Bank Involvement with SMEs: Beyond Relationship Lending

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Presentation

1. Motivation
2. Data
3. SMEs as Bank Clients
4. Business Model and Risk Management Systems
5. SME Side
6. The Effects of the Crisis
7. Conclusions

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Motivation: Conventional Wisdom

- SMEs receive inadequate financing
- "Conventional wisdom"
  - Lack of financing rooted in "supply-side" factors
  - Leading banks and other financial institutions uninterested in serving SMEs

Motivation: Conventional Wisdom

- Several reasons explain supply-side view
  1. SMEs are opaque (most stressed reason)
     - Unknown capacity and willingness to pay
     - Difficult for banks that rely on arms-length financing and hard, objective, and transparent information
  2. SMEs are more likely to be informal
     - Banks cannot lend
     - Contingent senior liabilities to government and employees
  3. Capital markets do not compensate

Motivation: Conventional Wisdom

- “Relationship lending” – a way to cope with opaqueness
- Relationship lending
  - Relies on “soft” information gathered by the loan officer
  - Continuous, personalized, direct contacts with SMEs, their owners and managers, and the local community
  - Direct contacts mitigate opacity problems
  - Berger and Udell (2006)

Motivation: Conventional Wisdom

- Implications of relationship lending
  1. Banks lend less to SMEs than otherwise
     - Require higher returns for SME loans, given costs
  2. Relationship lending difficult for large and foreign banks
     - Less capable of processing “soft” information
     - SMEs served by small or niche small banks
  3. Better institutions lead to less relationship lending
     - Less reliance on soft information
     - Well-functioning contract enforcement
- Evidence: banks (mainly small and niche) engage with SMEs through relationship lending

Motivation: This Work

- Whether and how much conventional wisdom holds
- What about alternative views?
- Has the crisis transformed this view?
- New data
  - Bank surveys
  - 48 banks (plus 1 leasing company)
  - 12 countries
- Hard evidence collected via bank questionnaires
- Anecdotal evidence obtained in interviews
- Data from SME surveys

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Data

1. Survey data across banks (2006-07) in 4 countries
   - Argentina, Chile, Colombia, Serbia
   - Large share (70%) of banking sector assets, 37 banks
   - World Bank

2. Survey data across banks (2009) on the effects of the crisis in 3 countries
   - Argentina, Chile, Colombia
   - 24 banks
   - World Bank

Data

1. Survey data in 8 countries/11 banks (2006)
   - Australia, Brazil, India, the Netherlands, Poland, Thailand, the UK, the US
   - IFC

2. Annual SME surveys in 7 countries (2002-2006)
   - Argentina, Chile, Colombia, Mexico, Peru, Puerto Rico, Venezuela
   - FRS (Inmark Group)

Data

Source	Year	Countries	Surveyed Population
World Bank survey	2006-2007	Argentina	14 banks
	2006-2007	Chile	8 banks
	2007	Colombia	7 banks and 1 leasing company
	2007	Serbia	8 banks
World Bank survey on the crisis	2009	Argentina	10 banks
	2009	Chile	6 banks
	2009	Colombia	8 banks
IFC survey	2006	Brazil	6 banks in total operating in Brazil, India, Poland, and Thailand
	2006	India	
	2006	Poland	
	2006	Thailand	
	2006	Australia	5 banks in total operating in Australia, the Netherlands, the United Kingdom, and the United States
	2006	Netherlands	
	2006	United Kingdom	
	2006	United States	
FRS (Inmark Group) survey	2002, 2004-2006	Argentina	918-928 SMEs, depending on the year
	2002-2003, 2005-2006	Chile	920-963 SMEs, depending on the year
	2002-2003, 2004, 2006	Colombia	920 SMEs
	2002-2006	Mexico	604-1,015 SMEs, depending on the year
	2003-2006	Peru	920 SMEs
	2002, 2004-2006	Puerto Rico	617-627 SMEs, depending on the year
	2002, 2004-2005	Venezuela	908-923 SMEs, depending on the year

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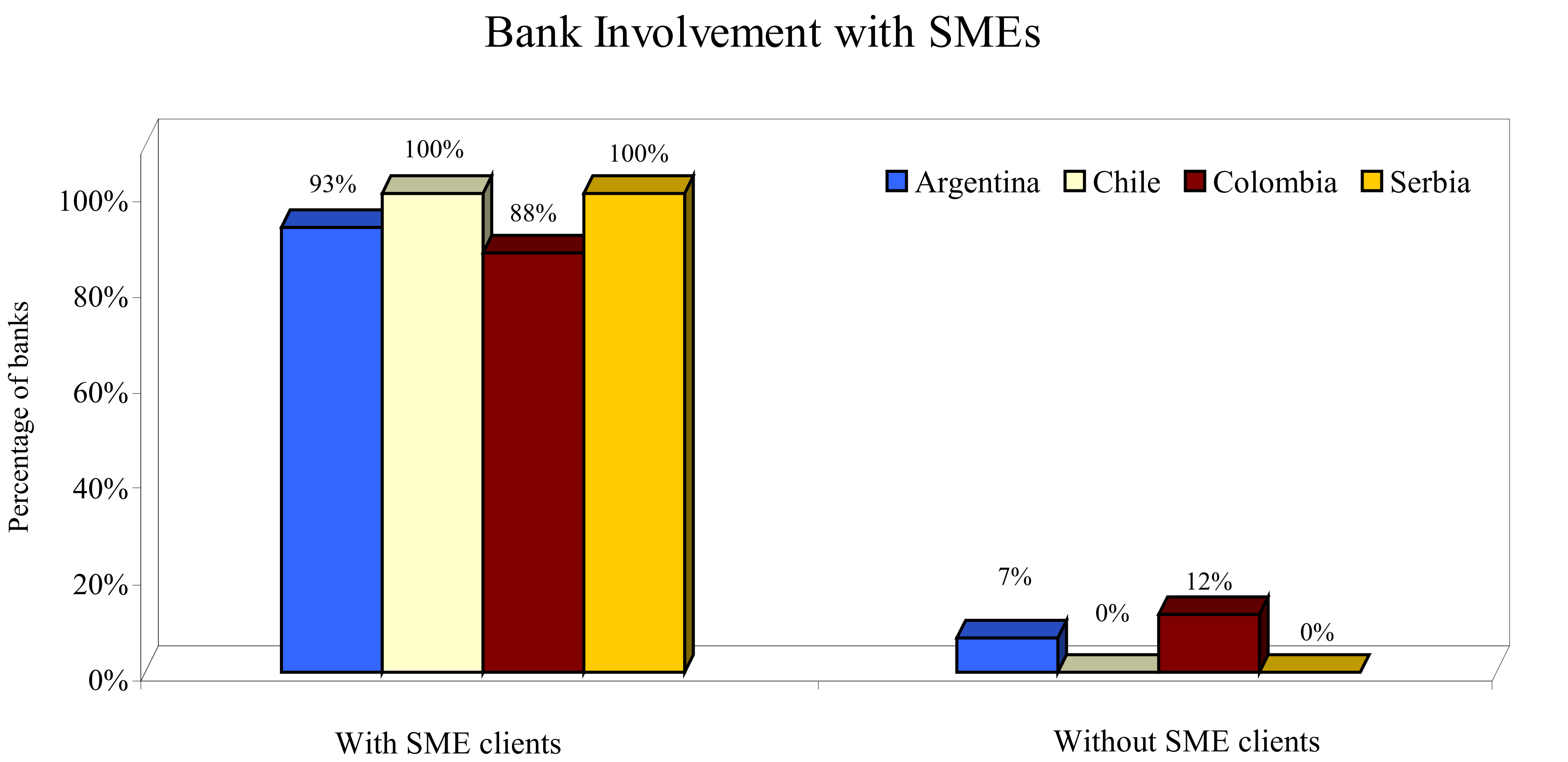
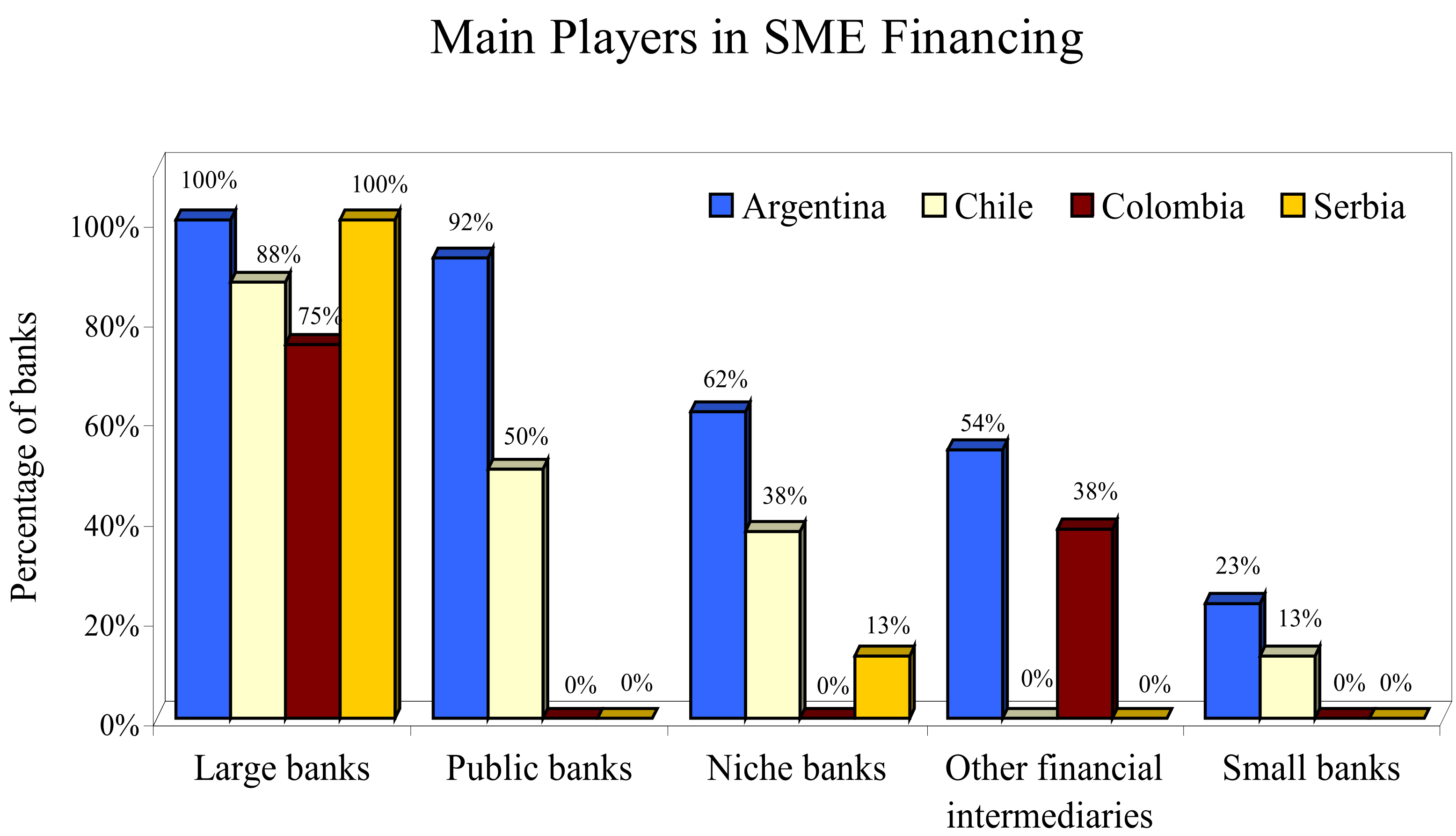
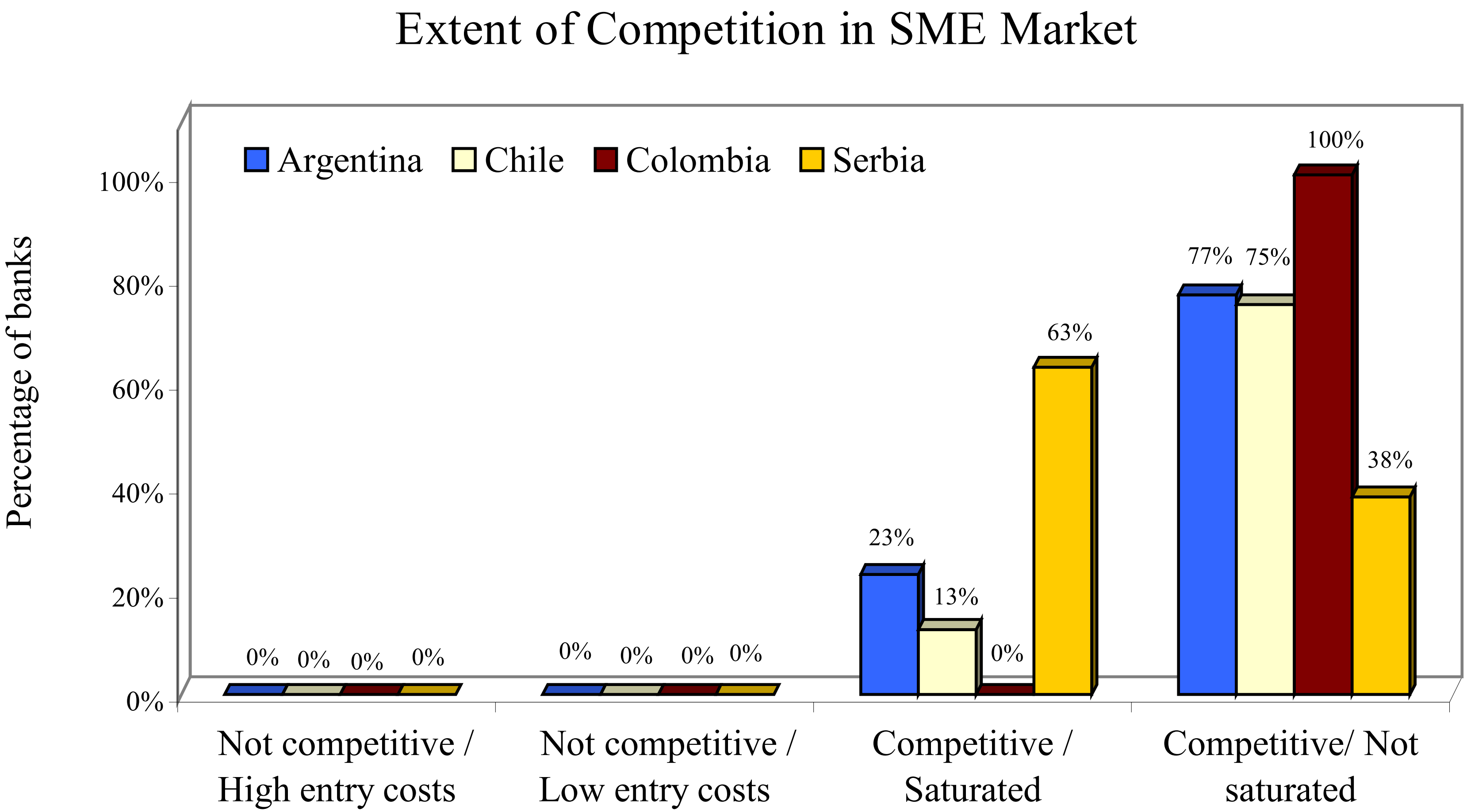
SMEs as Bank Clients



