71
Share of loans for investment	SMEs	46.18%	68.04%	1.58	0.18
	Large firms	49.82%	72.93%	4.26	0.01**
Share of secured loans	SMEs	81.48%	49.27%	-3.01	0.03**
	Large firms	74.85%	42.80%	-2.92	0.03**
Loan fees	SMEs	0.96%	0.37%	-2.90	0.02**
	Large firms	0.83%	0.22%	-3.23	0.00***
Interest rates on best clients	SMEs	11.16%	4.66%	-5.28	0.00***
	Large firms	10.22%	4.00%	-5.32	0.00***
Interest rates on worst clients	SMEs	15.65%	8.79%	-3.96	0.00***
	Large firms	14.09%	7.30%	-4.21	0.00***
Share of non-performing loans	SMEs	6.49%	6.93%	0.14	0.89
	Large firms	4.13%	2.54%	-1.19	0.25

Bank business models and risk management set-ups to serve SMEs

Banks have set up specialized departments to serve SMEs

Do banks have separate departments to serve SMEs?

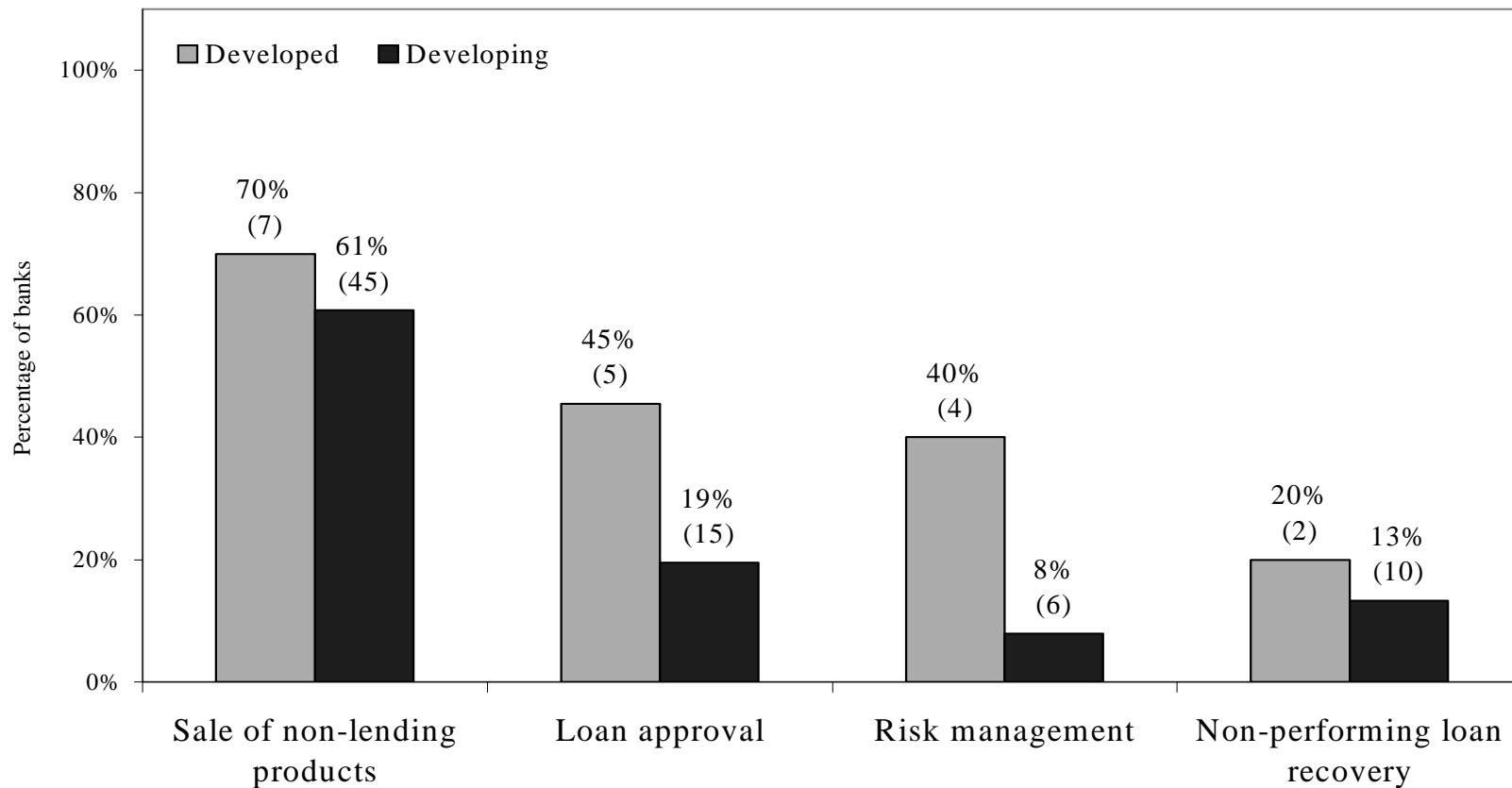


Total Responses Developing Countries: 77

Total Responses Developed Countries: 10

Banks have decentralized the sale of financial products, but the loan approval, risk management, and recovery functions remain centralized.

What aspects of SME banking are done only or primarily at the branch level?



