Day 1: Introduction

Post by Arun Hsu

Welcome to the 33rd edition of MicroLINKS Speaker's Corner titled "Lending at the Intersection of Micro and SME Finance"

The objective of this Speaker's Corner is to generate discussion and an exchange of ideas regarding the approaches that MFIs must adopt to successfully move up market and lend to SGBs. Of course, this discussion should also be relevant for commercial financial institutions that are attempting to move down market by serving the SGB and microenterprise segments.

The lower end of the SME spectrum is becoming an increasingly important target market for MFIs. Inevitably, some microenterprises grow and enter the lower end of the SME space. These small commercially oriented enterprises with growth potential are increasingly being referred to as small and growing businesses (SGBs). The financing needs of SGBs may differ from microenterprises in several ways including amounts and tenor.

The agenda for this Speaker's Corner is as follows. On Day One, Mary Miller (Development Alternatives, Inc.) will help us define the difference between a microenterprise and a small business. During Day Two, I will facilitate a discussion about lending approaches, tools and technologies needed to efficiently lend to the lower end of the SME spectrum. And finally, on Day Three, Christina Strong (CHF International) will facilitate a discussion on social impact and performance measurement approaches and tools to enable MFIs to stay connected to their mission while moving up market.

Thanks to all of you for your interest in this important topic. We look forward to hearing from you and learning from your knowledge and experience.

Let's hand this over to Mary, and start the discussions!

Day 1: Differentiating Micro & SME Finance

Post by Mary Miller

What defines the difference between a microenterprise and a small business? Governments and donors tend to use measures such as number of employees and total asset size; lenders tend to define them by size of loan that they will need, or that the institution is prepared to offer.

Other criteria for defining the difference between microenterprise and small business might include, depending on country:

- Does the business keep any records
- Are business and household funds co-mingled

- Does the business hire employees who are not relatives
- Does the business have any comparative advantages or proprietary knowledge
- Is the business registered

Questions for discussion:

1. What characteristics can be used to describe the difference between micro and small?

2. Are these characteristics country-specific? (What country are you operating in?)

3. Do these characteristics affect the lending approach of the institution? How?

4. What loan products have you seen that were designed with distinguishing differences in mind?

Post by Biplap Das

I believe that a micro-business can be defined as simply as

- an opportunity for people whose financial well being is at risk
- max. 5 people (family, close friends, same tribe) wearing several different hats throughout the day

Regards,

Biplab Das, Credit Suisse

Post by Arun Hsu

The recently established Aspen Network of Development Entrepreneurs (ANDE) is focusing its programs on small and growing businesses (SGBs), defined as commercially viable businesses with between 5 and 250 employees, that have strong potential for growth and thus for creating social and economic benefits in the community and more broadly the economy. I believe ANDE's definition of SGBs is highly relevant to this discussion.

SGB's are enterprises at the lower end of the SME spectrum in terms of asset size and financing needs. SGBs' capital needs are larger than typical MFI loans but too small to be attractive for commercial banks.

So perhaps the key differences between a micro enterprise and a SGB/SME include:

1. Commercial orientation
2. Growth potential
3. Financing needs

Arun Hsu
CHF International

Post by Bob Patterson

Dear Mary

I think the distinctions could be as follows:

micro (unincorporated sole proprietor, maybe or maybe not paying taxes) vs small (incorporated, in the above ground economy).

small (no separate finance function) vs. medium (full time finance function). The later has a big impact on how a bank deals with the company.

As well, the EU being the EU, there is a precise definition of SME in Europe:

“Medium” (*)
Maximum Employees: 250
Sales: 40 million
Assets: 27 million

“Small” (*)
Sales: 7 million
Assets: 5 million
(*) Either criteria defines the SME

Best regards

Bob Patterson
Warsaw

Post by Mary Miller

Bob, Biplab, Arun, thanks for your comments. A couple of elements that I am drawing out are the size aspect, i.e., micro generally stops at 5 employees (vs the literature which has usually referenced 10, but which has always seemed high to me). Perhaps more important though is the concept of growth and sustainability - SMEs are looking for growth, vs microenterprises which tend to be a limited, perhaps sometime activity.

Mary Miller, DAI

Post by Bob Patterson

I find a lot of micro SME are NOT necessarily growth-oriented. Rather it is "life-style" maintenance focus, especially if it's a family business operating in a comfortable market niche with a glass ceiling. Such SMEs are very risk averse and debt-allergic.

Post by Mary Miller

How then do we see the difference between small and micro - is it only number of employees /asset size/ more likely registered?

Also, my sense is that we should stop using the term SME - if this is covers 5-250 employees, the range seems far too great. Arun cited the Aspen (ANDE) definition of a "small and growing business" (SGB) which covers businesses from 5 - 250 people but distinguished that the business was to be commercially viable - is this enough distinction?

Post by Barbara Calvin

Dear All, Finmark Trust in Johannesburg conducted a Small Business Survey in 2006 which segmented the micro and small enterprise markets into seven separate segments. Segments 4 to 6 could be considered to be micro while segment 7 could be considered to be small. There were big differences between these segments in the South African context as follows:

Micro: generally unregistered (84%), 57% did not finish highschool, 35% had no prior work experience, 60% were in trading businesses, only 5% worked in fixed premises separate from their homes, only 46% kept any financial records, and only 6% had access to a computer.

Small: majority registered(94%), only 9% did not finish highschool, 12% had no prior work experience, only 20% in trading businesses, 33% worked in fixed premises separate from their homes, 93% kept financial records, and 77% utilized computers in their businesses.

Vulindlela assisted Finmark to conduct a study into collateral options for lending to micro and small enterprises. One characteristic which came to light is that microenterprises can grow organically and incrementally whereas small enterprises often need a larger jump in investments to start or expand their businesses. This leads to a different set of "best practices" for lending to small enterprises. I look forward to hearing more about others' experiences with this phenomena.

Post by Mary Miller

Barbara,

I have seen the Finmark studies before and think quite highly of them. Could you shed a bit more light on what differences you see available for collateral, also lending practice differences?