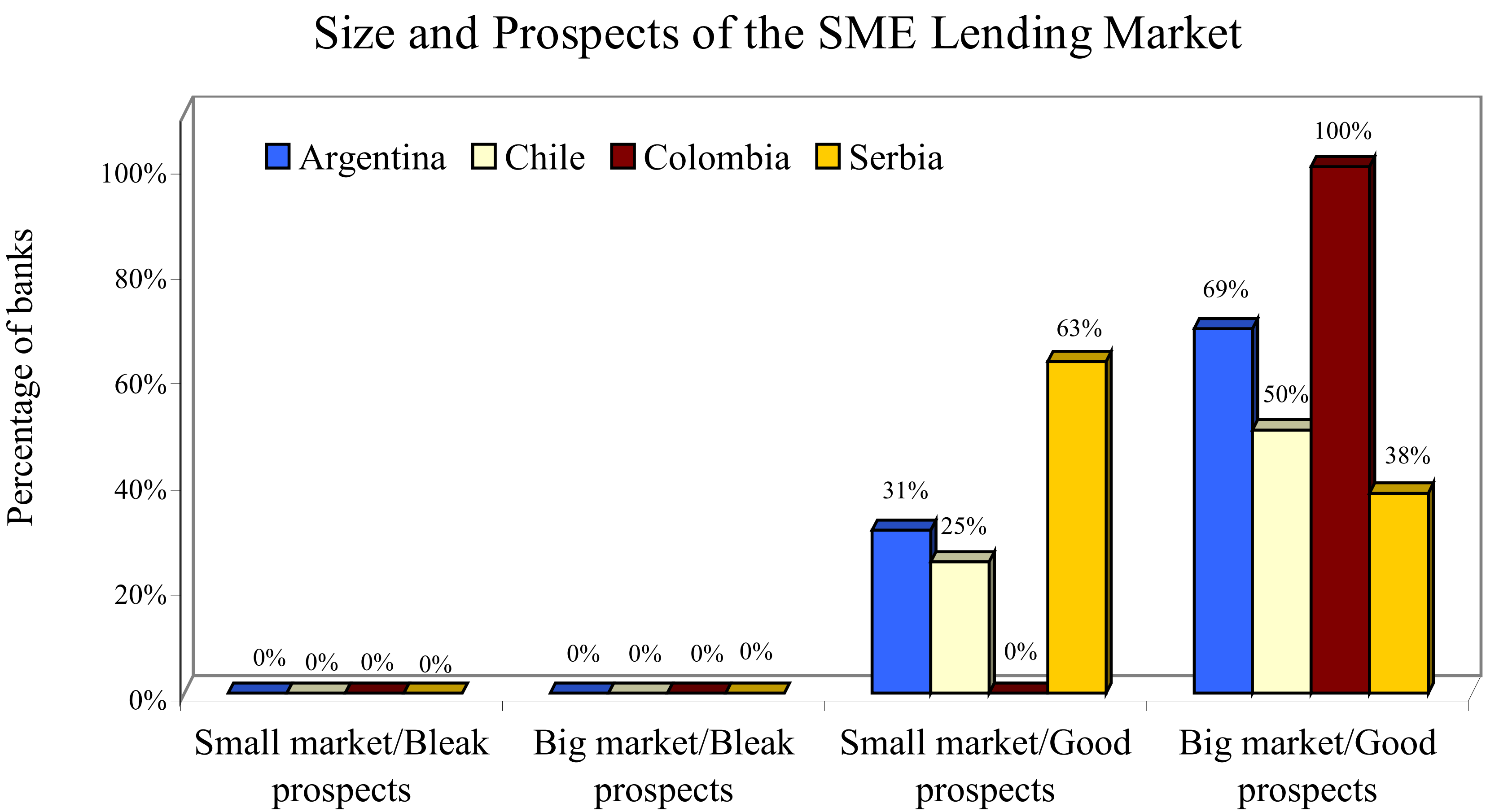
SMEs as Bank Clients



SMEs as Bank Clients



SMEs as Bank Clients



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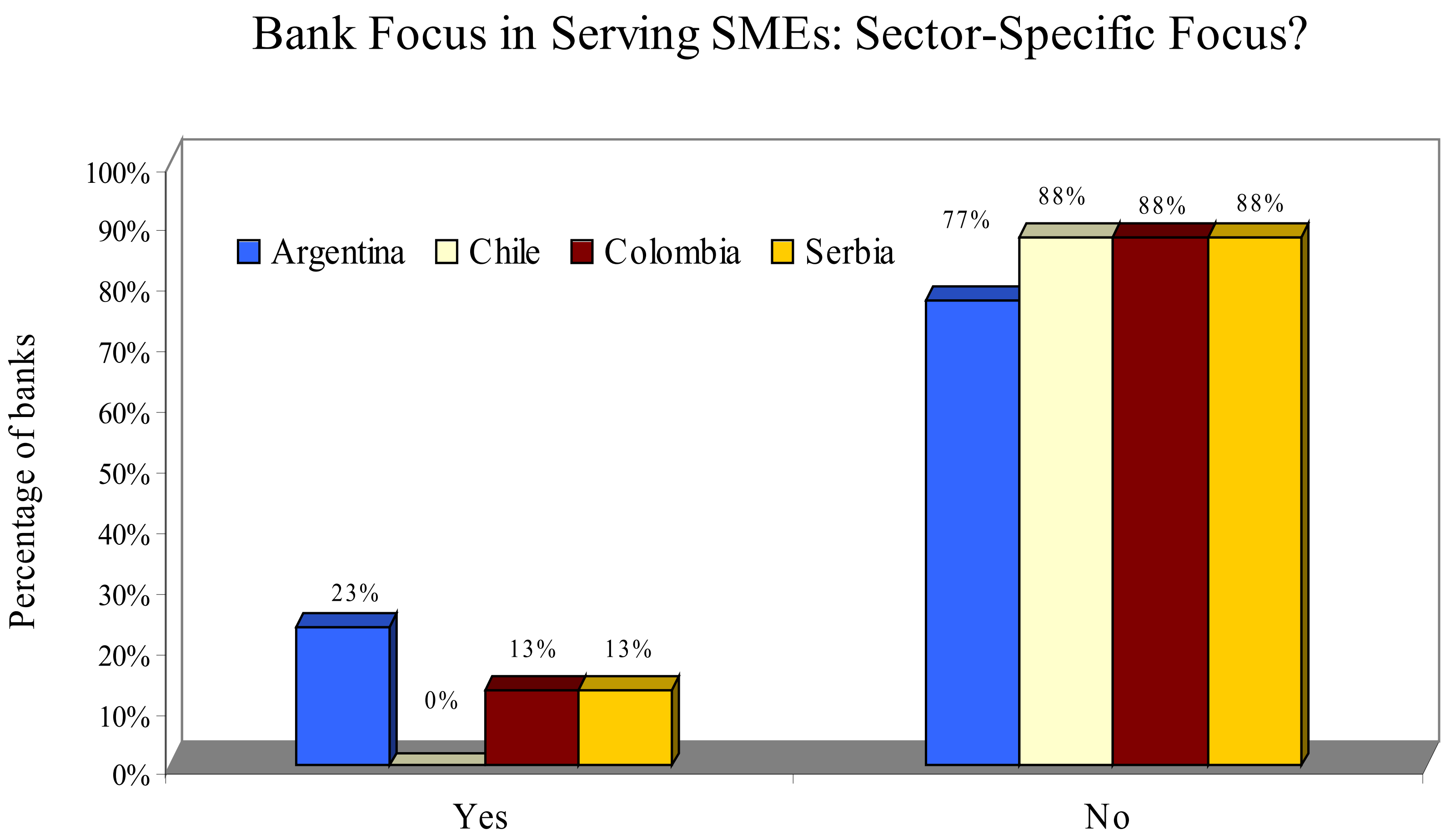