Responses Developing Countries: 74
Responses Developed Countries: 10

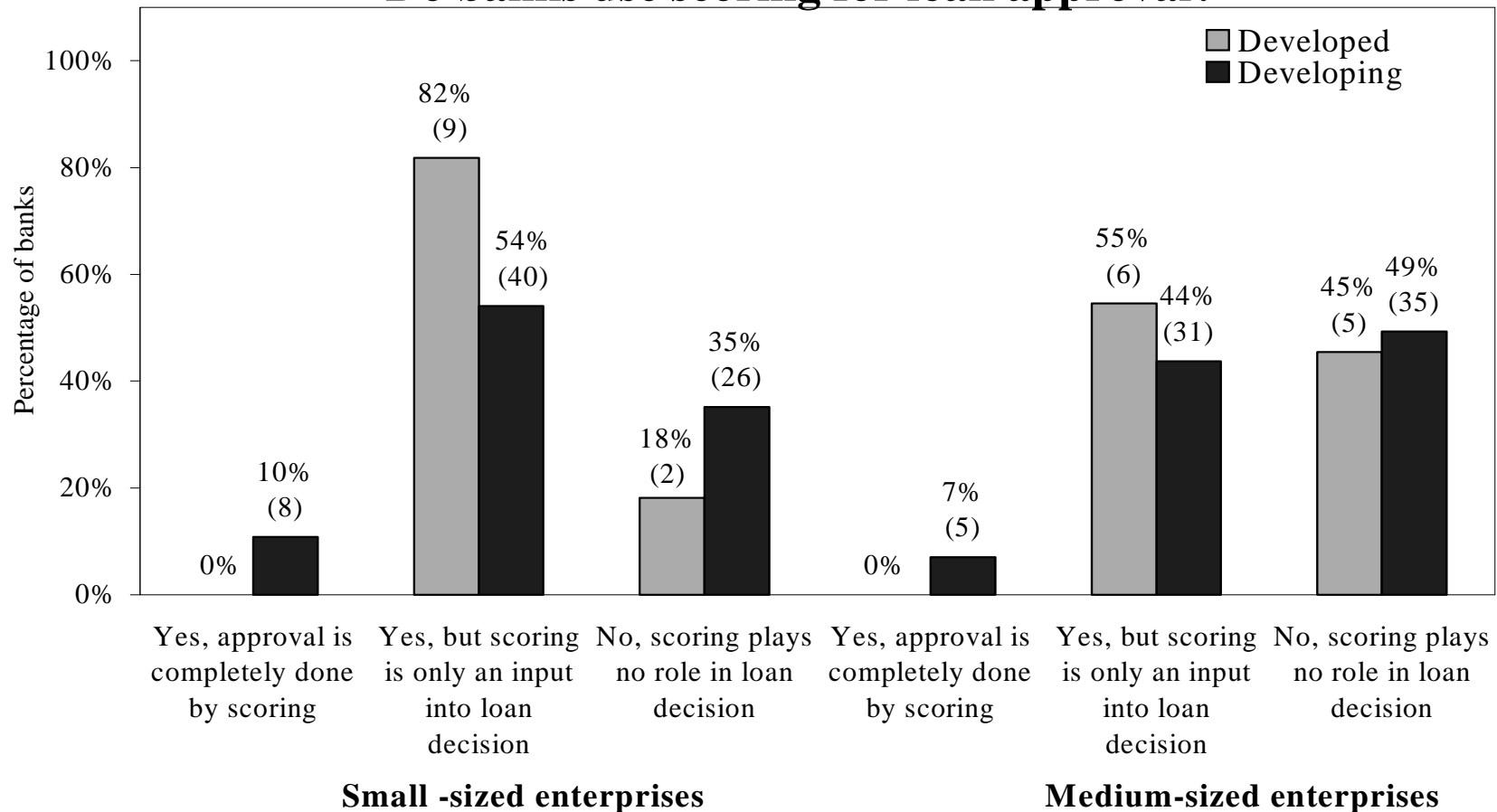
Responses Developing Countries: 77
Responses Developed Countries: 11

Responses Developing Countries: 76
Responses Developed Countries: 10

Responses Developing Countries: 75
Responses Developed Countries: 10

Banks use scoring models for lending to small firms (less so for medium-sized enterprises), but scoring is only an input in the decision process.

Do banks use scoring for loan approval?

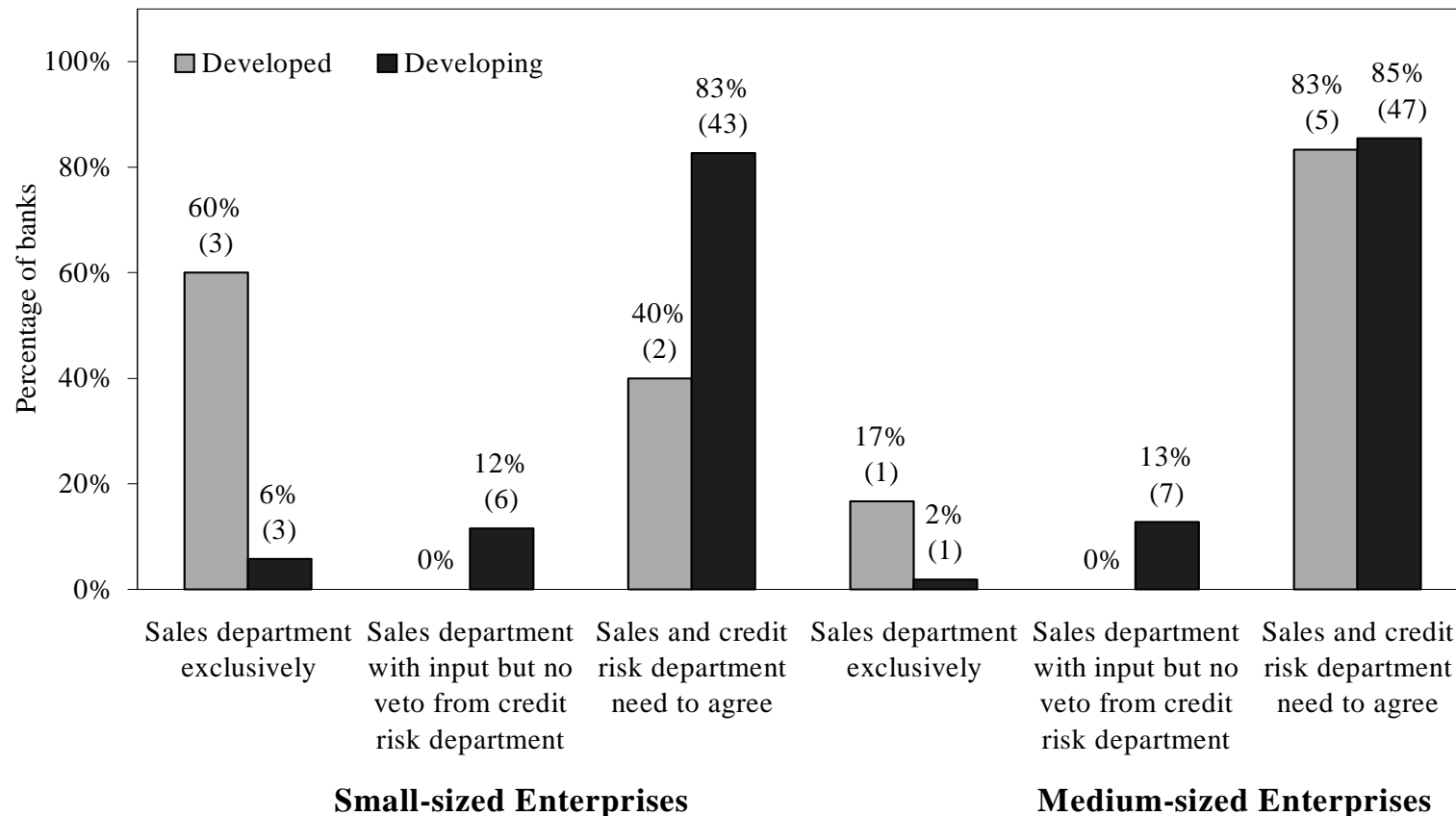


Total Responses Developing Countries: 74 (Small Enterprises)
Total Responses Developed Countries: 11

Total Responses Developing Countries: 71 (Medium Enterprises)
Total Responses Developed Countries: 11

When scoring is not used, lending decisions for SMEs are made by the credit risk and sales department in conjunction

Who makes lending decisions when scoring is not used?