In my experience for small businesses we do see this step growth as you have described, often coming because of acquisition of equipment or something that requires term loans or saving up.

Interesting that for South Africa, like Poland, registration seems to be a big breakpoint between micro and small - elsewhere I do see a lot of small that is not registered.

One other distinction that I have been seeing is that microenterprises are involved in a variety of small money-making ventures, whereas small businesses are more focused on a single activity. Is that your experience as well?

Post by Barbara Calvin

Regarding multiple businesses: From the FinScope Small Business Survey in South Africa, it was not possible to decipher how many businesses each respondent was operating. In answer to the question "Business is sole source of income", 75% of both Microenterprises and Small enterprises answered yes, but there may be multiple activities included in the business. In South Africa, 25% of households receive a monthly grant from the government, spread between old age and disability pensions and child grants up to the age of 18, so the responses reflected an expected average for the country.

Regarding lending practices: our collateral study revealed some elements are very similar between micro and small, and other elements are quite different.

Similar elements included:
- assessment of the owners character and skills involves the same process
- assessment of the business viability is also similar, although small businesses may have more records to rely upon and, as Arun pointed out, the term is longer for higher value small business loans which makes the projections more difficult

Differences included:
- expected coverage ratios on collateral for small enterprise loans are lower due to the higher loan sizes; collateral is expected to cover perhaps 40% to 75% rather than 75% to 125% for individual microenterprise lending.
- several financiers said they preferred to pay suppliers of borrowers directly rather than disburse to the borrowers accounts, which is not common in microenterprise lending.
- many financiers said they felt their small business clients needed more non financial support and coaching; that their skill levels were not quite strong enough to run their businesses successfully. This may be more of a South African problem than a global one?
- Since small business lending includes fewer high value deals, each one needs strong personal attention and relationship management. A credit officer typically handles far less clients than in microenterprise lending.
- Offices tend to be fewer and more centralized for small business lending.

Post by Jennifer Mandel

In my work on women's livelihoods in West Africa I saw both micro and small enterprises (based on the definitions used here (registered, number of employees, etc.) that engaged in multiple economic activities. My experience is that in many parts of Africa such diversification is both a matter of survival (at the micro level) and provides opportunities for growth (at the Small level). For example, wholesaling food staples provides regular income, but augmenting that with the sale of fabric especially at the holidays provides capital infusion.

It seems to me that another important distinction is the type of labor used - unpaid family (micro) or paid employees (small).

Post by Mary Miller

Jennifer, you described daily business activities for ongoing income and expenses, and special activities for capital infusion (e.g., sale of fabric at holidays) - what do you mean by capital infusion? Did you find the extra amounts of income being used for adding to inventory levels (like an increase in permanent current assets), being used to launch into another business, spent on special occasions, or otherwise being drawn out of the business, e.g., for school fees?

Post by Jennifer Mandel

What I mean is that at certain moments like the holidays people would take a portion of their regular capital and invest it in a higher value product. The returns from that could dramatically increase their available capital, but it was not something they could do all the time. I believe that the profits from the supplementary sale of fabric would then be reinvested in their regular business venture(s).

Post by Arun Hsu

Barbara Calvin noted the large jump in investment needed by small enterprises to start up or expand, and the different set of best practices needed to lend to these firms. I think this is one of the significant distinctions between micro and small businesses.

I have encountered many firms that needed technology and equipment to expand and/or become players in a value chain. Underwriting a term loan for equipment requires a monthly cash flow analysis for at least two years out and then annually for the remainder of the loan term. In my opinion this is where significant challenges surface for financial institutions. How do they underwrite these types of relatively small loans properly while maintaining the cost efficiency needed to make the activity profitable.

During tomorrow's session I hope we will have a good discussion regarding practical approaches and tools needed to profitably lend to small businesses.

Post by Barbara Calvin

Regarding collateral for micro and small enterprise lending, in South Africa the options best suited to one are more or less the same options best suited to the other. Lenders prefer collateral which can be appropriated in a timely manner, easily sold (marketable), involve low transaction costs, and provide protection in insolvency. Unfortunately the South African court system is highly inefficient (similar to many other countries) and there are few ways available for operating outside of the legal system.

The conclusion from our study was the best collateral options in this country for the micro market (excluding group lending for the lower segments) are: pledging of movable assets, leasing and installment sale, and cessions of contract payments. The best collateral options for the small enterprise market were the same but cessions of accounts receivable (factoring or invoice discounting) was also added for this segment. The report made five recommendations to policy makers for improving the collateral environment for micro and small enterprise lending in South Africa to reduce costs which are currently very high in relation to value realized.

The full report will be available within a few weeks for anyone who is interested. It included some theory on collateral and a brief survey of global practices, so is somewhat relevant beyond South Africa.

Barbara Calvin
Partner, Vulindlela Development Finance Consultants

Post by Sunimal Alles

Hi, this is an excellent discussion as I have seen service providers becoming stagnent or holding on to their "clients", which is preventing the very poor become not poor and "rich", like most of us. As professionals in development, I feel that we should also discuss the need to find loan products that are able to transcend the vulnerable and very poor to become not poor and be able to be credit worthy and even obtain "Credit Cards", so that they can overcome the challenges they face today. Currently, I see that the very poor have some relief by obtaining "goods on credit" from wholesale traders as many MFIs have sidelined them and focus on providing loans to those who are able to pay back on time, in order to cover costs. Therefore, the purpose of finding loan products for those who are between Micro and Small is very important and if MFIs are not willing to serve the Micro as they lack credentials (or ideas for developing MicroEnterprises) we have a task that is enormous ahead of us. Maybe, we also need to redefine the names we have attributed to the lenders (MicroFinance Institutions-MFIs serving ONLY the very poor and destiture (and transfering them to the others>>>), MacroFinance to serve the not so poor and mainstream banks serving the not
poor) in order that donors and investors know the reality and subsidize only the true MFIs, as I see that many MFIs now lend to the "rich", which does not leave any funds for the poor and destitute. To answer

your questions:

1. What characteristics can be used to describe the difference between micro and small ?

Micro businesses/enterprises are very often individual (or family) unregistered (or registered as sole proprietorships-if they have to put a board in front of their houses) ventures and I am seeing more and more individuals venturing into trading (ambulant and market stalls) leaving their true talents/strengths as many business are failing. This is mainly due to globalization where it has become cheaper to purchase a new item rather than repair (i.e. Watches, radios, TVs, household goods such as washing machines with electronic controls etc) or consumers and the wealthy (and credit card holders) buying at "supermarkets" rather than buying commodities at the family run village/urban stores. I have seen many stores close and "middle class" families become poor and destitute (as their only business had to close down). The few micro businesses that are surviving are packaging (small packets of salt, suger, soap - in slums), sewing, vehicle repair, plumbing, wood working (repair) and small metal working.

SMALL ENTERPRISES are those where there are between two and fifty employers, on many occasions they are partnerships between two friends that employ others. Here again many Small enterprises are finding it difficult to survive due to globalization, unless they are in trading or services (offering security services has become a good business over the past few years and can be run by two partners). As globalization is here to stay, I see that many small business need to become larger to survive and seek to feed into the value chains that are profitable such as hiring agricultural machinery (as there is a food crisis) and providing quick transit (transport) as there are many people buying and selling goods.(rather than repair or manufacture)

2. Are these characteristics country-specific? (What country are you operating in?)

I currently provide services to identify economic opportunities to enhance livelihoods among the displaced and those who live in post conflict areas by developing Value Chain Associations (VCAs) in Uganda, South Sudan, Rwanda and DR Congo. I think the characteristics are more rural and urban and wealth level based than country specific. I have carried out surveys in 15 countries to develop processes for provision of services to enable people live better lives and enhance livelihoods and find that MicroEnterprises/business needed to provide services to the very poor are different in size and assets/goods than those serving the not poor. In order to entice the wealthy to purchase at the corner store, all businesses need to have sufficient capital and even credit card machines.

3. Do these characteristics affect the lending approach of the institution? How?

From what I have seen, most Small enterprises/businesses are able to access loans from institutions as they have some assets, registrations and an address. However, very few banks and MFIs will lend to poor sole proprietor MicroEnterprises, leaving them to seek loans from money lenders or the rich shopkeeper. (or at times obtain goods on credit from wholesalers) There is an approach that we have tested and I will outline that in the next few days as it is a solution.

4. What loan products have you seen that were designed with distinguishing differences in mind?

The needs for loan products of MicroEnterprises and SMEs of the early eighties (my first exposure in Burkina Faso) is much different than now. This is constantly changing and the products designed in 1980 to serve MicroEnterprises and SMEs are not appropriate now. Therefore we need to be willing to change approaches and products. If we have the objective in mind (Serving the very poor/destitute to become not poor and become "Rich" >>>) and put our minds together, we will be able to do it rapidly as there are so many specialists in the world now, and also influence donors and investors.

Post by Mary Beth Theisen

Hi, sorry for the late post - had some problems joining. This is a very useful discussion.

Legal distinctions such as whether or not the business is registered and the ability to separate business financial records from personal seem to be valid criteria for distinguishing between micro and small (or SME) businesses because they are necessary for the more sophisticated financing structures needed as businesses grow in size. Small business financial needs are rarely well served by the limited product range that works very well for micro businesses. In SMEs the loan is more likely to be successful when the timing and repayment terms are tied to the financing need (equipment or cash flow) and source of repayment.

Best,
Mary Beth Theisen

Post by Christina Strong

These are some very interesting comments from Mary Beth and Sunimal, some of which I think can be very linked to the case for incorporating Social Performance standards into the regular reporting practices of MSMEs, which we will discuss tomorrow.

The crux of that is in the mission you point out at the beginning and re-iterate at the end of your statement - "to make the very poor not poor, but 'rich'." There is a core purpose for which all these institutions - be it micro, small, or medium - are lending to people that the commercial banks aren't and I think that is important to remember this distinction while we are talking about the distinctions of micro v. small.

I think that the point you both make on the need to adapt loan products appropriately for both micro and small institutions, to ensure that they are serving their target populations, is one tool that can be used to a) distinguish small from micro and b) differentiates small/micro from commercial.

As you stated in your post - the products developed in the 80s no longer fit market needs for any size institution and it would not be best practice business to leave them unchanged. Mary Beth made suggestions on the ways in which SME product needs differ from those of micro institutions in terms of adjusting timing and repayment schedules.

Can either of you, or others with experience from the field, speak in more depth about how an MFI might assess or change their loan products to be efficient for an SME and appropriate for their target market?

Post by Natalie Domond

Great discussion. Thanks for everyone's contributions.

Given our Day One focus on defining SMEs, I thought there might be interest in sharing how DAI worked with the Haitian Banker's Association (APB) to develop and adopt a uniform definition for an SME in Haiti.

Since 2006, DAI has been managing the USAID Haiti MSME project that works with financial institutions to enhance lending to micro, small, and medium enterprises. One of the program's mandates is to support and stimulate lending to SME's (which account for more than 80% of employment in Haiti). In fall '07 we began working with the APB, whose members were interested in moving down market and realized early on that no uniform definition of an SME existed. Therefore, we worked with an APB working group to develop an SME definition that takes into account the local/country conditions. The final definition focuses on key elements of an SME definition (assets, turnover, and employees) as well as other considerations (legal status, management capacity, etc). The APB working group defined an SME as having 10-100 employees, annual revenue of USD 125,000 to USD 1,250,000, and maximum total assets of USD 1,250,000. The definition was eventually adopted by the APB and its members and they were then able to move forward on developing and approving pre-screening eligibility criteria for SMEs.

While some of these banks were already lending to SME's, by establishing a uniform definition banker's association members were able to move forward with a common understanding of some of the characteristics of this target market segment and develop or refine processes and products accordingly.