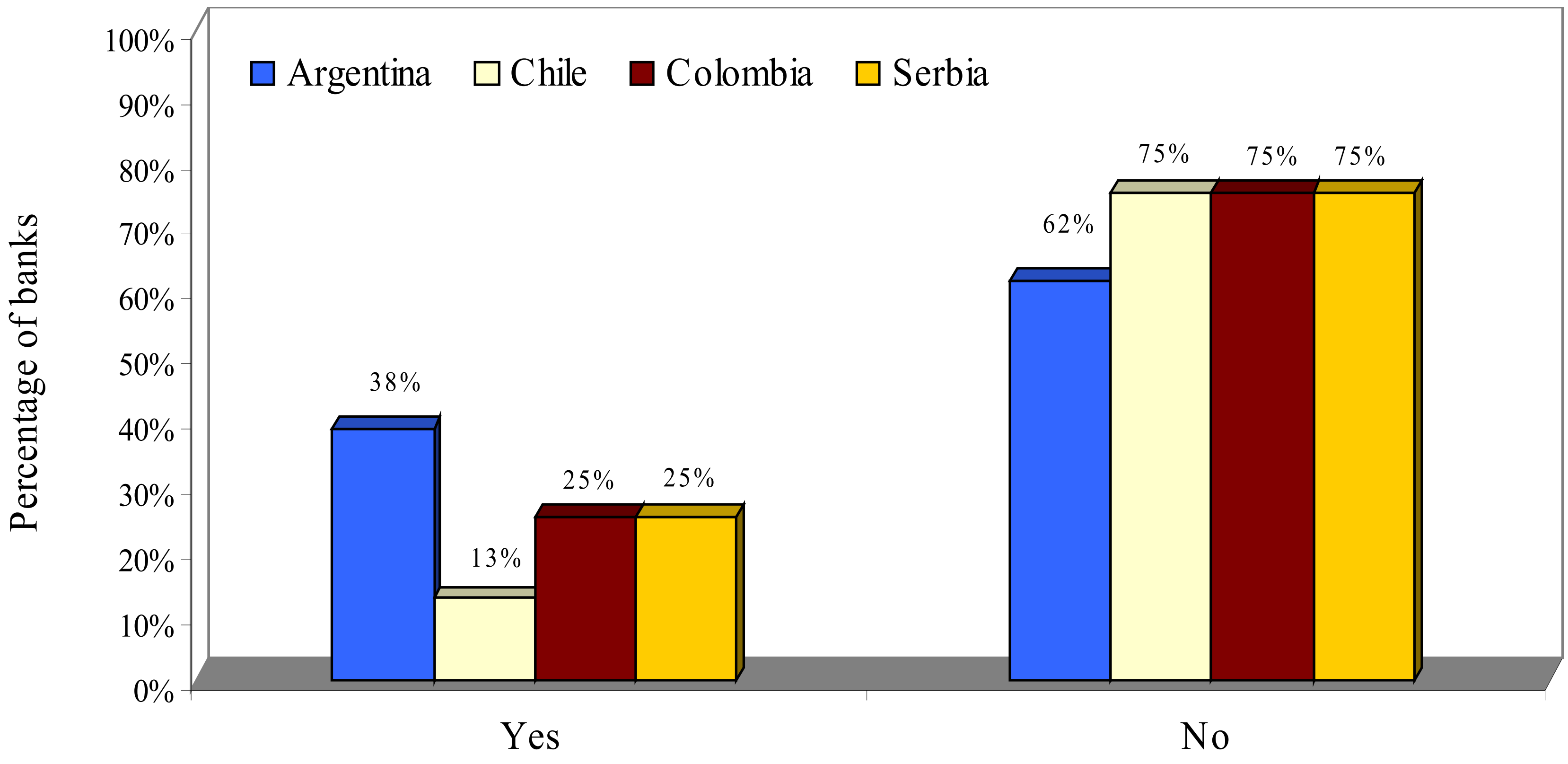
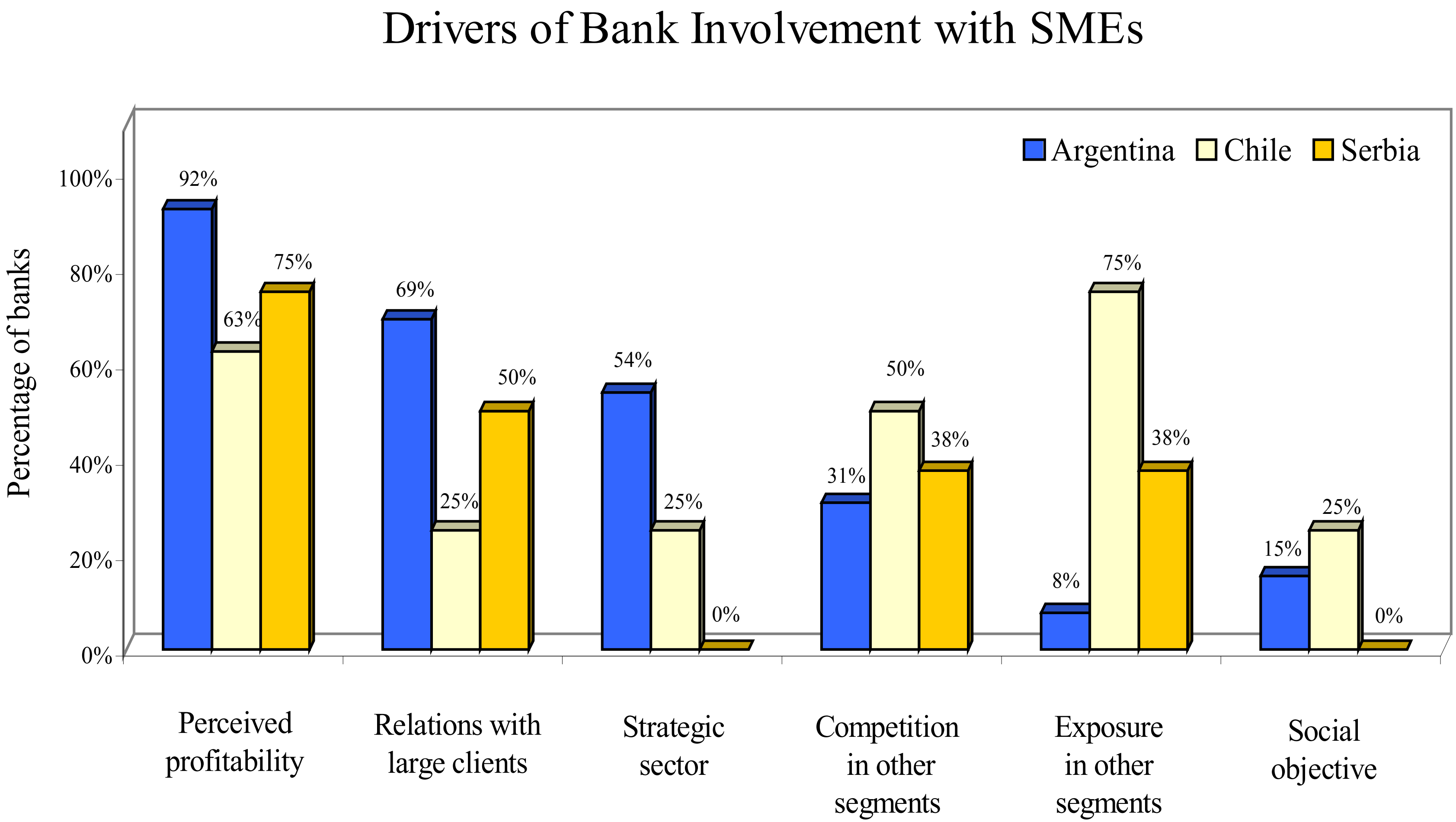


SMEs as Bank Clients

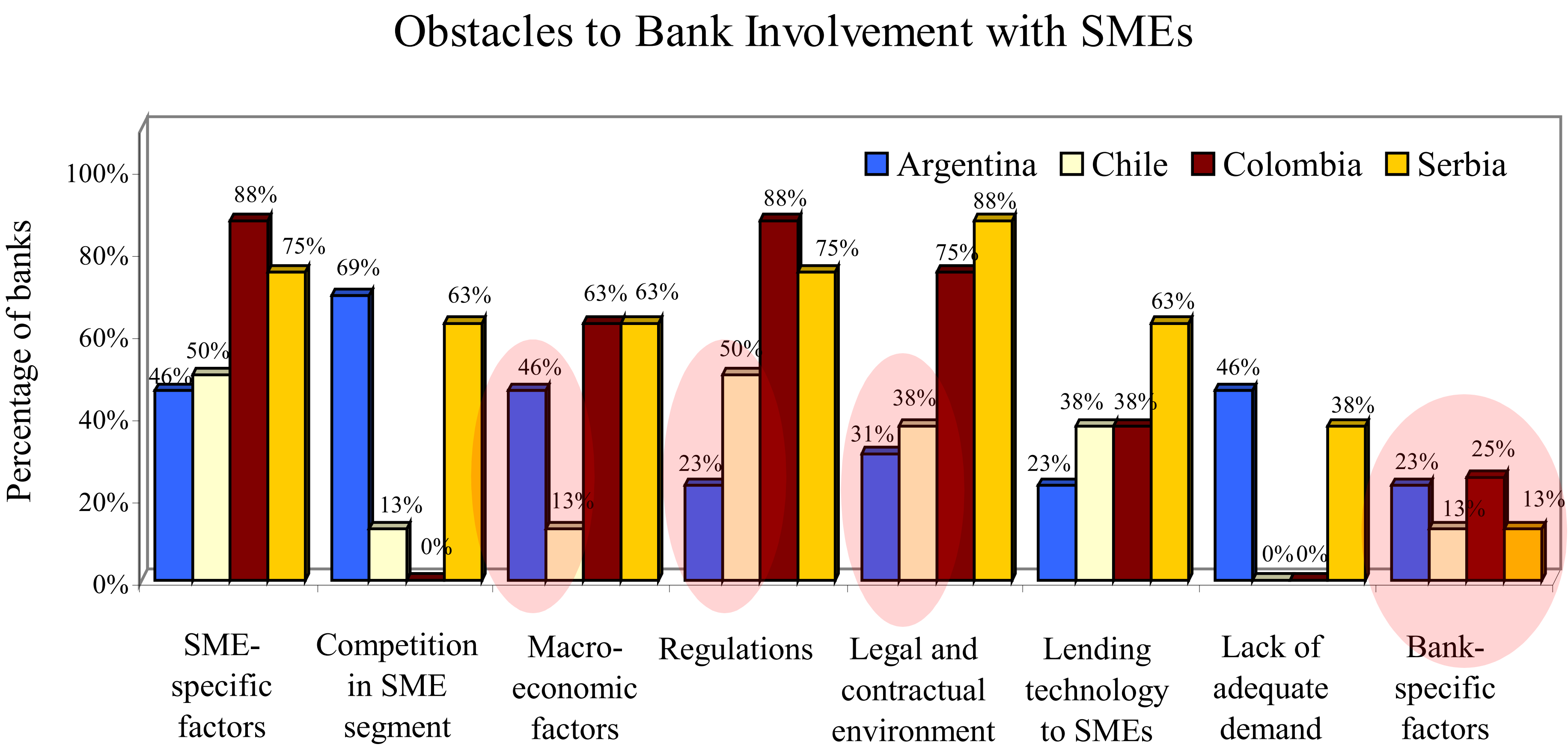
Bank Focus in Serving SMEs: A Specific Geographic Focus?