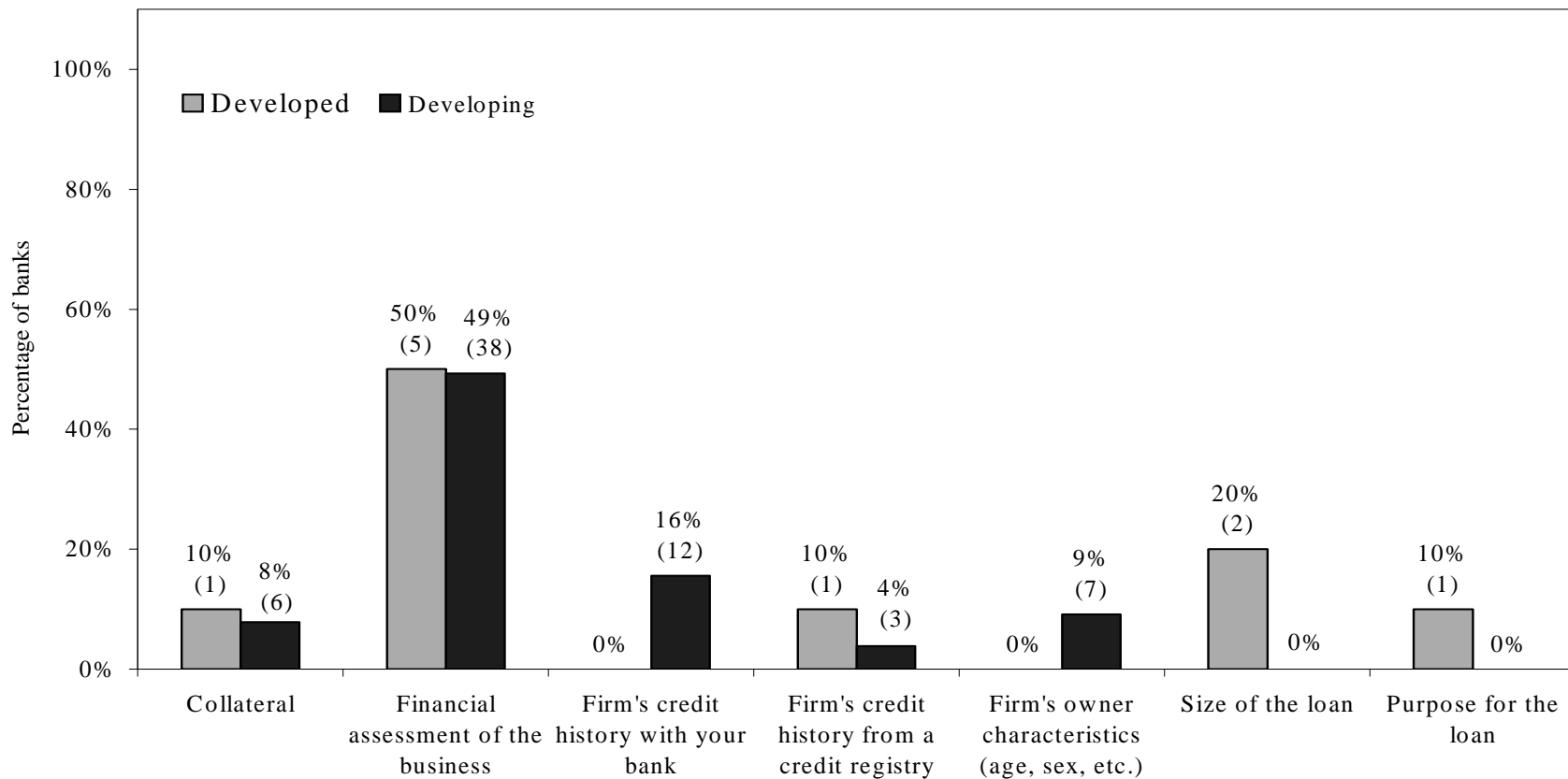


Total Responses Developing Countries: 52 (Small Enterprises)
Total Responses Developed Countries: 5 (Small Enterprises)

Total Responses Developing Countries: 55 (Medium Enterprises)
Total Responses Developed Countries: 6 (Medium Enterprises)

Firms' credit history and owner characteristics are important lending criteria in developing countries, while loan size is important in developed economies.

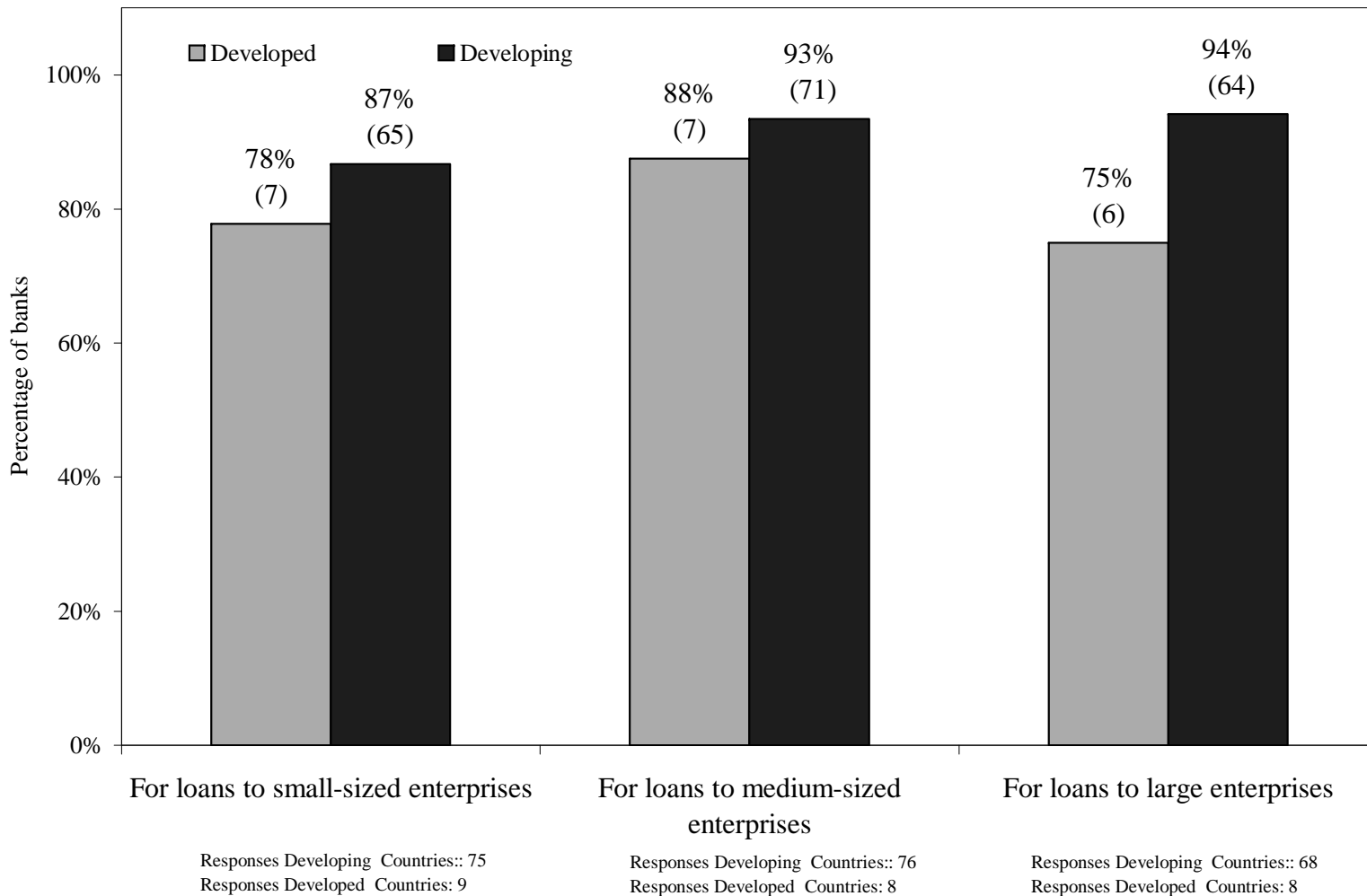
What is the most important factor in making loan decisions?