The final definition document, which provides a good process flow and information on how to create a similar definition in any country context is available on MicroLINKS. The site also has more detailed information on our approach to working with the APB to spur SME lending in Haiti (this includes a mix of French and English documents about working group activities and events).

http://www.microlinks.org/ev_en.php?ID=28630_201&ID2=DO_TOPIC

Post by Barbara Calvin

Microcredit providers generally start with a short term (less than 12 months) working capital product only, but add longer term fixed asset products over time. Even some microenterprises can benefit from longer term loans structured as leases, or including grace periods, or with variable repayments to reflect their business patterns; so I'm not sure it is correct to say tailored products are only required for small enterprises.

When PRODEM in Bolivia began tailoring products for their rural micro-clients, they came up with interest only loans, with principal payments reflecting the cashflow of the client, whether it was a crop or dairy herd etc...Tailored products appear to have become standard best practice for agricultural lending, whether for micro or small enterprise clients.

Post by Christina Strong

I did not mean to infer that tailored products were only necessary for small enterprises, to be certain, appropriate product development is necessary for any lending institution. I was just interested in hearing the types of product adjustments that were typical for an MFI moving up market.

Do others in the field have examples of how MFI products have been adjusted for this?

Day 1: Summary

Post by Mary Miller

Thanks to all for the useful information provided on the initial discussion topic, What is micro vs. what is SME - following is my summary of information from Day One:

The two particular differences that are noted between micro and small are

- Employees - for micro businesses these are usually family members or close friends, who may not be paid but would share in the family's income from the microenterprise; employees of small businesses are paid as employees. Numerically the break is at 5 persons.

- Registration - small businesses are typically registered whereas microenterprises are not.

Data from South Africa also indicated that microentrepreneurs typically have not completed high school, whereas a majority of small business owners are high school graduates.

While not universal, in general microenterprises served to maintain lifestyles (albeit often at a survival level) while small businesses required a specific investment either for startup or for growth. Both types of enterprises may diversify activities, but diversification at a micro level is more of a survival tactic, but is a form of growth for small businesses.

There was some commentary on lending approaches, particularly that small businesses required longer term loans to finance particular investments, and particularly needed loans matched to use of funds and source of repayment.

Mary Miller DAI

Day 2: Lending Approaches, Tools & Technologies

Post by Arun Hsu

First, I would like to thank Mary Miller for facilitating Day One. Please note that you can still post to the Day One topic. We certainly want to hear from all time zones!

During Day One, we made progress in identifying useful distinctions between micro and small businesses that are relevant for our Day Two discussion which focuses on small business lending best practices -- approaches, tools, and technologies.

In general, lenders target borrower segments when they are convinced they can make a profit. The profitability of lending is determined by net interest margin, operating costs, and loan losses. Many lenders, whether MFIs or commercial banks, avoid making loans to small and growing businesses because the costs of underwriting are relatively high compared to the loan amounts and information asymmetries make it difficult to assess risk. Thus, most lenders believe that operating costs and loan losses associated with small business lending are too high.

The overarching question for Day Two is: What are practical approaches, tools, and technologies that can improve efficiency (reduce costs) and improve risk management so as to enable MFIs and other lenders to profitably lend to the lower end of the SME spectrum?

In order to stay focused, I recommend addressing institutional level capacity rather than financial and legal infrastructure remedies.

Areas of discussion might include rapid screening techniques, credit scoring, segmentation, credit analysis templates, cash flow projection tools, loan structuring analysis, loan products for small businesses, loan documentation, disbursement risk management, and loan monitoring. If you have an innovative approach for any of these areas, we would be interested in hearing about it.

Questions we can try to answer might include: What micro lending techniques are relevant for small business lending? To what extent should lenders assist small business borrowers develop business plans and financial projections? How should MFIs organize themselves to pursue the small business segment? Can small business lending be profitable on its own, or are deposits and other services necessary for a profitable customer relationship?

Arun Hsu
CHF International

Post by Abraham Ndofor

Since most small businesses are either owned by one individual, a family, or a number close friends; an important element that influences the out outcome of any lending activity is the character of the owner(s). The outlook and performance of the business is dependent on the owners who in most cases are also the main managers of the business. Therefore, the quality of the loan performance is dependent on how well the lender's analysis of the owners character, capacity to manage and willingness to repaid the loan and interest once the business is doing well; is done. The second aspect that a lender to small businesses must consider is the structuring of the loan. While micro enterprise loans are often very short term, the same cannot work for small businesses. These need a little more time to produce and turnaround the loan capital to generate revenue. Holding capital for longer time requires some ability in cash management and this is where to have a business account in a financial institution becomes very important. It is important for the owners to separate the business funds from their person funds. The need for some form of Book Keeping for the business is another important aspect. If lenders insist on these small aspects and perhaps guide the owners to open accounts in banks or credit unions (savings and loan cooperatives) such lending will produce better results.

Post by Mary Miller

In Kenya in particular I have seen a lot of use of bank statements for business analysis when small businesses are not doing real bookkeeping - as long as the business transacts all its business through a single current account (or multiple account activity can be consolidated) you have a pretty good surrogate of an income statement. The process falls apart, though, when cash is received and paid out, but not passed through the account. Are others seeing this? How can you encourage small businesses to pass all financial transactions through the account?

Post by Bob Patterson

Dear All

Following on Mary Miller's comments, in the case of SMEs (maybe less so with micros), I think a running" (see below) deposit account is almost mandatory for good lending practice. In Poland, split banking is rather common. Banks in turn won't/can't finance the working capital cycle without tangible security. So a mortgage on RE is commonly used to justify ST credit. Good (at lest prudent) banking maybe but bad financial management...The economy in turn suffers through B-t-B payment "constipation".