SMEs as Bank Clients



SMEs as Bank Clients



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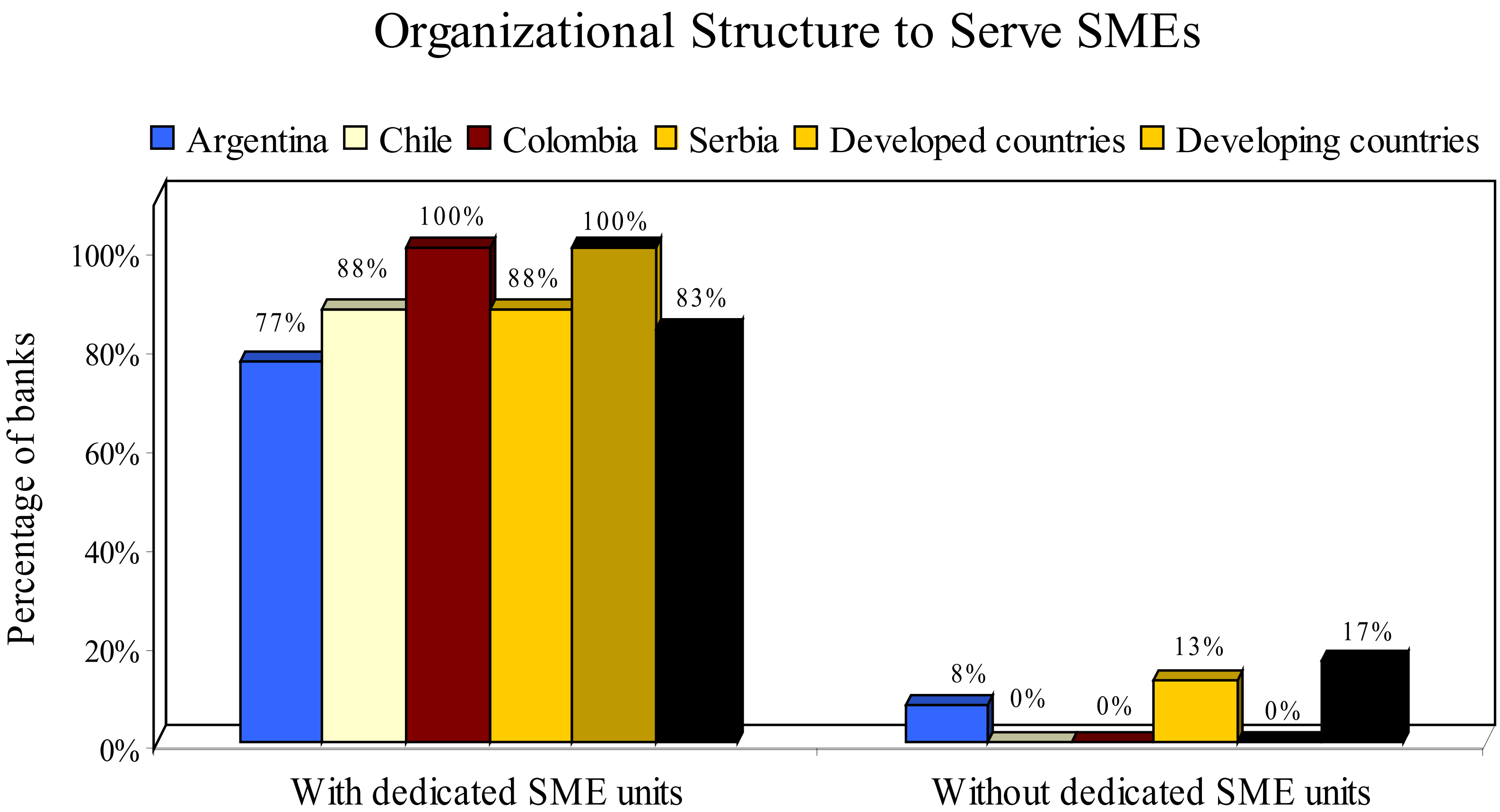
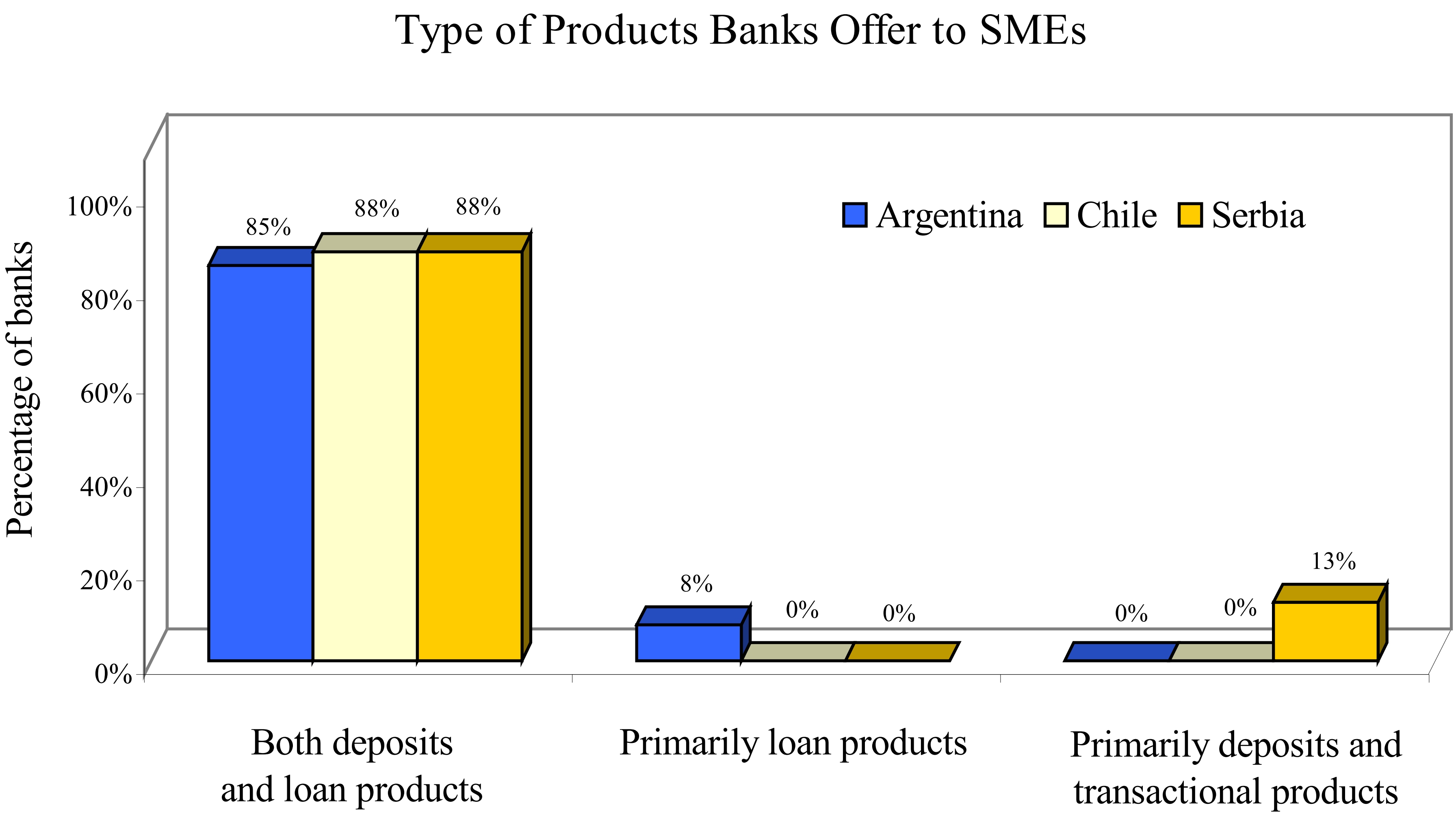
Business Model and Risk Management Systems

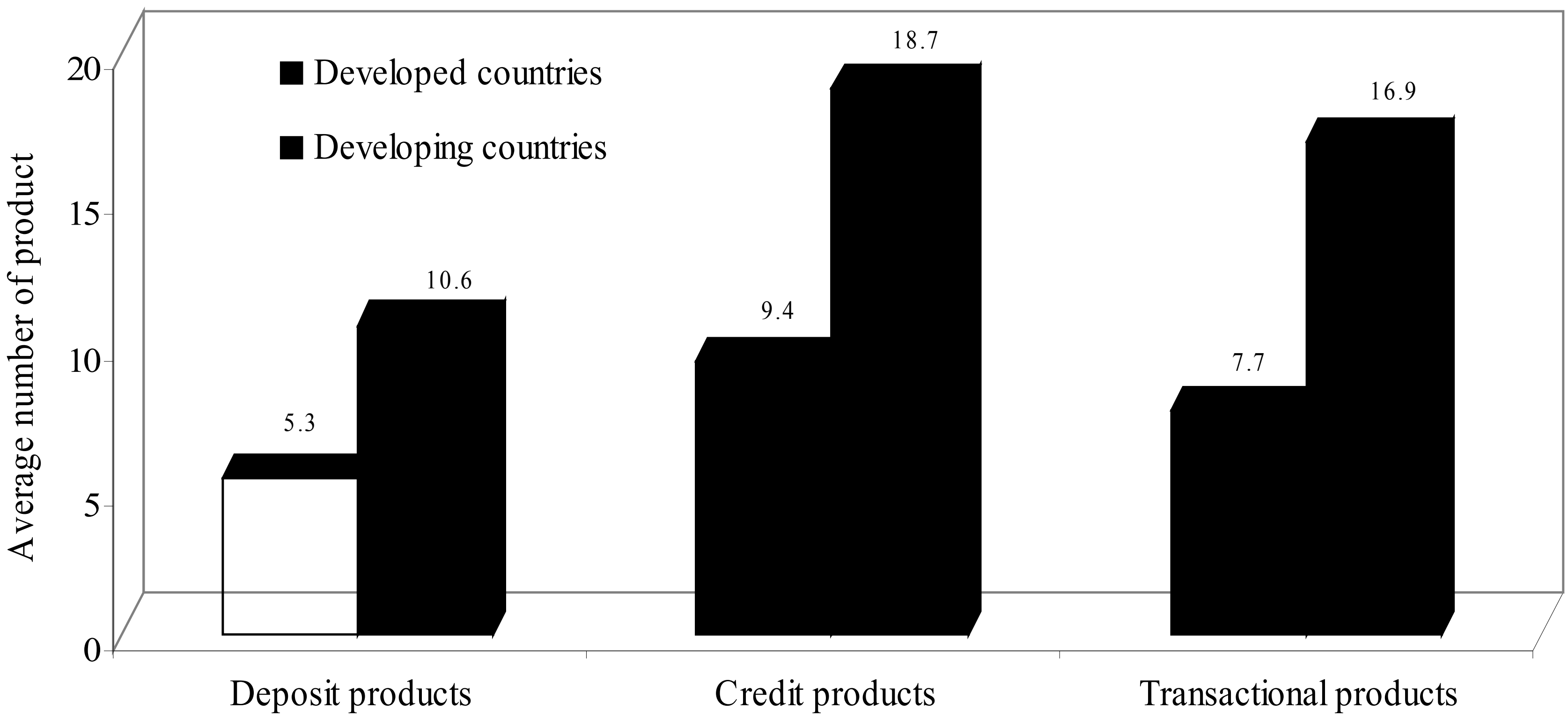


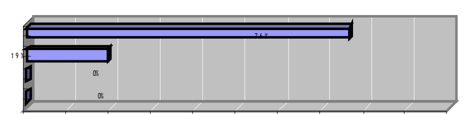
Business Model and Risk Management Systems