Total Responses Developing Countries: 77
 Total Responses Developed Countries: 10

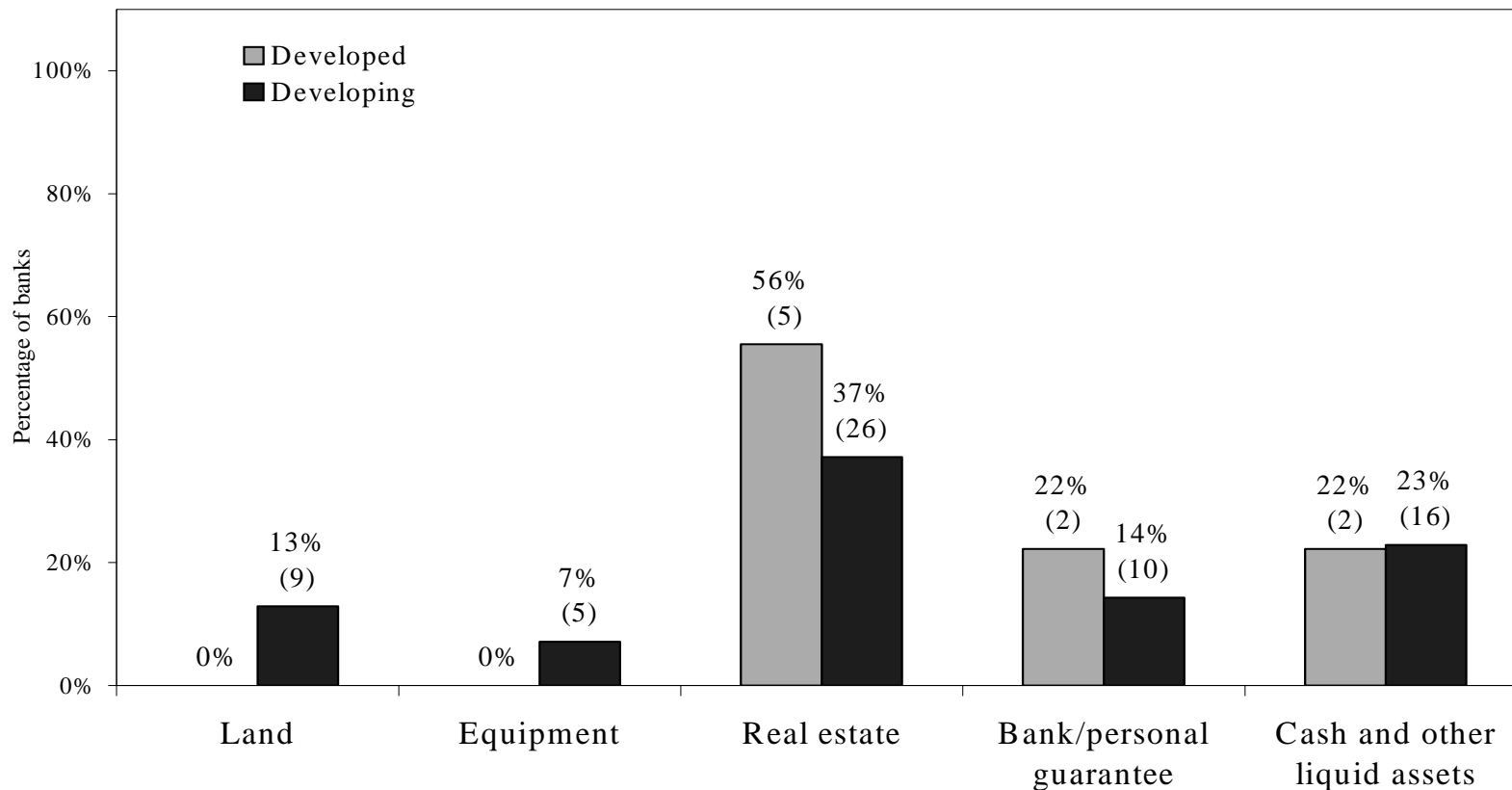
At least three quarters of banks require collateral to make business loans.

Do banks require collateral for lending?



Real estate is the most frequently used type of collateral for SME lending, but less so in developing countries where other collateral types are also used.

What is the most commonly used type of collateral?