Cheers

Bob Patterson
Warsaw

From Patterson's Banking Compendium: "Running Account" (Scottish archaic) – A business's current account that is active in the sense of it running or "operating". Observation of deposit and withdrawal patterns can in turn help outsiders overcome the asymmetric information problem. A business's cash flow activities reveal much of about its financial health. (Note how all of the components of the cash flow statement – operations, financing and investing – can flow through the deposit accounts of a bank.). If watched and interpreted intelligently, a running account can tell a lending banker a great deal about the debt service capacity of a borrower. For example, annual deposits should be about equal to accounts receivables collections and in turn sales. If receivables are, say, 15% of sales, then a bank can gauge what is a reasonable credit usage (say, 50%-65% of receivables). In many markets, banks traditionally insisted on such accounts in order for borrowers to qualify for any short-term revolving credit. Early Scottish banking principles relied on running accounts in the absence of financial statements. In contrast to English bankers, who financed trade on a transaction-by-transaction basis discounting individual bills of exchange, the use of the running account was a financial innovation that permitted continuously revolving credit. Working against a running account is the desire for split banking, either to diversify banking services or for convenience sake (a depositing bank may be situated closer to the business than a lending bank). As well, it must be admitted, tax evasion motives may resist the use of a running account. Bearing in mind that short-term credit is based on a bridging the arrival of cash receipts in the asset conversion process, a running account is a natural fit with such forms of credit granting. To capture the benefits of a running account, a bank must organise and interpret deposit information. While reviewing individual transaction entries and bank statements can reveal a lot, the bank also needs to summarise information in a user-friendly form such as an account transaction history/profile.

Watching the Signs

A banker must understand commercial bills - but how is he to learn? As to his own customers, he has in his ledger the best means of information. Any skilled eye can tell without difficulty the signs of good trade and bad trade in a running account; scarcely any mercantile man ever fails without his account having shown unmistakeable signs to any sort of careful observation.

Walter Bagehot, “Recent Events in the Money Market”, 1875

Post by Joe Dougherty

Mary, et al:

Getting small businesses to formalize is a chicken-and-egg problem, it seems to me. Lenders would like potential borrowers to be formally registered, keep formal financial records, and pass all their business transactions through their bank accounts. But doing so costs money and effort (and attracts the unwelcome attention of the tax man!).

As far as I know, in most countries the only incentive that small businesses really have to formalize would be access to credit. But if credit is unavailable anyway, or if it is unaffordable in terms of interest and fees, or in terms of high collateral requirements, then it's not much of an incentive. Small businesses don't formalize and banks don't lend, and the cycle continues.

The only two solutions I can think of are: 1) for governments to offer better incentives for formalization - e.g. better legal protection, lower taxes, or actual monetary incentives; and 2) for lenders to figure out better ways to get around the lack of formalization. Right now, lenders in many countries seem to 'get around' the lack of formal accounts by requiring collateral in excess of 100% of the loan. A better way might be offer borrowers discounts for producing formal, verifiable financial records. After all, if there are formal financial records, then the borrower's risk is lower (because there is less information asymmetry), so the risk premium should be lower. Also, in some countries, there are significant transaction fees on checking and savings accounts - removing or lowering these fees for borrowers might also help.

The problem is one that Arun alluded to earlier - internal capacity of financial institutions. I have never seen a financial institution in a developing country that really understands customer profitability. None of them can tell you how much profit they earn from a given customer, including all loans, deposit accounts, and transaction services - let alone how much profit they earn on a risk-adjusted basis. I think it would be worthwhile for donor-funded programs to help financial institutions develop that capacity. If lenders understand what drives customer profitability, they are more likely to develop a suitable suite of products and services for their small business clients.

Post by Arun Hsu

Very interesting comments from Joe. Since most financial institutions in developing countries are unable to determine customer profitability, it is not surprising that they are reluctant to target small businesses. They simply do not see the profit potential. Despite all the bank capacity building that has been done by donors, it seems that there is still a long way to go.

Donors have tried to encourage commercial banks to move down market and lend to small businesses through funding mechanisms, loan guarantee programs, etc. Without these subsidies and incentives, few banks in developing countries seem interested in lending to small businesses.

On the other hand, MFIs are reluctant to move up market due to a number of concerns including the costs associated with having to adopt SME underwriting methodologies.

It would be interesting to hear from MFIs that are successfully moving up market. What motivated them to do this? What challenges have they encountered and how have they overcome them?

Post by Nicole Pasricha

Thanks for the interesting discussion. With regards to the questions posed today, I have to agree about the still weak capacities and incentives of banks to serve the small business market in most countries we have worked in. Similar to MF, the level of specialized knowledge, informal or formal client mentoring / support, and volume for profit is necessary - but with higher risk for higher loan amounts and longer terms. I absolutely love the idea of proper costing / profitability analysis per client - does this exist in developed country banking tools that we could adapt and use it in the places where we work?

With regards to MFIs that have successfully gone upstream, I think that there they have mainly successfully grown with their existing clients, and have been able to support them with larger loans because the knowledge of the business is already there. It seems much easier for MFIs (with good credit analysis technology for informal businesses) to move up than to convince commercial lenders to go down. But this probably depends on the market. On the other hand, MFIs often lack the capital to serve the SME market on a large scale, or across unknown and varied industries, whereas banks would have an advantage in this respect.

Lastly, there was some discussion recently on microlinks regarding value chain financing. In my mind, it seems like banks or MFIs who want to target the SME market could do so effectively using a value chain approach. They could investigate a few key subsectors to understand the market linkages, risks, and business models. Then they would be ready to target SMEs in these value chains, with a good credit technology for evaluating these specific businesses, lowering their costs and risks. It could help for agricultural SMEs, but I believe for SMEs more broadly as well. Has anyone seen this approach for SME lending?

Best wishes
Nicole Pasricha
Sr Consultant / Microfinance
MEDA

Post by Joe Dougherty

Nicole:

In response to your two questions....