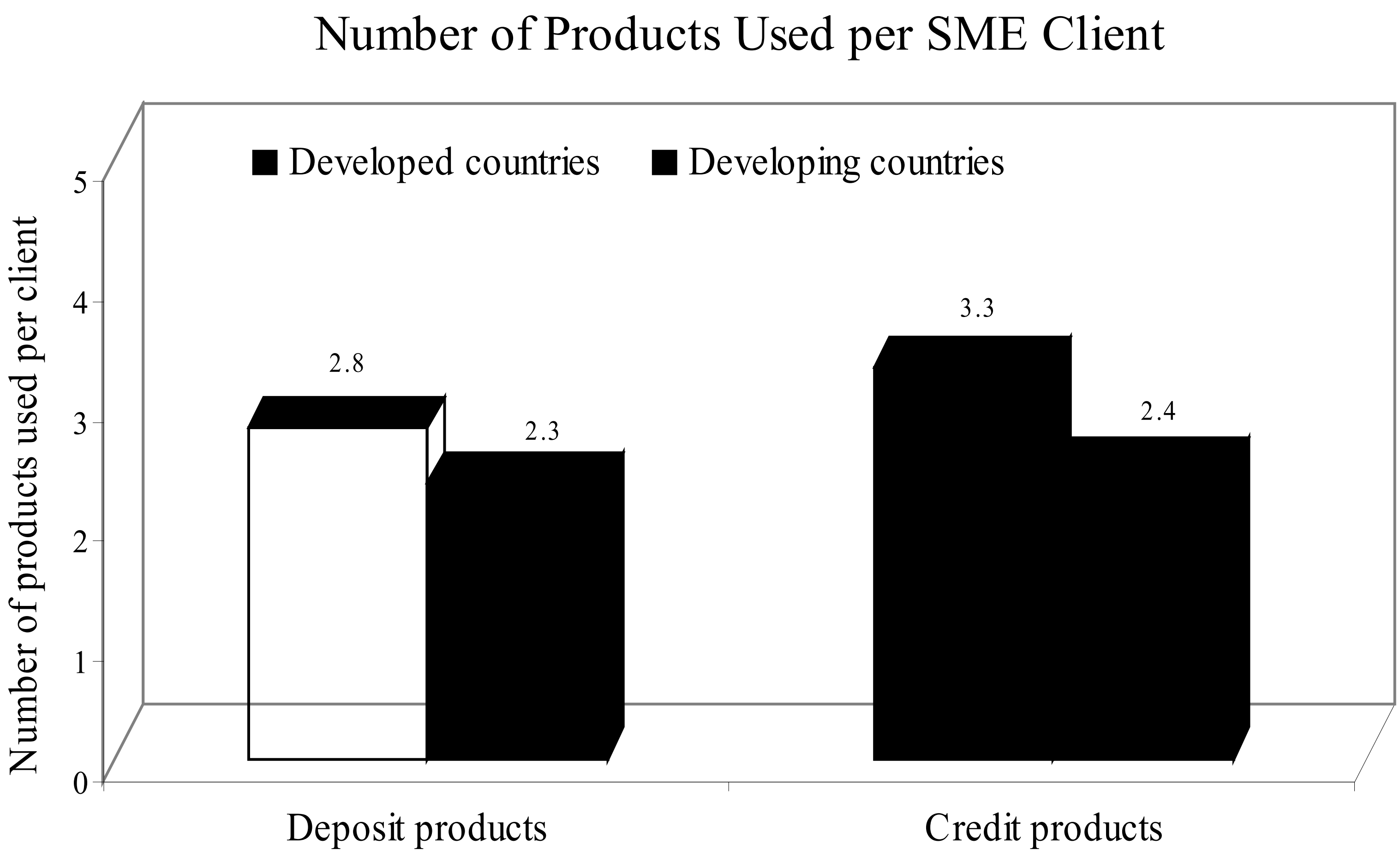
Business Model and Risk Management Systems

Average Number of Products Offered to SMEs





Business Model and Risk Management Systems

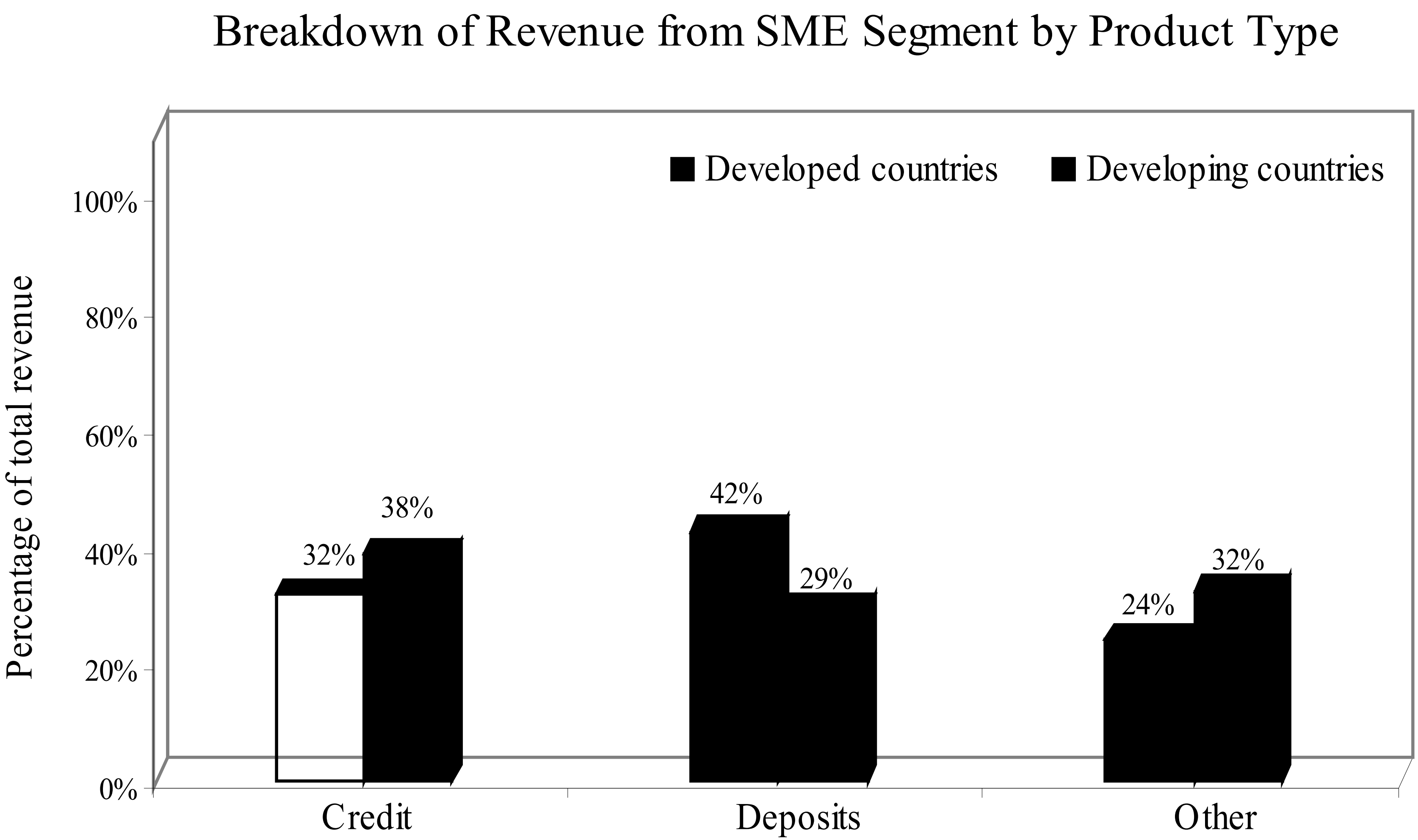


Business Model and Risk Management Systems

Bank Products Offered to SMEs

Banking Products			Precentage of Banks			
			Argentina	Chile	Colombia	Serbia
Deposit or savings products	1.	Checking or saving accounts	85%	67%	83%	75%
	2.	Investments	77%	89%	83%	0%
Financing products	3.	Terms loans	85%	100%	100%	100%
	4.	Credit cards	85%	89%	83%	100%
	5.	Factoring	15%	56%	33%	0%
	6.	Leasing	77%	78%	17%	0%
	7.	International trade financing	77%	78%	17%	0%
Services and other products	8.	Foreign exchange	15%	56%	0%	25%
	9.	International payments and collection	69%	78%	33%	75%
	10.	Payment to employees	85%	78%	83%	25%
	11.	Payment to suppliers	100%	78%	67%	25%
	12.	Tax payments	23%	67%	50%	0%
	13.	Collection of receivables	77%	78%	83%	25%
	14.	Insurance products	46%	33%	0%	0%

Business Model and Risk Management Systems



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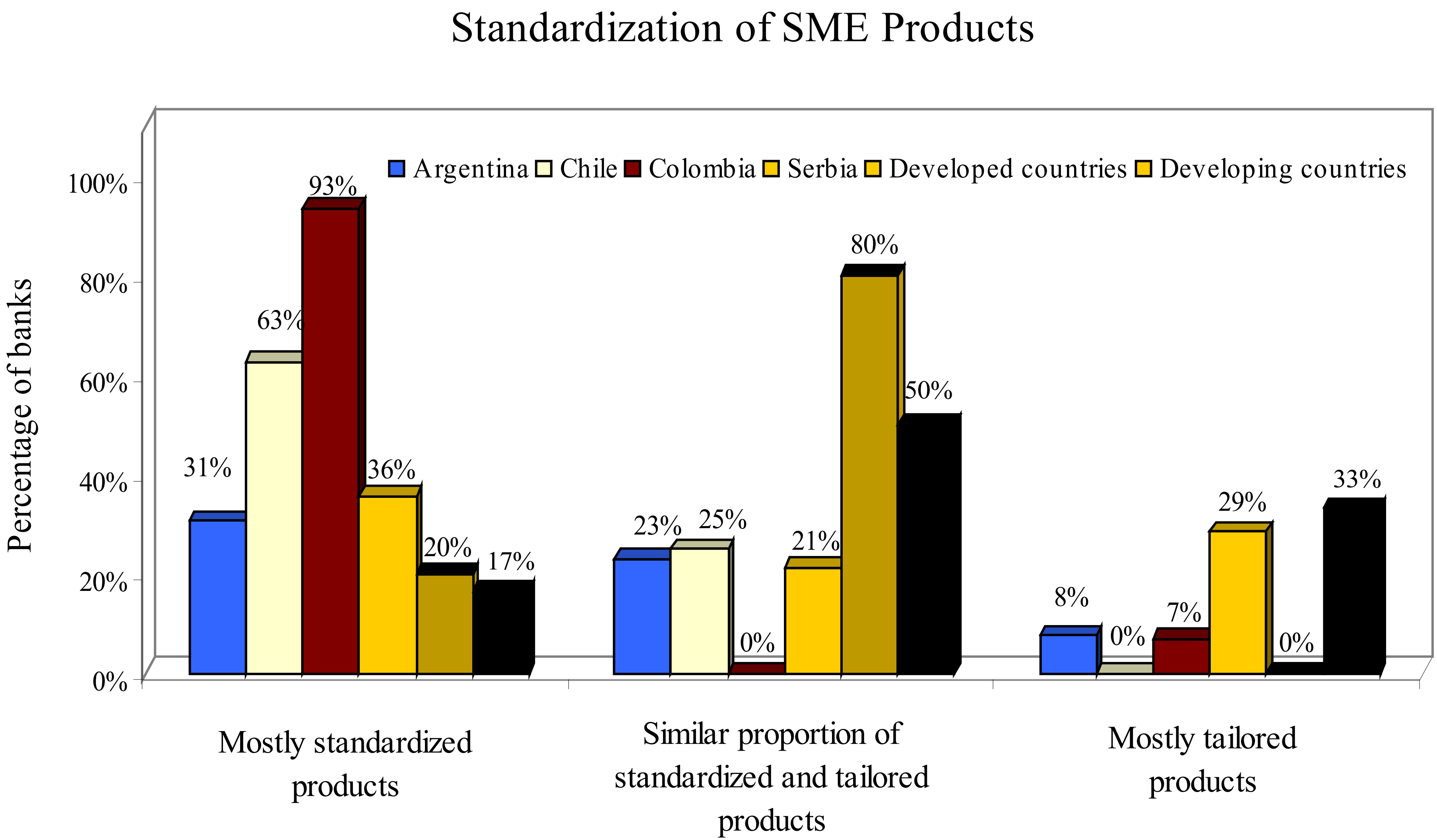