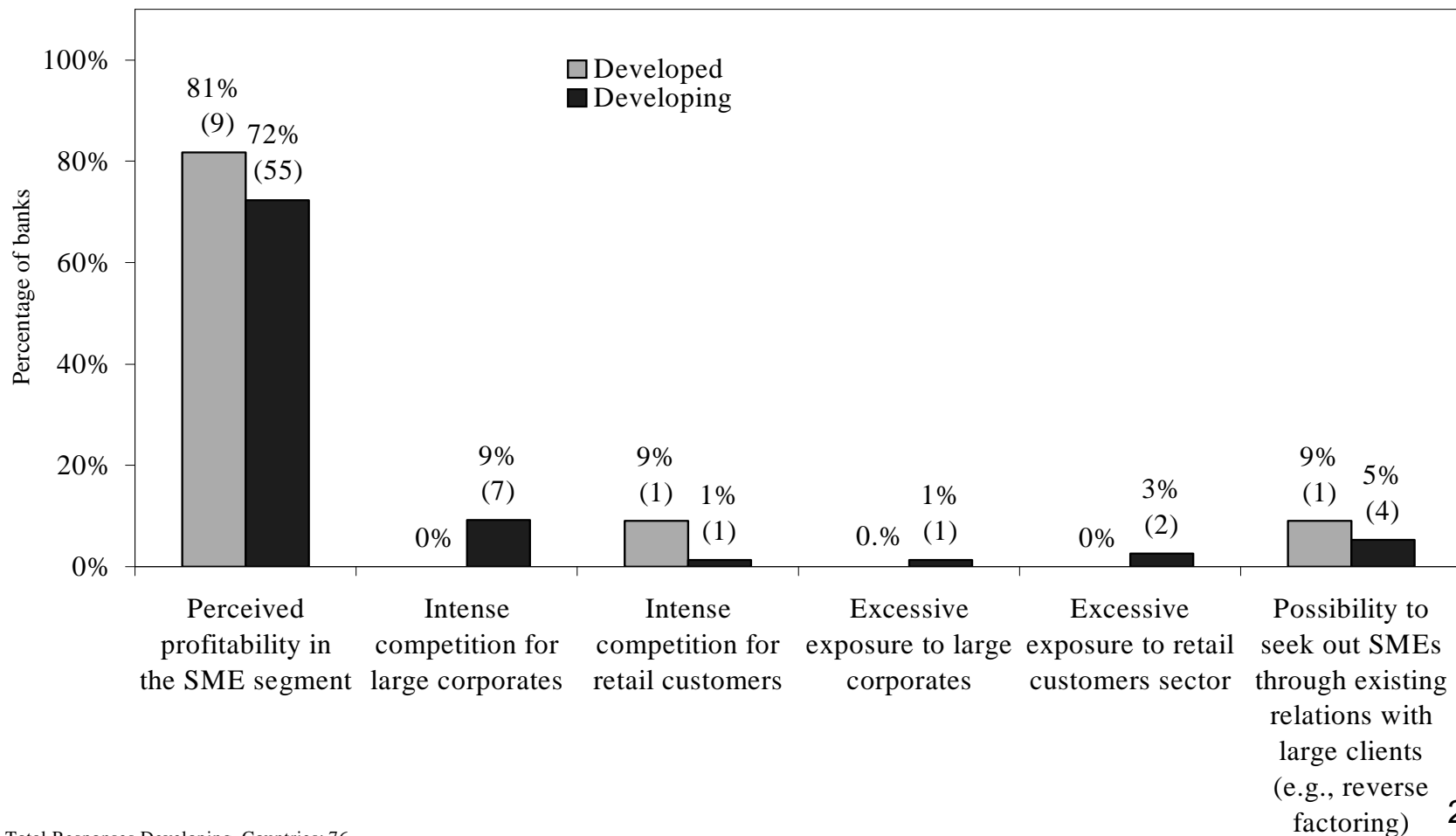


Total Responses Developing Countries: 70
Total Responses Developed Countries: 9

Factors determining SME bank finance:
Drivers, obstacles, and the role of government
programs and regulations

The most important driver for banks' involvement with SMEs is the perceived profitability of this segment.

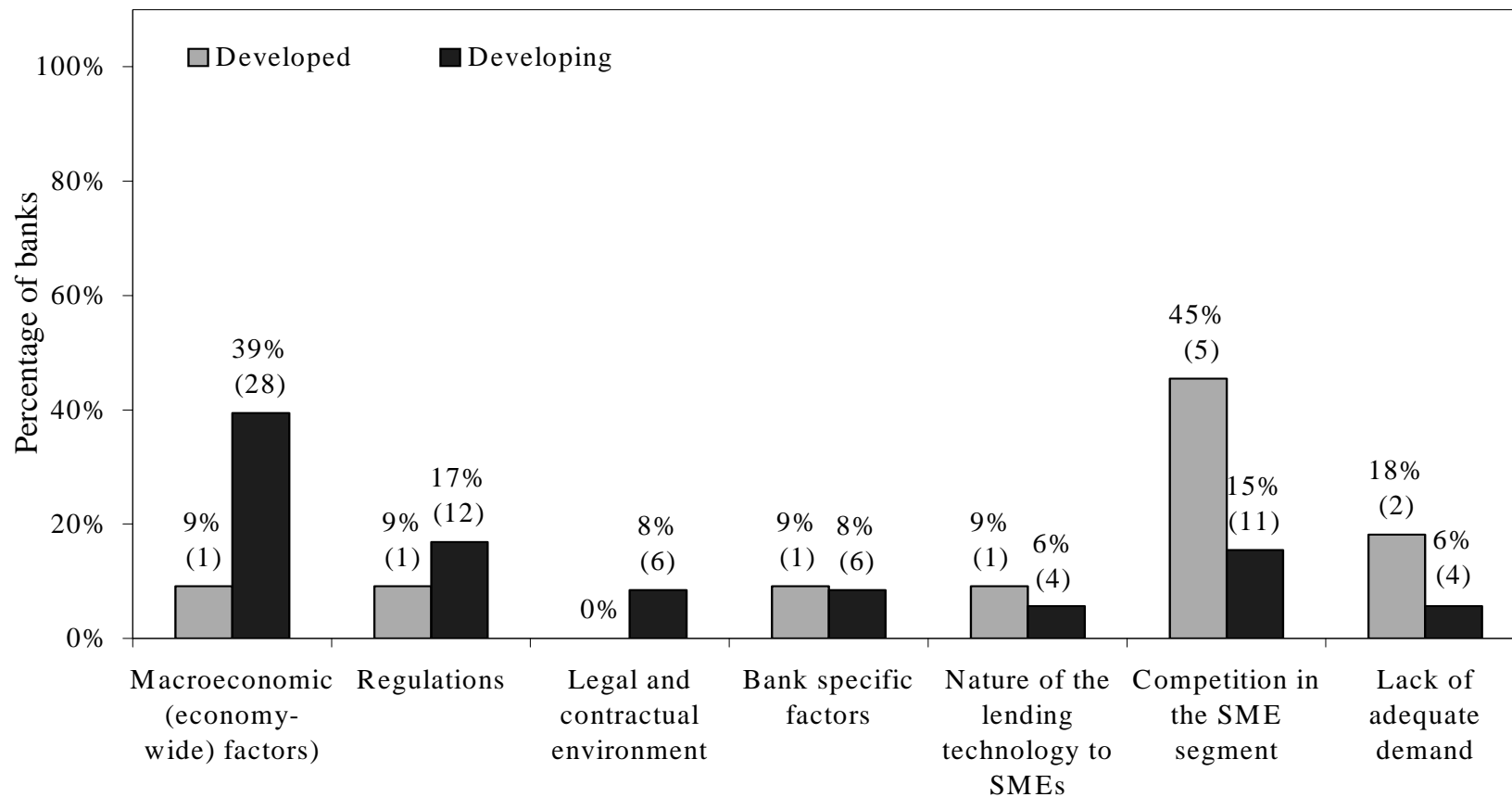
What is the most important driver of SME bank finance?



Total Responses Developing Countries: 76
 Total Responses Developed Countries: 11

Banks in developing countries perceive macroeconomic factors to be the most important obstacle to SME financing, while competition is the main obstacle among banks in developed countries.

What is the most important obstacle to SME bank finance?