1. Yes, some banks (i.e. the best ones) in developed markets have tools that allow them to assess customer profitability. I believe they can be adapted to developing countries, and I did so when I used to worked in private management consulting. Donors don't have much of an appetite for this kind of work, though, because the development impact is not obvious to most people - i.e. it sounds like you're helping banks become more profitable, which isn't exactly a high priority. I believe, however, that customer profitability analysis should be included in larger 'capacity building' engagements with commercial lenders (or non-commercial ones, for that matter.)

2. Regarding the value chain approach: It makes sense for lenders - especially smaller ones - to focus on a few sub-sectors (or value chains, if you prefer), so that they can really get to know the players, risks, and opportunities. Good banks in developing countries (e.g. Nigeria's Access Bank, or BOA in Tanzania) already do that. Good banks also already leverage what we would call 'value chain relationships' to get information about a borrower's performance, understand borrowers' repayment capacity, and increase their security (i.e. by paying the borrowers' suppliers directly, as someone mentioned earlier, or by using forward contracts as collateral. I believe there are opportunities to help other lenders employ this approach.

I hope that's helpful.

Post by Nicole Pasricha

Dear Joe & all

Yes, this is very helpful, thanks for the advice. If you know of any place to access these types of customer profitability analysis tools (even for purchase, or for training opportunities on the topic) please do let me know.
Thanks also for the examples of the banks using VC approaches to SME lending, I'll try to learn more.

I also enjoyed the breakfast seminar on Zambia recently. Those were some good lessons learned on SME lending to agriculture sector. If you or others recommend any resources on that topic, I'd also be very interested to pick those up. This is a particularly weak area for banks/MFIs we work with, even those (somewhat) successfully doing SME lending. On my end, I will attach a recent report that came out analyzing some recent approaches to financing SMEs for both credit and equity.

Post by Arun Hsu

Thanks Nicole for your thoughts and ideas. Getting to know and targeting specific value chains is an interesting approach to gaining efficiency and lowering the risks of lending. In addition, understanding business models is an essential skill for credit officers and is often overlooked in credit training programs.

I also think this is an area where closer collaboration between the enterprise development and access to finance folks is needed. Hopefully, we will also hear ideas from those of you working with value chains and the demand side of finance.

Post by Barbara Calvin

Arun is making a good point that banks have an inherent hesitation to serve small businesses. In South Africa, the cost structure of the banks prevent them from taking a "relationship management" approach to small enterprise lending. The banks appear to allocate internal costs of overhead (transfer pricing) such as MIS or HR support, on the same basis to the micro and small enterprise units as they allocate to the corporate divisions. This prevents them from doing term lending below about USD $10 000.

But the legislative & judicial environment does play a role which I believe is important. In Peru, where they introduced a low cost and flexible regime for "floating pledges" in 1998, for loans up to $30 000, this supported rapid growth of MFIs which also moved up-market to serve small business. If South Africa had a similar legislative framework, I believe the banks would be willing to move further downmarket, since realization of collateral would be more reliable and less costly. From our collateral research, it appears that not many countries have an ideal regulatory environment for small enterprise lending, which means they have been forced to depend more on donor or government guarantee programmes.

Post by Nicole Pasricha

Dear all
I appreciate Jennifer and Barbara's comments on serving the needs of SMEs in all of their banking needs. ProCredit is an example of a microlender that has successfully targeted SMEs in many markets. The challenges I saw with the PC approach (at least in Central America) was:
1) the full service relationship: we simply could not provide the range of deposit, payments, and credit services required by some of these businesses. Other banks could offer factoring, lines of credit with no collateral, and a host of full banking services. This says nothing of MFIs who do not even have deposit licenses trying to serve SMEs - they are really at a disadvantage.
2) Process and Pricing: while we had the analysis down, our systems and requirements (of checking banking statements, looking at business records, etc etc) were simply too burdensome for the busy SME manager. They wanted a faster, cleaner process. Our lengthy analysis also increased our costs and we could not compete with the lower interest rates of other commercial banks in the SME client segment.

Is there a way that the bank was able to overcome these challenges in Kosovo and Moz? (or perhaps the markets were different, without a lot of competition for SMEs?) Or are there other examples, like South Africa of high-quality but streamlined SME underwriting practices in informal environments?

More generally, I am interested to hear of experiences with other types of financial products for SMEs, like leasing or factoring or trade finance, where the credit and risk analysis could be simplified and allow good MFIs or micro/small business banks to get involved.

Post by Jennifer McDonald

Thanks to Nicole for sharing experiences from Central America. Each market is certainly different.

Part of the challenge is to prepare loan officers to manage the relationships with more sophisticated clients. When they are learning their job, they have trouble managing clients' expectations and winning their trust. This will be much more difficult in a competitive market where clients have more alternatives.

I believe that some Procredit banks have involved higher level staff (a credit manager or experienced client relationship manager) early in the loan origination process. Rather than relying on loan officers to manage the complete loan cycle as they do for micro-loans, this lets the bank set the tone with the client and gives support to the loan officer.

And again, when clients do much of their banking in your institution, you can be much more efficient in how you lend to them because you already have better information. To do this the bank does need to really compete on products and services beyond loans.

Post by Jennifer McDonald

A few years ago, I had the experience of working in microfinance banks that targeted both micro and SME clients (Procredit banks in Kosovo and Mozambique).

I would agree that there are opportunities for MFIs to move into this market. While it is a different business, there are lessons from microlending that transfer very well to SME lending.

1. Our loan officers were used to checking different sources of information to verify business income flows. For SMEs they used bank statements and cross-checked various records kept by the firm (ie. tax documents, internal book-keeping, order books, supplier receipts, accounts receivable, etc.) Although SMEs were more complex, the procedure wasn't substantially different from analysis of some larger micro-enterprises.

2. Flexibility with regard to collateral. A microlender is accustomed to using different forms of collateral, depending on what the client has to offer. It may be necessary to adopt some new types of collateral or to adjust procedures for larger clients, for example, streamlining procedures for registering mortgages for real estate.

3. Managing risk by ensuring that all stakeholders in a loan are involved. While for microenterprise loans we need to ensure that key family members are on board, for SME loans, the focus would be on verifying the often complex partnerships.