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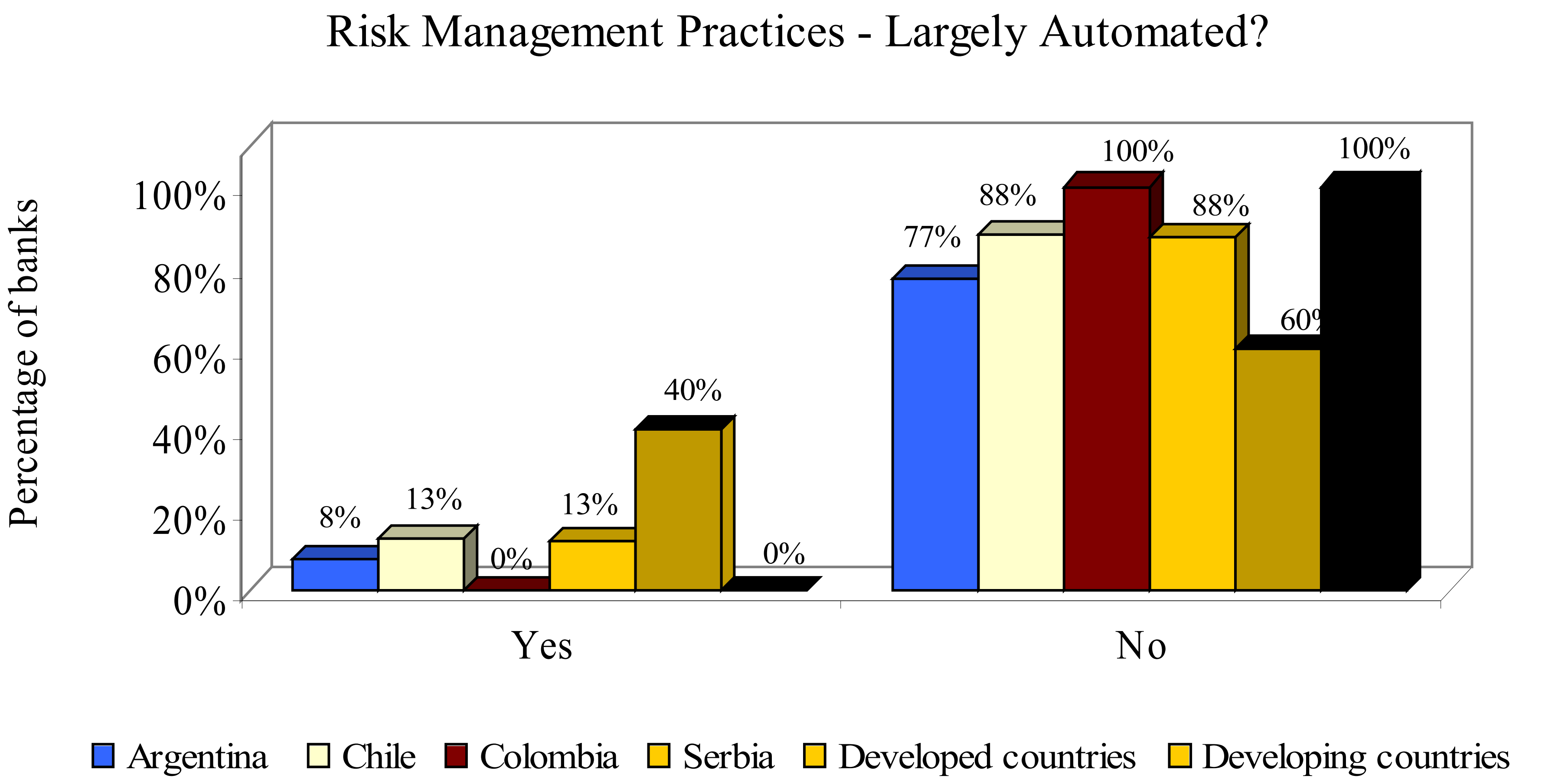

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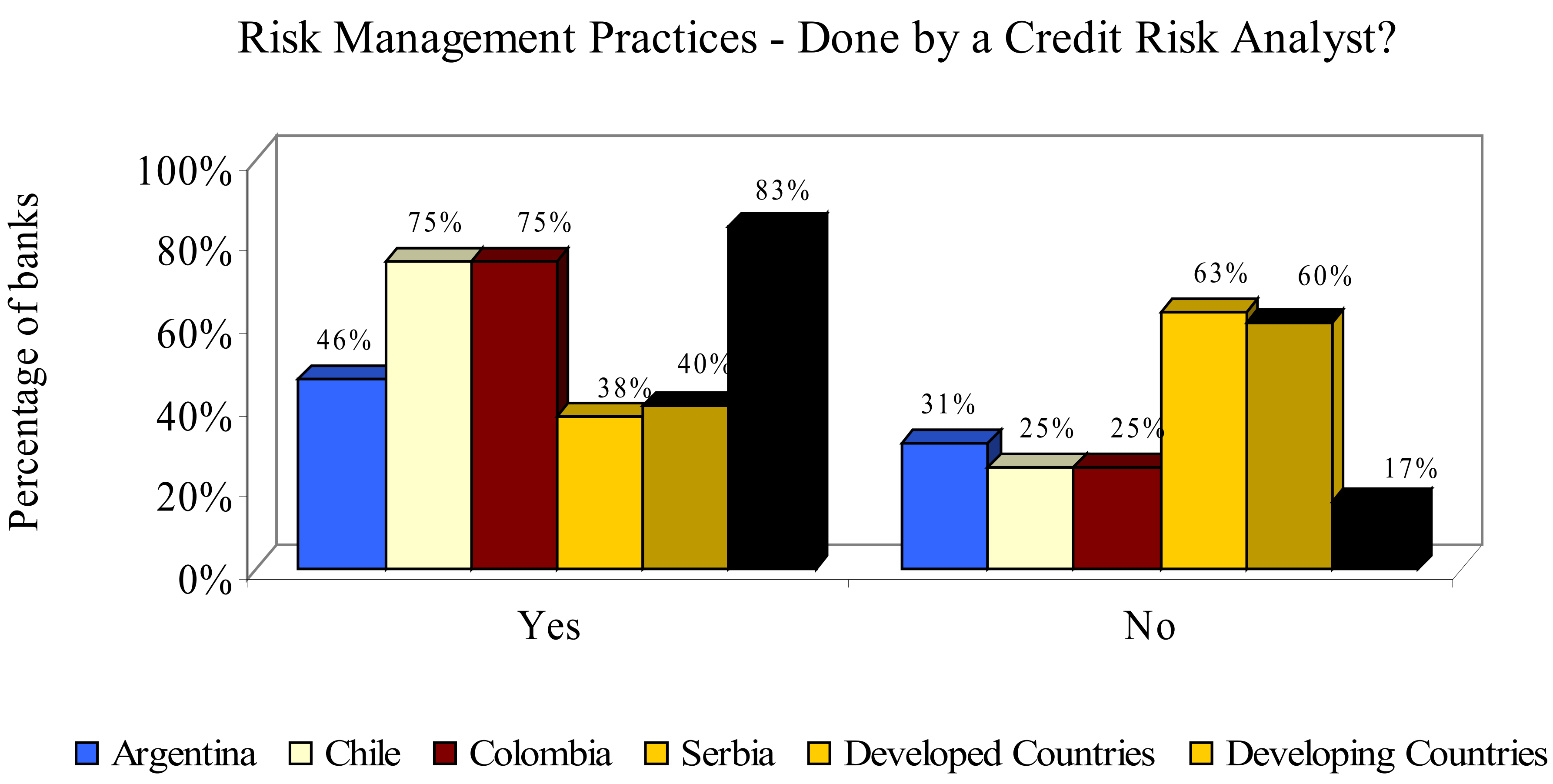

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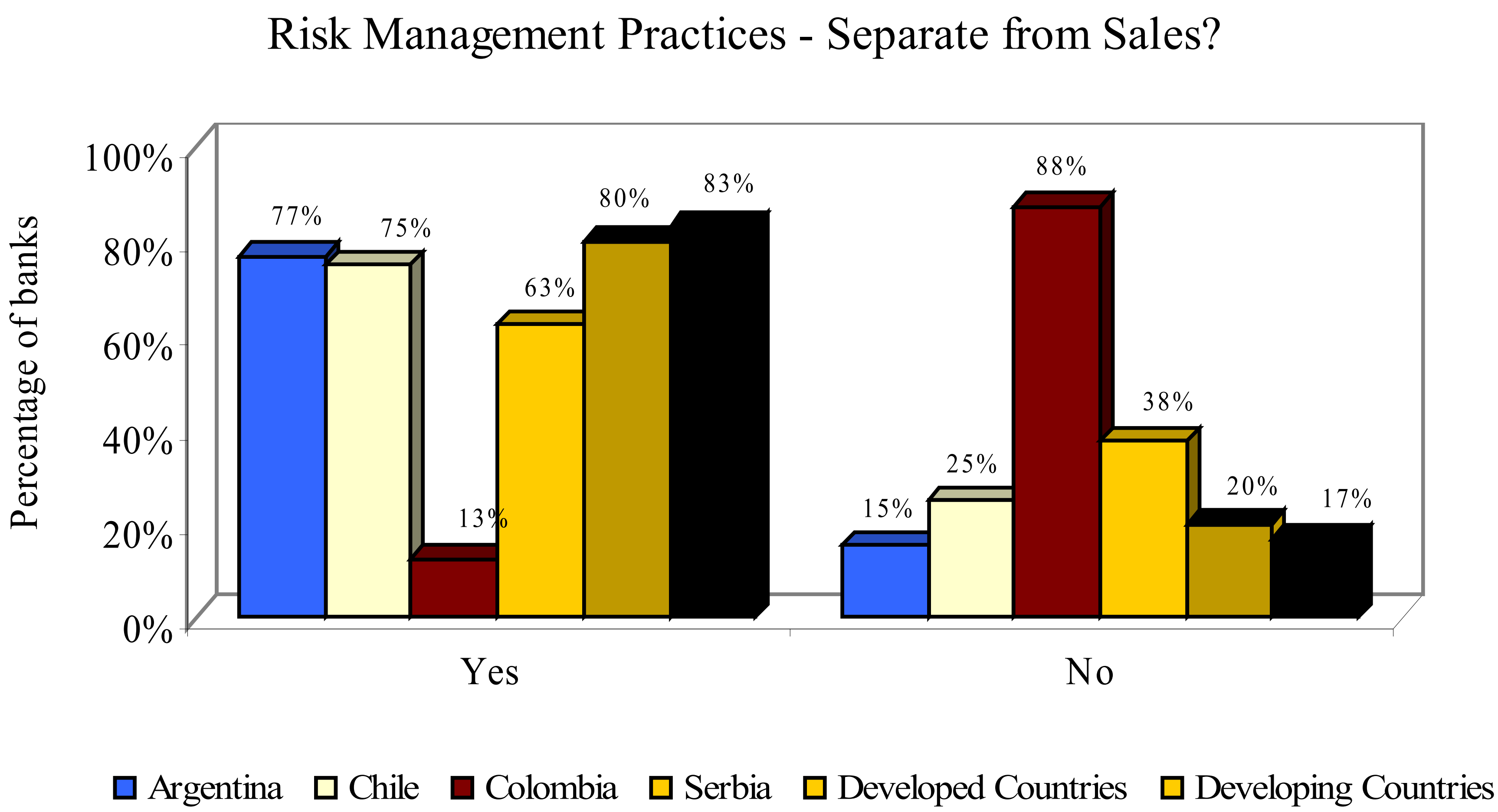