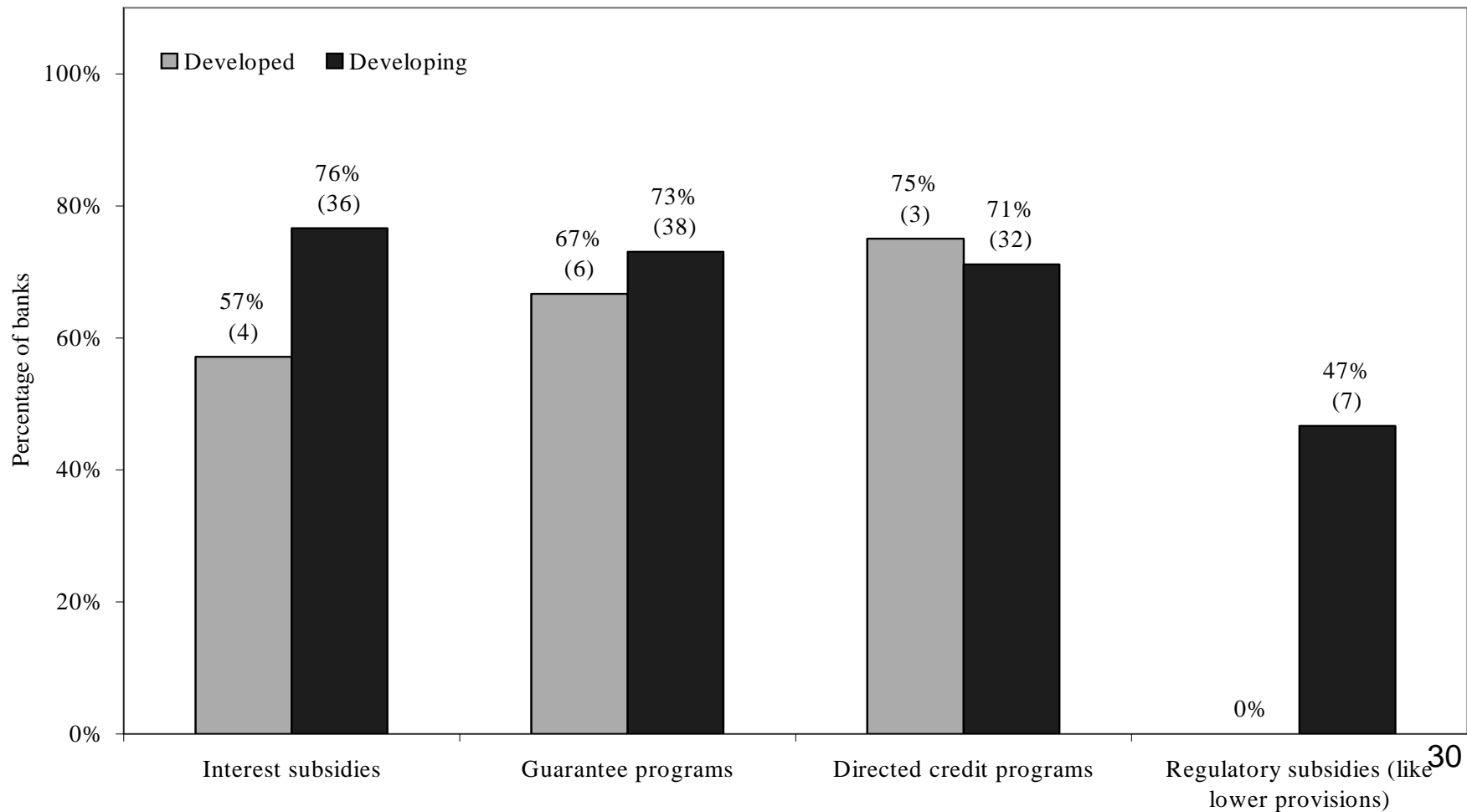


Most countries have some kind of government program in effect to promote SME finance

Countries	Number of countries with programs	Guarantees	Directed credit	Interest rate subsidies	Regulatory subsidies
Developed countries	6 (out of 7)	6	3	5	3
Developing countries	32 (out of 45)	28	24	23	16

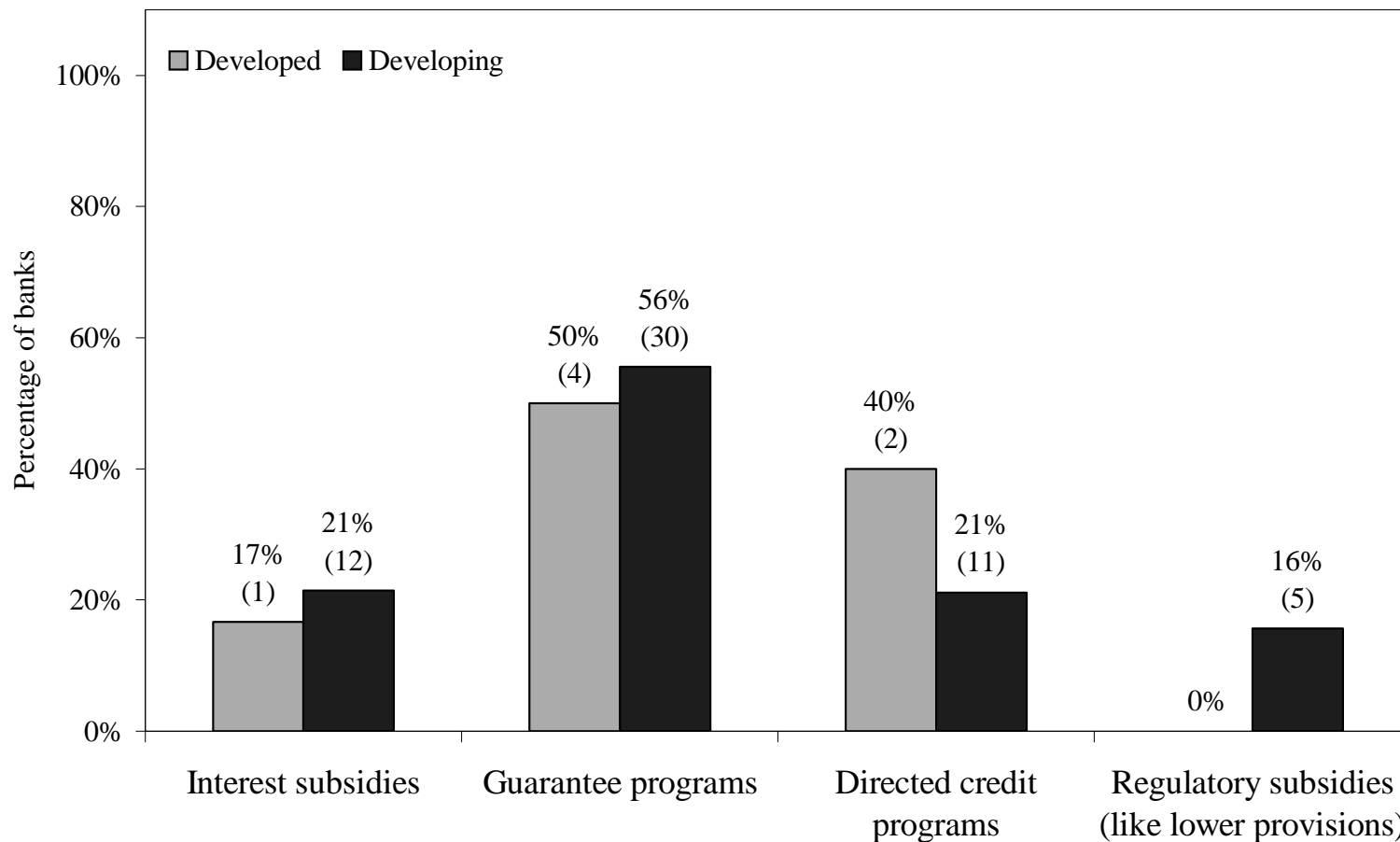
Banks have a positive perception of government programs to support SMEs.

