

## SME Access to Credit: Enhancement through Upscaling

### Context

One of the major challenges in SME financing is shifting the mindset of banking institutions from traditional, collateral based lending to cashflow based approach. SMEs, by nature, do not necessarily have an established system in doing their business and lack assets to use as collateral. As such, traditional bankers generally see this sector as *high risk* for lending. Although banks already appreciate the profitability of SME lending, there remains a lack of knowledge and skills in providing loans to SMEs. Through building awareness of and continued education on the benefits of SME lending, these challenges are incrementally overcome. The strongest convincing tool for bankers to make the shift is the profitability of the SME loan portfolio.

In 2001, the DTI Small Business Corporation (SBC) initiated the provision of SMEDSEP assistance to banks to improve lending to the SME sector. The German Government through GTZ responded by commissioning the financial sector study that served as the basis in defining specific intervention strategies including the use of innovative and tailor-made approaches.

### Problem

Banking institutions in the Philippines generally lack knowledge and skills in providing SME lending resulting in the lack of access to credit by SMEs in the country.

### Solution

Implement the **Upscaling Approach** through cashflow based lending, providing SMEs better access to credit.

### Approach

#### Upscaling in SME Financing

*Upscaling* is a technical term in Development Finance. This is adopted by a bank that decides to move to a new and **higher** level of market segment using innovative procedure like cashflow based method.

The case described in Diagram 1 shows rural banks that are into microfinance and consumer lending using traditional, collateral based method of lending. SME lending, which targets the underserved *middle* market segment, requires the Upscaling Approach.

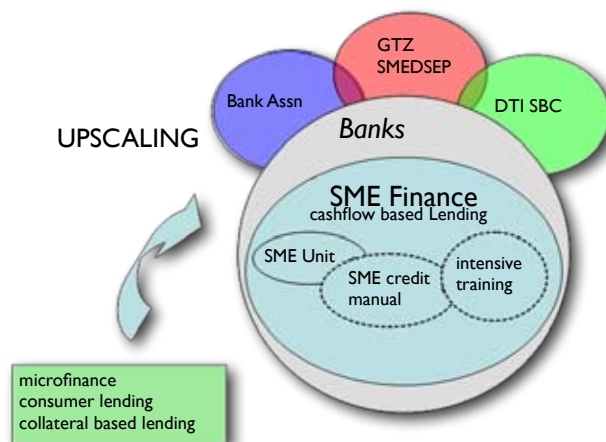


Diagram 1

An SME Unit within the bank with dedicated human resources is a basic requirement in implementing the Upscaling Approach. This Unit undertakes intensive capacity building in defining the Lending Manual and going through the whole process of SME Lending until SME Finance eventually becomes a permanent product of the bank. The capacity building activities include a combination of onsite coaching and traditional classroom based training.

Collaboration of the key players DTI SBC as lead agency with bank associations (for example the Rural Bankers Association of the Philippines, RBAP) and GTZ as advisor is essential.

Upscaling involves two phases: Preparatory Phase and Operational Phase. It requires significant time of preparation (see **Preparatory Phase Box**). A study on the financial sector showing demand for SME credit is helpful in convincing banks on the profitability of SME Lending at this phase. The preparatory stage also includes an accreditation process wherein banks are preselected based on indicators such as stability, profitability and transparency, among others. Those preselected go through a Due Diligence Procedure which is a detailed bank assessment. Finally, the decision to conduct the Upscaling Approach is sealed by a Service Agreement.

The **Operational Phase** takes off from a training needs assessment of the partner bank. Capacity building strategies are undertaken chronologically as described below. The attainment of milestones proceeds from successful implementation of each element starting from establishing the SME Unit to full adaptation of the SME Lending tools. Performance monitoring facilitates learning, leading to the expansion of bank's SME portfolio and making necessary adjustments.

### Preparatory phase (up to one year)

- financial sector study
- accreditation process of banks
- service arrangements with bankers association, federation and individual banks



### EFFECTIVENESS

- capacities of banks to continuously serve the SME clients increased
- banks cover part of the capacity building costs which include onsite coaching and training

### SUSTAINABILITY

- SME lending adapted as regular loan product of banks
- availability in the market of SME loan products increased and sustained: *no market distortion - no subsidies needed.*

### Operational phase (until two years)

- Training Needs Assessment
- capacity building and trainings
  1. establish SME Unit
  2. develop and implement SME Credit Manual and Procedures
  3. conduct intensive training / coaching on and off the job
  4. adaptation of SME Lending tools to the specific needs of individual banks
- monitoring of portfolio performance and quality

In the Philippines, the network of rural bankers is comparatively strong under the leadership of the Rural Bankers Association of the Philippines (RBAP). Making the Service Agreement directly with the participating banks in the Upscaling Program could be more efficient. However, experience suggests that going through the meso level like RBAP and also the provincial federations of rural banks not only makes the work feasible but also creates bigger impact to the industry since other member rural banks which not directly participating in the Upscaling Approach also benefit.

## Key Results

### RELEVANCE

- *underserved SME segment* in the country supported
- profitability of banks strengthened

### EFFICIENCY

- wholesale financing to banks for midterm to long term SME loans provided by DTI SBC
- innovative tools on SME lending utilized by banks while attaining economies of scale
- portfolio growth for banks enhanced

## Success Factors

- commitment of bank owners - Board of Directors
- dynamic bank management
- support of bank associations
- size of the bank - *bigger is better*
- favorable regulations and environment
- bank trainings and capacity building activities are fee based
- financial resources for marketing and administration cost of SBC and Bank Associations readily available.

**Table 1: MSME Loan Portfolio Performance (SMEDSEP two Partner Rural Banks in the Visayas)**

Indicators	No. of loans	Volume (mPhP)
Baseline (June 2007)	83	30.9M
May 2008	286	75.4M
Increase	245%	152%

Source: SMEDSEP Monitoring Data

### CASE: First Agro Industrial Rural Bank (FAIR Bank)

FAIR Bank in Cebu is one of the nine anchor rural banks of SMEDSEP in the Visayas. It has five branches. The bank organized an SME unit headed by the bank President and with dedicated SME account officers. The SME account officers together with the top management received training from SMEDSEP. On the job coaching further exposed the SME unit on cash flow-based approach on credit appraisal. The bank is now using credit scoring tool.

In two years time, FAIR Bank posted a 316 percent increase of enterprise loans from PHP37m by end 2004 to PHP154m as of end 2006. This comprises 56 percent of the total loan portfolio during the same period. Arrears rate of business loans is less than one percent.