4. Assessment of character and management capacity of the borrower.

I would see the biggest challenges for managing risk for a microlender entering this market to be handling loans that require projections, rather than the cash-flow analysis that we are accustomed to. In addition, the business models are more complex. I agree with the comment that specializing in certain sectors assists lenders to manage risk, although in smaller markets you may not have this luxury.

There are a number of operational challenges as well. How to organize the different segments in your credit department, where to locate specialized SME loan officers, how to ensure collaboration with branch staff who receive inquiries from SME clients, and how to effectively meet the other needs for financial services that SMEs may have.

The comments about using bank statements to verify income are very interesting and important. When one institution is able to offer full and competitive financial services to the SME, it is possible to make access to larger loans conditional on banking more of the business's turnover with the lender.

Commercial banks in some markets offer competitive lines of credit to their best SME clients just on the basis of net worth and turnover banked in the current account.

Jennifer McDonald
Boulder Institute

Post by Arun Hsu

Jennifer, thanks for sharing your ideas and Kosovo and Mozambique experiences.

I would like to elaborate on the point you made regarding the significant challenge micro lenders face in handling loans that require projections.

Since cash flow projections are critical to assessing repayment capacity and structuring loans for SMEs, one would expect that credit officers in commercial banks that lend to SMEs would be proficient at developing and analyzing financial projections. However, this is often not the case.

Part of the problem is that universities tend to teach accounting using a very mechanical approach. Therefore, many bank loan officers are good at calculating ratios but have not developed the ability to “see” and “understand” a business through its financial statements.

In addition, cash flow projections are often done on an annual rather than monthly basis and are therefore not that useful for evaluating a business model, guiding loan structuring, or assessing repayment capacity.

Furthermore, individually developed spreadsheets are often used. Not only should the assumptions be reviewed, but the formulas and structural integrity need to be checked as well. This is highly inefficient and subject to a high degree of error. In addition, I have seen many cases when the balance sheet, income statement, and cash flow statements do not tie together correctly.

If commercial banks have such a difficulty with projections, then it’s not surprising that micro lenders also find it difficult to deal with financial projections for their SME clients.

There is some truth to the statement that financial projections are a substitution of error for chaos. However, it is better to do them than not. And to do it reasonably well requires a solid grounding in accounting fundamentals and a lot of practice. The use of financial projection templates is also essential. The challenge we face as consultants and trainers is to help bankers and micro lenders become proficient in developing and analyzing financial projections as quickly as possible by using innovative skill building techniques.

Post by Bob Patterson

I'm an accountant, ex-banker and a teacher so I'm sympathetic to this comment about a gap in accounting knowledge by some SME bankers. Spreadsheets often only make it worse as the logic of accounting is lost on users.

I have a fun little teaching tool ("Balance the F/S") that I sometimes use. I use it to benchmark accounting knowledge. About 50% of SME loan officers can do it correctly in 30 minutes. Tells me if group needs more coaching.

Cheers

Bob Patterson
Warsaw

Post by Arun Hsu

Bob thanks for your contributions to this discussion. The devil is in the details and you have provided some really important details.

The teaching tool you mentioned is a really simple, yet efficient and effective way to enable the adaptation of the training to the knowledge level of the audience. Saves so much time and the outcomes are so much better.

You also mentioned the shortcomings of using spreadsheets. What sort of approaches / tools do you recommend for enabling businesses and bankers to develop a set of financial projections?

Post by Bob Patterson

Hi Arun

Of course Excel is a gift from accountant's heaven. Would not end run it. Rather, as a question of learning forecasting, I do it manually. Best way is a case study based on an actual company. Have the class forecast and compare to actual results.

I teach ACCA accountancy exam prep (you know them?). What is interesting is that all the exams are manually computed. While Excel is universal, it's still good to 'pencil in' numbers at least as a learning step.

Post by Barbara Calvin

I agree that offering a transaction account is an important service element for small businesses and improves risk management through better information on the clients deposits and withdrawals. I'm not sure, however, that the small business should be encouraged to put all their transactions through the account. In South Africa, bank fees are among the highest in the world and bank branches are not convenient to the majority of small and microenterprises. Individual microlending methodologies have developed ways to estimate income and expenditure without relying on bank accounts to provide a full picture; the same methods can be applied to small businesses.

Day 2: Summary

Post by Arun Hsu

Thanks to all the contributors for your interesting and substantive ideas and observations.

It seems that improving access to finance for the small and growing business -- the lower end of the SME spectrum -- continues to present many challenges and obstacles.

It's good to see that increasing thought and attention is being focused on this area.

During Day 2, we covered a range of issues that impact the flow of financing to small businesses:

- customer profitability analysis
- using bank accounts to monitor cash flow
- value chain approaches
- financial projections
- capacity building
- relevance of non lending services
- leasing, factoring, trade finance
- legislative and judicial environment
- organizational issues
- challenges faced by MFIs moving up market
- challenges faced by banks moving down market

I wanted to focus on practical issues and ideas and I think we accomplished that!

Thanks again to all contributors.

Day 3: SME & Social Performance

Post by Christina Strong

Hello Participants and thank you for the great discussions so far!

Building on the dialogue from Day 1, where we highlighted key factors that distinguish Small- from Micro-level enterprises and Day 2, where we identified examples of small business lending best practices, Day 3 will attempt to explore how SMEs can use the types of best practices we have discussed, and other Social Performance tools, to maintain their commitment to a social mission while cultivating a strong business model.

As mentioned in dialogues yesterday – commitment to a social mission is what ultimately separates many Micro- and SME institutions from commercial banks. With many microfinance institutions moving towards larger loans and a more commercial business model, the industry has seen a flurry of debate around the future direction of microfinance. With investments coming from increasingly commercial sources and MFIs moving up-market and beginning to turn profits, there has been much talk of “Mission Drift” and concern that the industry is losing its commitment to poverty lending.