Do banks' have a positive view of government programs to promote SME bank financing?



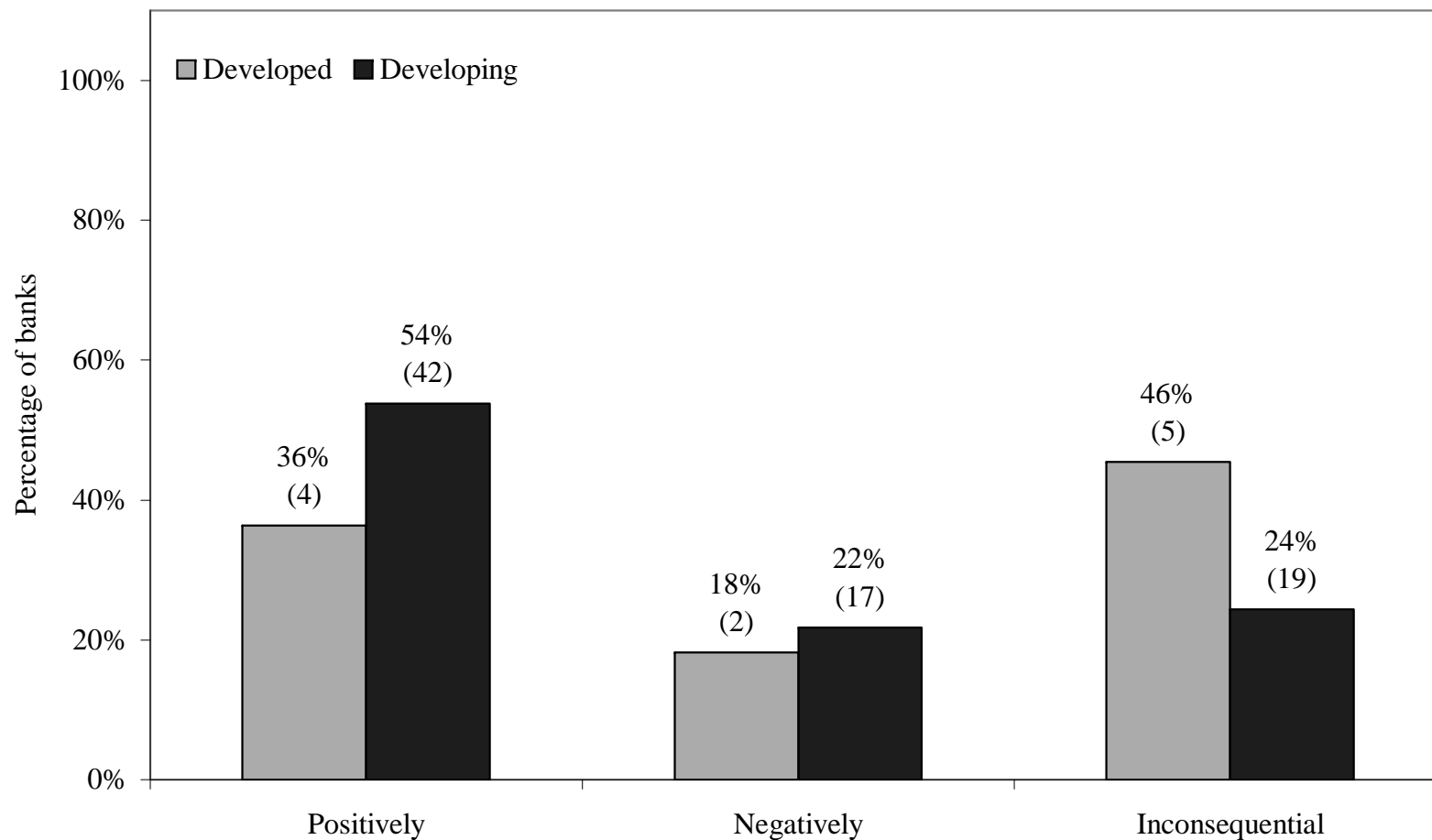
Banks from developed and developing countries rate guarantee programs as the most important government program influencing SME banking.

Which is the most influential government program in SME banking?