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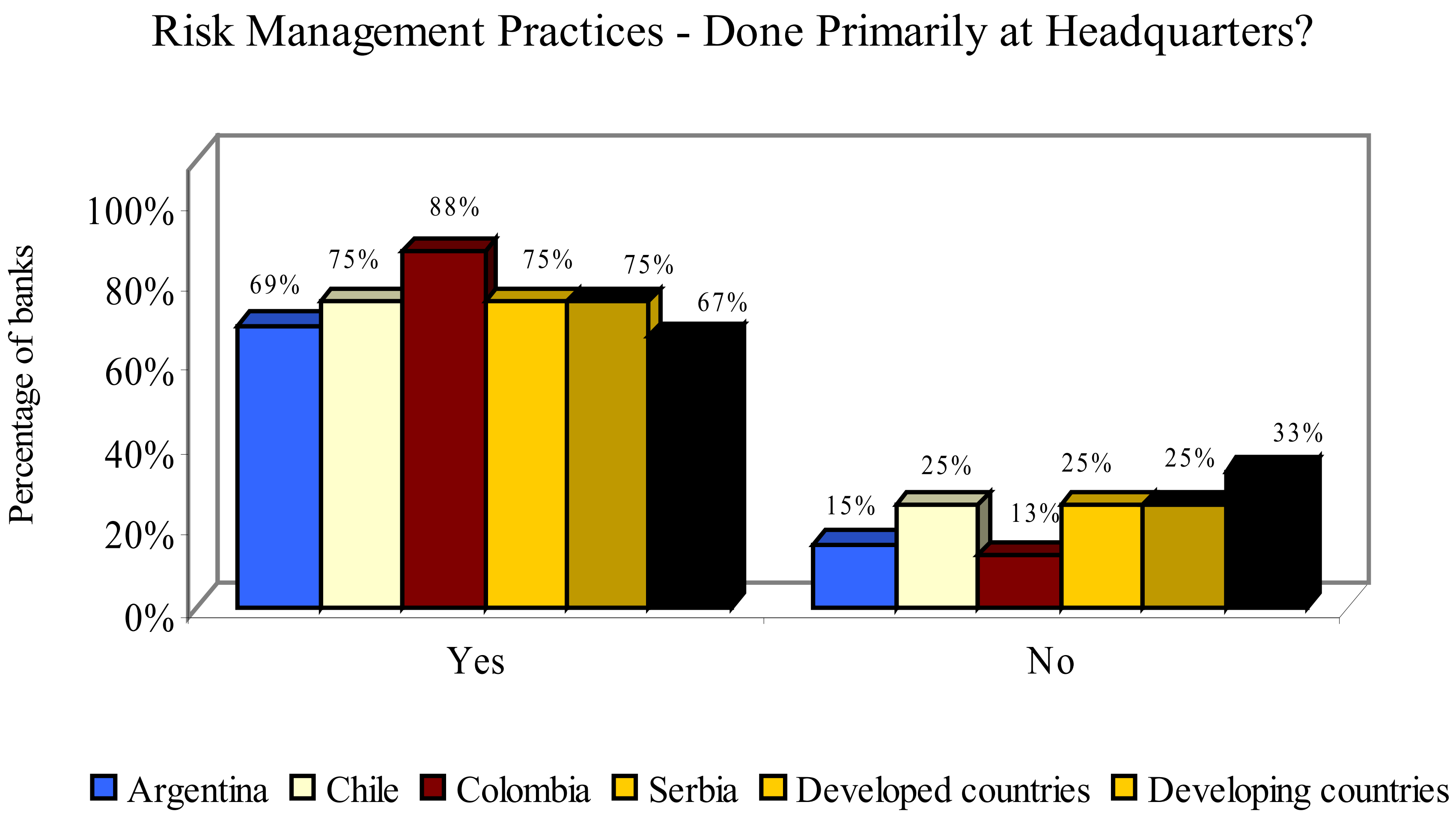

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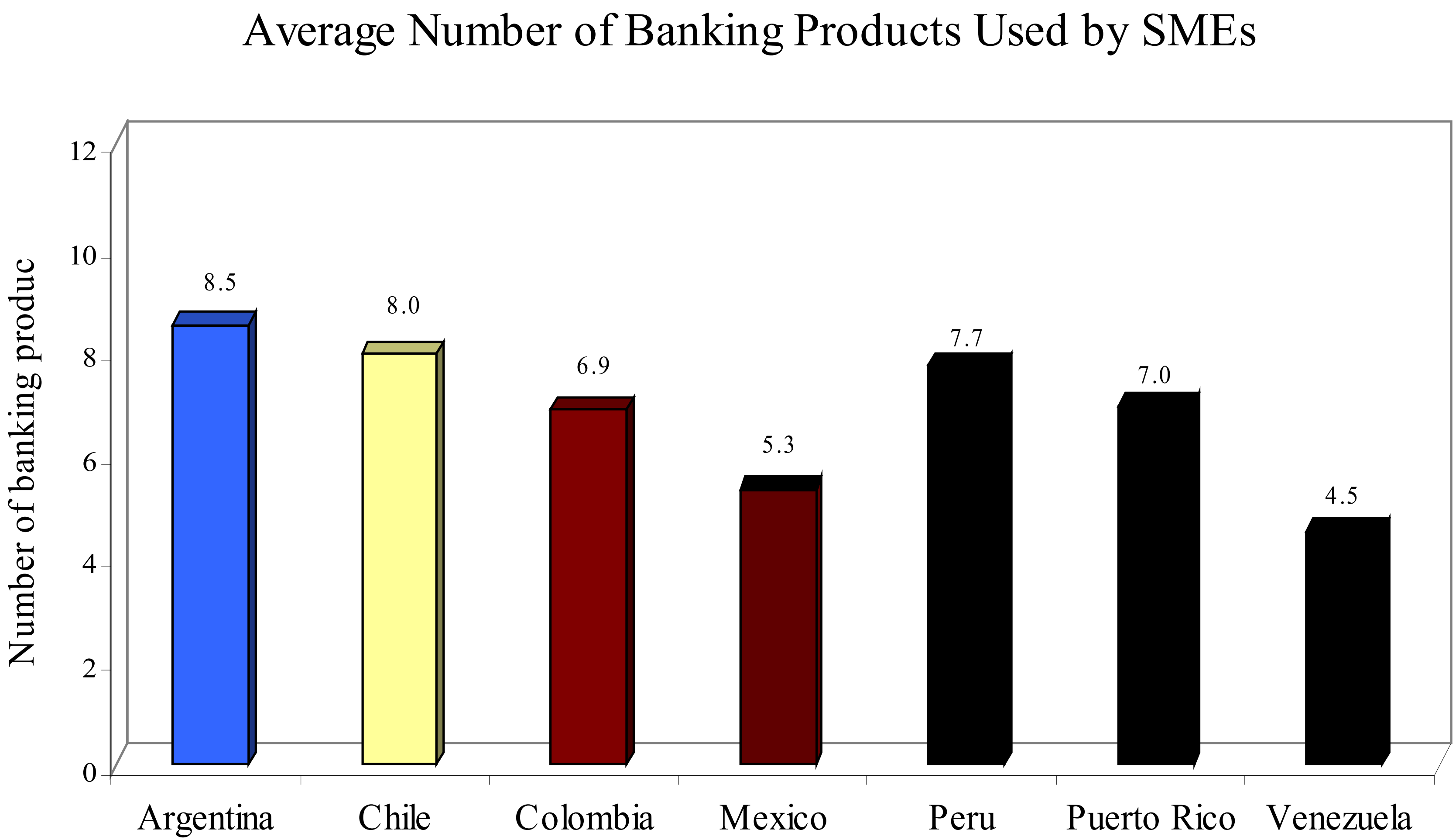
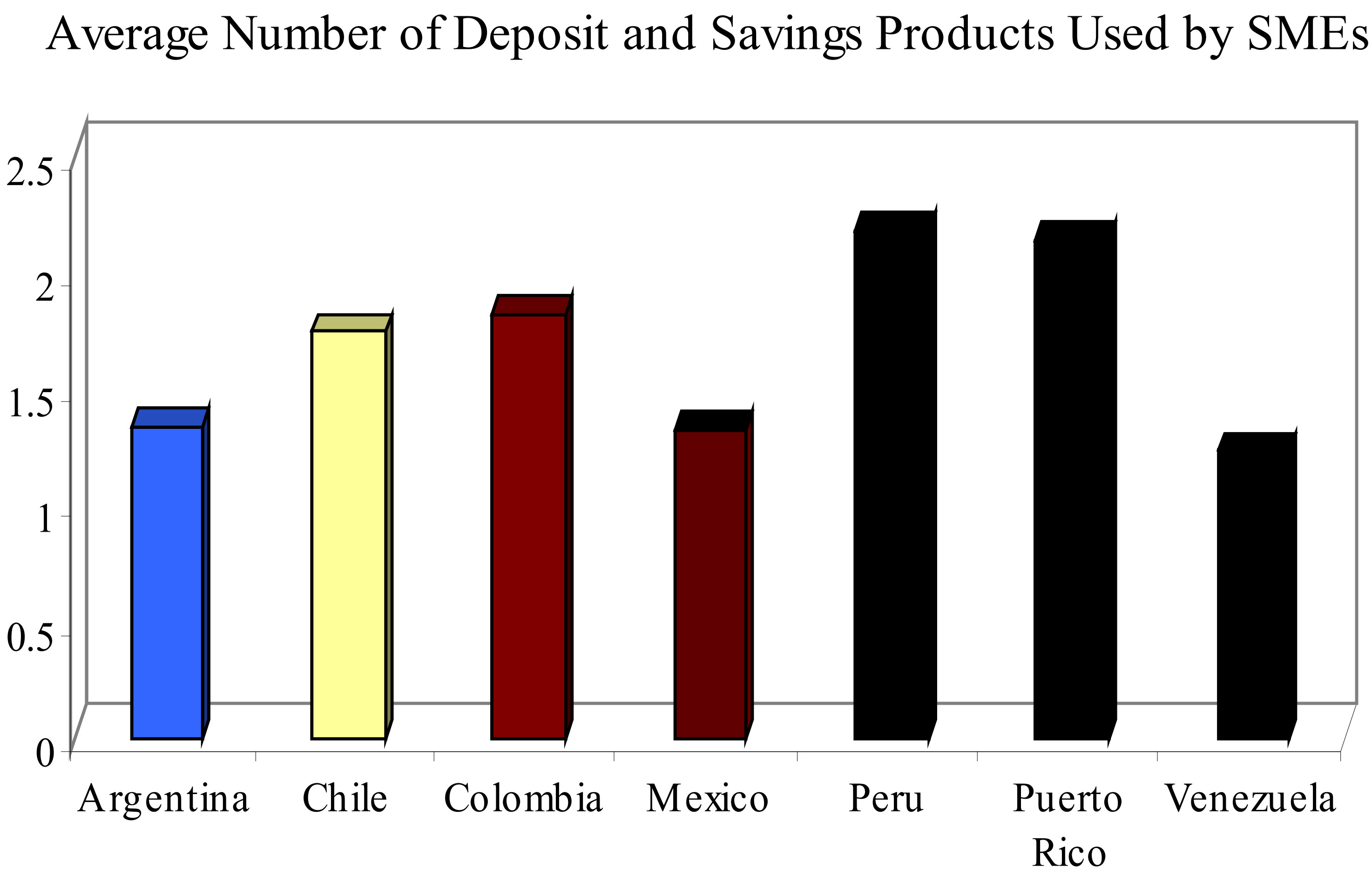
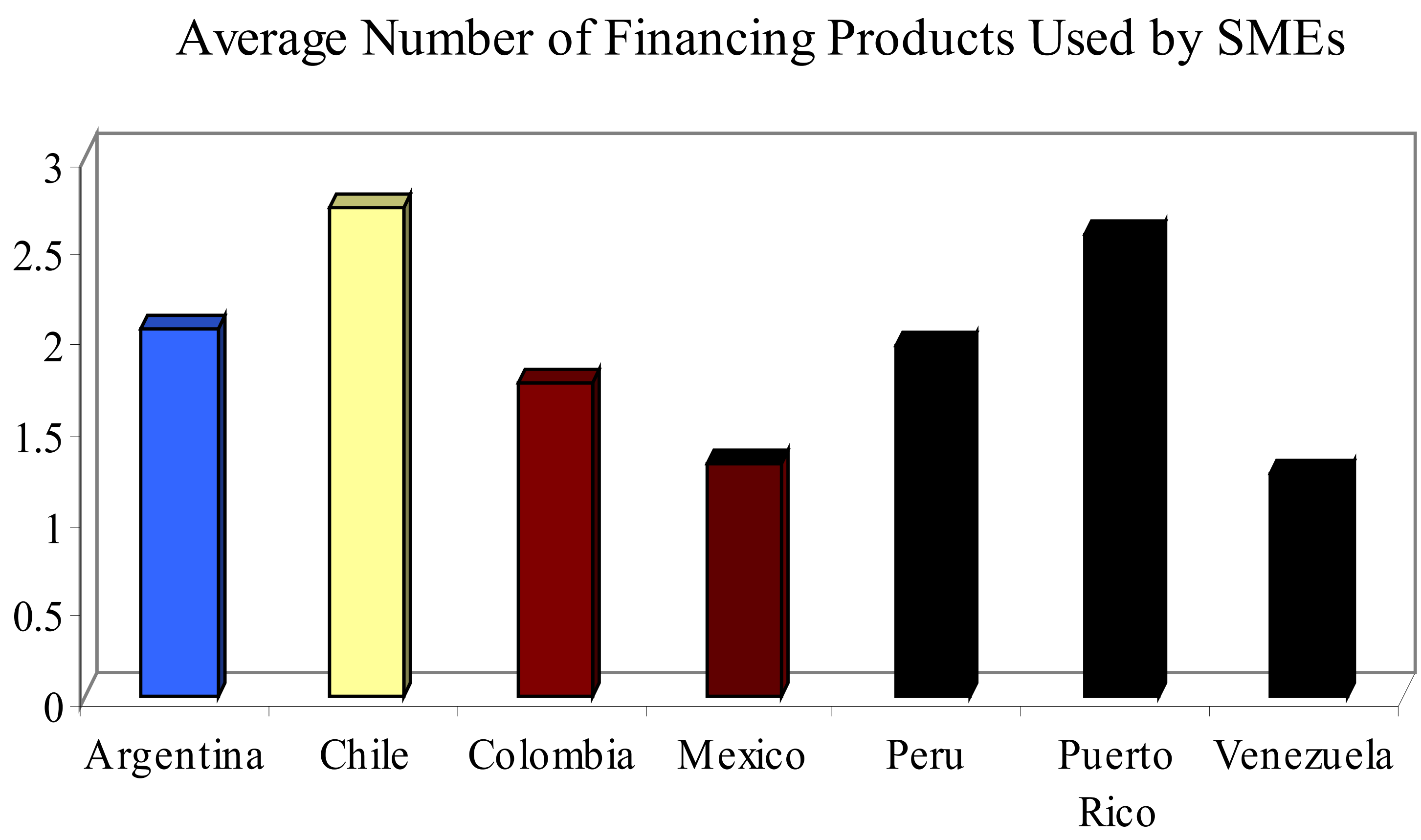
SME Side


