Information Brief 5.1

Downscaling: 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 there are banking institutions that 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. And 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 the 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.

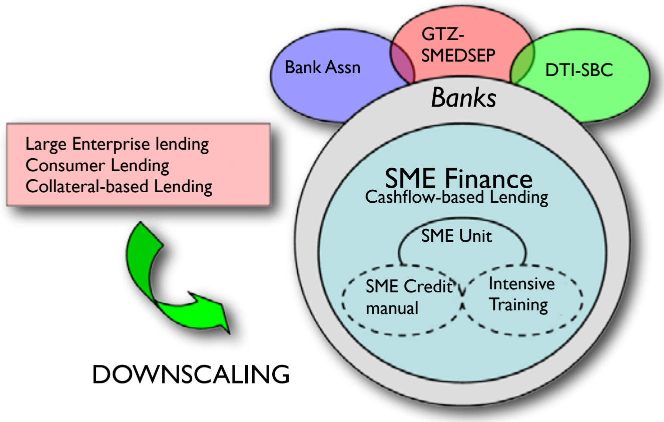
Solution

Implement the Downscaling Approach through cashflow-based lending and provide SMEs better access to credit.

Approach

Downscaling Approach in SME Financing

Downscaling is a technical term in Development Finance. This is used by a bank that decides to move to a new and **lower** market segment using innovative procedure like cashflow-based method. In the case of the GTZ experience in the Philippines, this approach is applied to thrift banks with national-scope banking operations.



The case described in the diagram shows a thrift bank that is into large enterprise and consumer lending using traditional, collateral-based method. SME lending, which targets the underserved "middle" market segment, requires Downscaling approach.

An SME Unit within the bank with dedicated human resources is a basic requirement in implementing the Downscaling 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 DTI-SBC as lead agency with Bank Association and GTZ as advisor is essential.

Downscaling involves 2 Phases- The Preparatory and Operational Phases. It requires significant time of **preparation (**see **Preparatory Phase**). 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 Downscaling Approach is sealed by a Service Arrangement.

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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 until full adaptation of SME Lending tools. Performance monitoring facilitates learning, leading to the expansion of bank's SME portfolio and/or making necessary adjustments.

Preparatory phase (up to 1 year)

- Financial sector study
- Accreditation process of banks
- Service Arrangements directly with individual banks.

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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

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

Success Factors

- Commitment of bank owners/ Board Of Directors.
- Dynamic bank management.
- Favorable regulations/environment.

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

Indica-tors	# of Loans	Volume (Million Pesos)	None Perfor ming 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.

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