

Upscaling: Enhancing Access to SME Credit

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

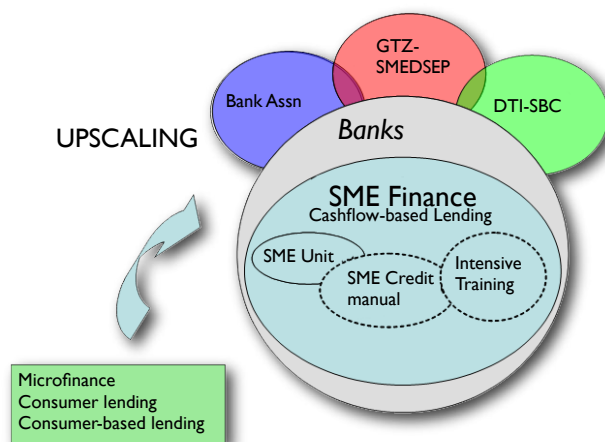
Implement the **Upscaling Approach** through cashflow-based lending, providing SMEs better access to credit.

Approach

Upscaling in SME Financing

Upscaling is a technical term in Development Finance. This is adapted 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 the diagram 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.



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 on-site coaching and traditional classroom based training.

Collaboration of key players- DTI-SBC as lead agency with Bank Association (e.g. Rural Bankers Association of the Philippines, RBAP) and GTZ as advisor- is essential.

Upscaling involves 2 Phases: The Preparatory and Operational Phases. 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 pre-selected based on indicators such as stability, profitability and transparency, among others. Thereafter, those pre-selected go through a Due Diligence Procedure, which is a detailed bank assessment. Finally, the decision to conduct Upscaling Approach is sealed by a Service Arrangement.

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

In the Philippines, the network of rural bankers is

Preparatory phase (up to 1 year)

- Financial sector study
- Accreditation process of banks
- Service Arrangements with bankers association, federation and/or individual banks.



- Innovative tools on SME lending utilized by banks while attaining economies of scale
- Portfolio growth for Banks enhanced

EFFECTIVENESS

- Capacities of banks to continuously serve the SME clients increased
- Banks pay part of the costs capacity building which includes on-site coaching and training

SUSTAINABILITY

- SME lending adapted as regular loan product of banks

Operational phase (until 2 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

comparatively strong with Rural Bankers Association of the Philippines' (RBAP) leadership. Making the Service Arrangement directly with the participating banks in the Upscaling program could be more efficient. However, experience suggests that going through the meso-level RBAP and, also the provincial federations of rural banks, not only makes the work feasible but also suggest bigger impact to the industry since other member-rural banks 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 mid-to long-term SME loans provided by DTI-SBC

- Availability in the market of SME loan products increased and sustained (No market distortion. No subsidies needed).

Success Factors

- Commitment of bank owners/BOD.
- Dynamic bank management.
- Support of bank associations.
- Size of the bank- bigger is better.
- Favorable regulations/environment.
- Bank trainings and capacity building activities are fee-based.
- Financial resources for marketing and administration cost of SBC and Bank Associations readily available.

MSME Loan Portfolio Performance (SMEDSEP 9 Anchor Rural Banks in the Visayas)

Indicators	# of Loans	Volume (Million Pesos)	None Performing Loans	MSME Ratio to Total Loan Portfolio
Baseline (End-2004)	20,904	440.0	6.0%	59%
Qrt2, 2006	39,107	620.0	4.9%	73%
Increase	87%	41%		24%

Source: SMEDSEP Monitoring Data

CASE: First Agro Industrial Rural Bank (FAIR Bank)

FAIR Bank in Cebu is one of the 9 anchor rural banks of SMEDSEP in the Visayas. It has 5 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 less than 2 years, FAIR Bank posted a 257% increase of enterprise loans from P37M in end-2004 to P132M as of 3rd quarter 2006. This comprises 24% of the total loan portfolio during the same period. Arrears rate of business loans is less than a percent.