In addition, this debate comes at a time where interest is high amongst the general public and a new set of socially responsible investors, thus resulting in a growing demand for the microfinance industry to improve the transparency and quality on their social impact reporting.

To start off today's discussion, I would like to hear whether or not SMEs, or MFIs moving up-market into larger loans, feel pressure to meet a double bottom line: Is "mission drift" a relevant concern for SMEs?

If so: Are you currently pursuing or already using, any social performance tools or other best-practice processes to put it into practice? What are the challenges to doing so?

If not: Why not?

Other questions to consider might include: Can Social Performance tools or methodologies be useful in this regard if standards are not set or consistent across SMEs? Can standards that apply to MFIs even be used for SMEs? What aspects would need to be adapted to reflect the aims and impacts of an SME lender?

For those of you looking for some background and definitions on Social Perfomance, please visit the documents posted for Speaker's Corner 18:
http://www.microlinks.org/ev_en.php?ID=16461_201&ID2=DO_TOPIC on Mainstreaming Social Performance.

Post by Christina Strong

Please note one minor clarification in this post: where reference is made to SMEs, it is meant to read SME Lenders.
Apologies.

Christina Strong
CHF International

Post by Arun Hsu

Job creation seems to be a impact indicator that most donors use in practically every enterprise development and SME access to finance project. These projects often have three year time frames. Many MFIs also track employment creation and preservation.

SME start-ups certainly create employment. However, existing businesses might acquire technology that results in decreases in employment as manual labor is displaced by automation.

So as MFIs move up market, the suitability of using job creation as a short term social performance indicator becomes more debatable.

Post by Mary Miller

I consider employment a nuisance to measure, and don't like it because financial institutions never measure this for their own purposes, i.e., it is only done for a donor.

If it is measured, I prefer that the measure just be of the business's performance, not deemed to be the result of the loan. A leap of loan - more assets - more possible sales - greater production - more employees has a lot of holes in it.

Post by Christina Strong

This is a good point on setting indicators; often donor and institutional objectives don't match up and can run at cross-purposes. This brings to light the need for all types of stakeholders - institutions, donors, networks etc. - to be engaged in the process of defining social performance standards and indicators specific to SME lending.

For example, the Social Performance Standards Report recently released by the MIX was created to collect information on 22 core indicators selected by The Social Performance Task Force as a result of multi-level stakeholder discussions. Rather than focusing on only output/outcome indicators like employment generation, it covers four broad operational areas where an institution can emphasize and uphold their commitment to social impact:

1. INTENT - Mission and Social Goals, Governance (commitment of management to mission)

2. STRATEGIES AND SYSTEMS (Internal systems and activities) - Range of products and services, Training on social performance, Staff performance appraisal and incentives, Market research on clients , Measuring client retention, Poverty assessment

3. POLICIES AND COMPLIANCE (Internal systems and activities) - Social responsibility to staff, to community, to environment, to clients; Cost of services to clients
4. ACHIEVEMENT OF SOCIAL GOALS (Outputs and Outcomes) - Geographic outreach Women outreach, Clients outreach, Outputs, Employment, Children in School, Poor and very poor clients at entry, Clients in poverty, Clients out of poverty

A broader approach to measuring social performance could allow for SME lenders to show donors how they are meeting social goals, even if the traditional measurements don't appear to be meeting social goals. Do you see this holistic approach as more appropriate for SME lenders?

I am attaching the work book that is used by MFIs willing to report on the MixMarket; if more institutions begin to adopt Social Performance reporting tools such as this, do you think donors will begin to accept a more comprehensive approach to measuring social impact?

MixMarket Reporting Work Book

Day 3: Summary and Closing Remarks

Post by Christina Strong

Dear Participants,

Thanks you for the engaging discussions on Day 3 of this forum! Throughout the day we explored how SME lenders can use lending best practices and other Social Performance tools to maintain their commitment to a social mission while cultivating a strong business model.

During the discussions, we established that commitment to a social mission is what ultimately separates many Micro- and SME institutions from commercial banks, and we also addressed several key challenges to incorporating Social Performance into SME lending:

INDICATORS

- SME lending institutions often only track "social" indicators, like employment creation & preservation, at the request of donors.

- Donor-driven social impact indicators may work at cross-purposes to healthy SME development.

- As a result, any Social Performance standards and indicators that are developed for up-market lending will require input from stakeholders at all levels of the playing field if they are to be effective.

APPROACH TO SOCIAL PERFORMANCE

- Social Performance can be incorporated on a broader level than just traditional impact assessments. For example, creating appropriately tailored product terms and conditions is one way to fulfill a social mission, by responding to the changing needs and capacities of the clients you are trying to serve.

- Whether or not SME lenders decide to pursue social performance with a more comprehensive approach will largely depend on some of the questions we left unanswered:

Will Social Performance tools be useful if standards are not set, or made consistent, across SMEs?

Does Social Performance even matter to most up-market lenders?

I look forward to seeing the debate continue on this in the future!

Post by Brandon Szabo

Dear all,

On behalf of the microLINKS team, I'd like to thank our excellent facilitators for this discussion forum– **Arun Hsu**, **Mary Miller** and **Christina Strong**– for their dedicated support. Thank you also to all of our participants! This week's discussion had 50 posts and included 69 registered participants from 20 different countries. Thanks again for your participation!

The discussion forum will remain through the day, so please feel free to continue the conversation and add any questions or comments that you may still have.

The messages and related resources shared in the forum will continue to be available at **www.microlinks.org/sc/micro2SMEfinance**, and in about 2 weeks we will add to those resources a compilation document that includes all the postings in one easy-to-search document. The summary will also be posted in the **resource section**. Also be sure to review the other resources submitted by the facilitators and your fellow participants during the discussion.

If you are interested in future Speaker's Corners or other activities on microLINKS, USAID activities, or other information related to microenterprise development, please consider signing up for our monthly electronic newsletter, Connections, at **www.microlinks.org/connections**.

Thanks again to everyone. I hope you enjoyed it and we look forward to seeing you online (or in person) again soon.

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