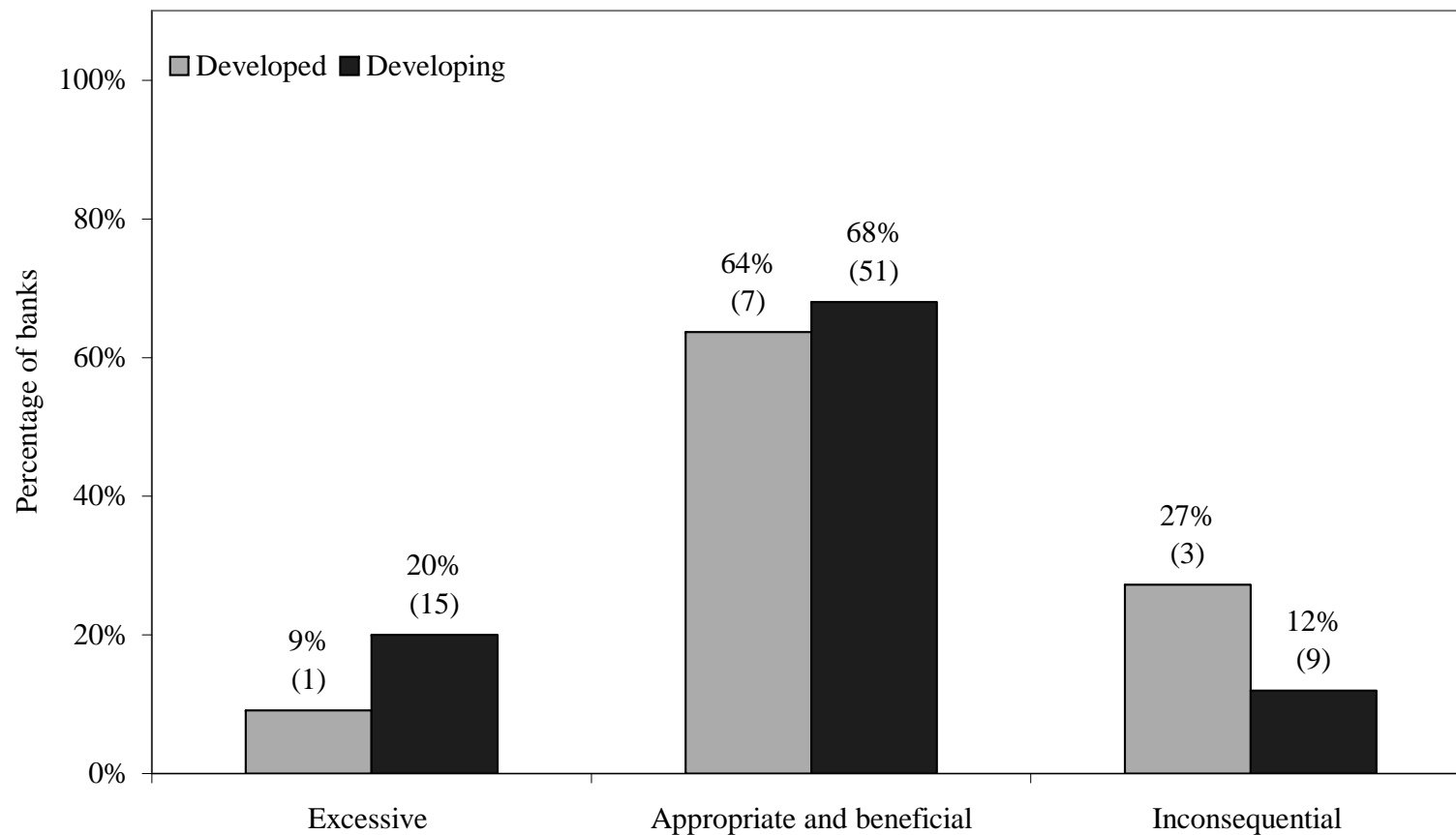
Most banks perceive prudential regulations to have a positive or inconsequential impact on their involvement with SMEs.

How do prudential regulations affect banks' involvement with SMEs?



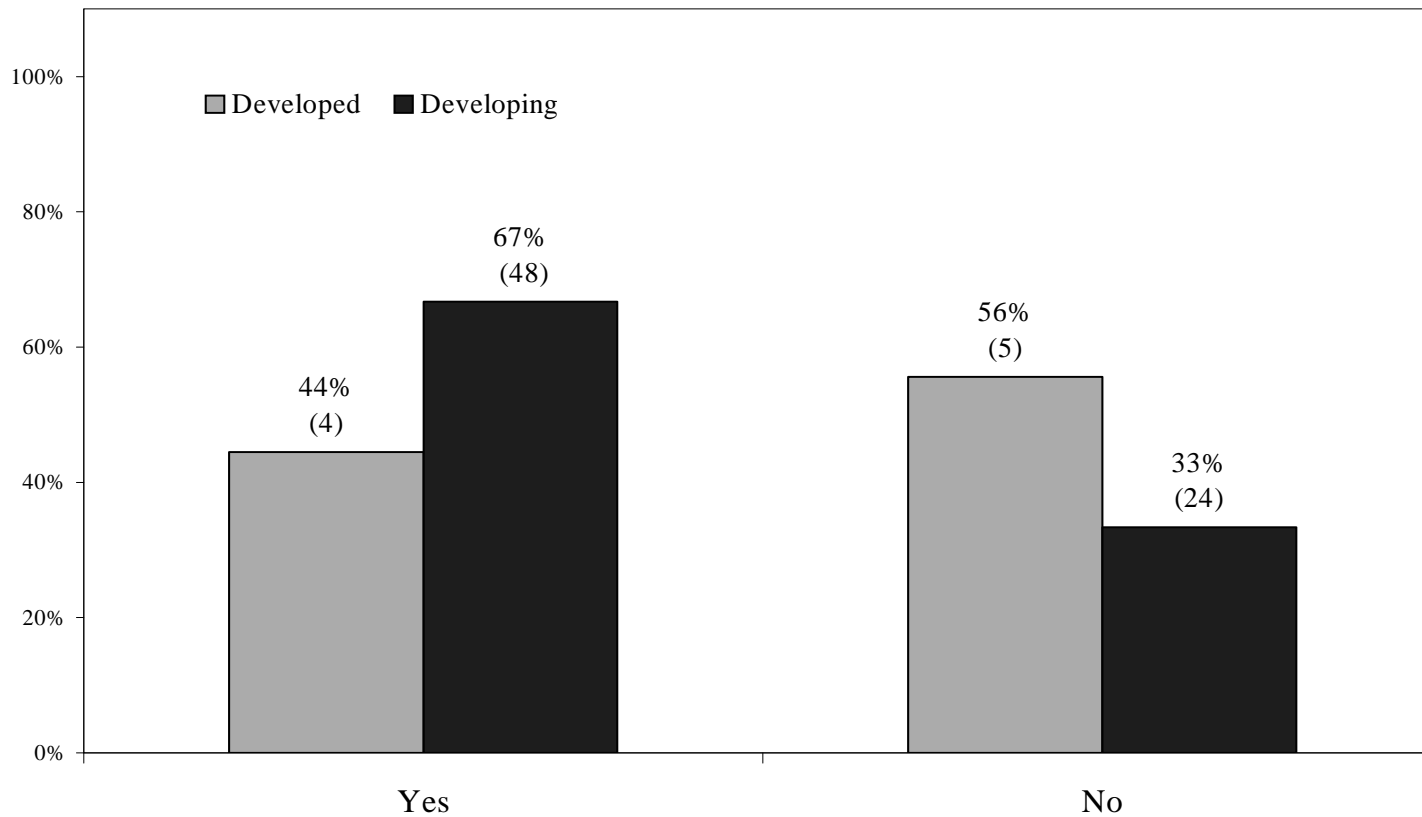
Banks generally rate documentation requirements for SME lending as “appropriate and beneficial”.

What is banks’ impression of the burden posed by documentation requirements?



Access to credit history information is particularly important for banks in developing countries.

Does the existence of credit bureau facilitate SME lending?



Total Responses Developing Countries: 72
Total Responses Developed Countries: 9

Conclusions

- Paper surveyed banks around the world to document the state of SME financing across countries and to compare it to large firm financing, wherever possible.
- Banks perceive serving SMEs as a profitable endeavor and almost all banks have SME clients.
- We found surprisingly small differences when we compare banking to SMEs relative to large firms.
- Instead we found differences in exposure, lending practices, business models, drivers and obstacles of SME finance for banks operating in developed vis-à-vis developing countries

Going forward

- Expand the number of banks and countries surveyed in order to see if we can corroborate our findings in a larger sample.
- Explore in greater depth what drives the differences we have found across developed and developing countries.