Average Number of Banking Products Used by SMEs
Number of banking produc
0
2
4
6
8
10
12
8.5
8.0
6.9
5.3
7.7
7.0
4.5
Argentina
Chile
Colombia
Mexico
Peru
Puerto Rico
Venezuela

SME Side


Average Number of Deposit and Savings Products Used by SMEs
2.5
2
1.5
1
0.5
0
Argentina
Chile
Colombia
Mexico
Peru
Puerto Rico
Venezuela

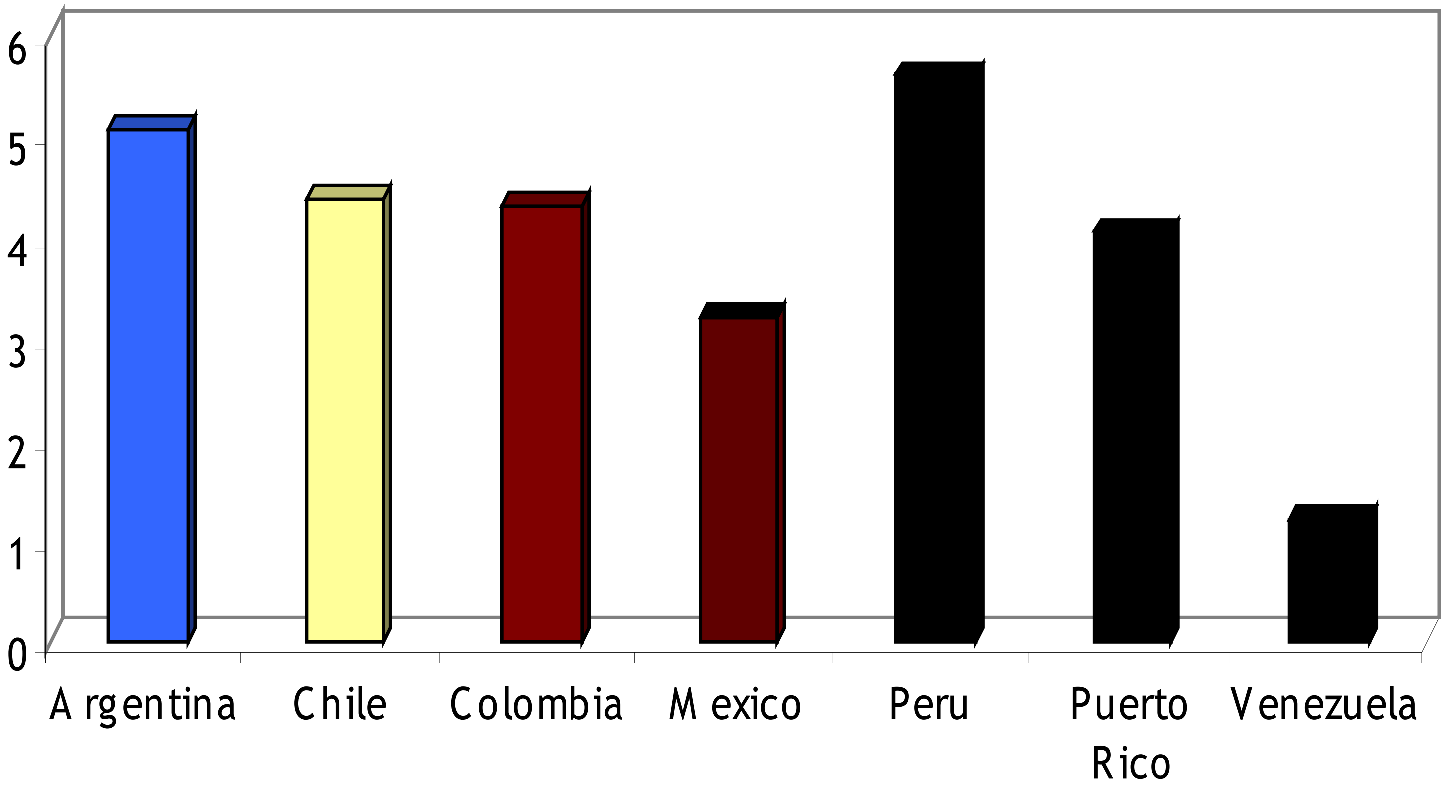
SME Side



Average Number of Financing Products Used by SMEs
3
2.5
2
1.5
1
0.5
0
Argentina
Chile
Colombia
Mexico
Peru
Puerto Rico
Venezuela

SME Side

Average Number of Services and Other Products Used by SMEs



SME Side

Deposit and Savings Products Used by SMEs (% of SMEs)

Deposit/savings products	Argentina	Colombia	Chile	Mexico	Peru	Puerto Rico	Venezuela
Current account	100.0	86.9	100.0	95.8	89.7	98.0	84.6
Savings account		71.1			52.5	62.9	34.3
Term deposits	12.5	11.0	22.8	11.9	6.0	19.0	1.4
Mutual funds	2.0	4.1	27.9	6.7	0.9	2.2	0.5
Other investment products	1.4	2.9	4.4	5.4	0.4	11.0	0.5
None	0.0	0.0	0.0	0.0	0.0	0.0	0.0

SME Side

Financing Products Used by SMEs (% of SMEs)

Financing products	Argentina	Colombia	Chile	Mexico	Peru	Puerto Rico	Venezuela
Term loans		40.5				39.2	
Short-term loans			38.7				2.8
Working capital loans					40.0		
Medium-long term loans			23.4		6.5		7.5
Investment loans							
Term loans with fixed asset guarantees	4.4		18.8	2.7			0.3
Loans supported by public programs or guarantees	2.7		8.1			3.1	0.3
Lines of credit	25.7	29.4	75.1	29.8	18.0	43.3	
Overdrafts	28.8			4.3	20.6	40.0	0.7
Check/document discounting	35.4	2.7	5.1	1.4	10.1	19.7	3.4
Leasing	4.3	8.9	12.6	1.2	5.9	12.3	0.3
Factoring	1.9	1.8	7.5	1.1	1.7		0.3
Foreign trade financing	2.9	5.6	13.2	2.0	5.2	4.4	3.0
Credit card		13.9			11.2		
Letter of credit	2.1	1.0	14.6	1.5	7.8	13.8	0.3
None	30.8	29.8	13.2	64.9	29.1	21.7	51.3

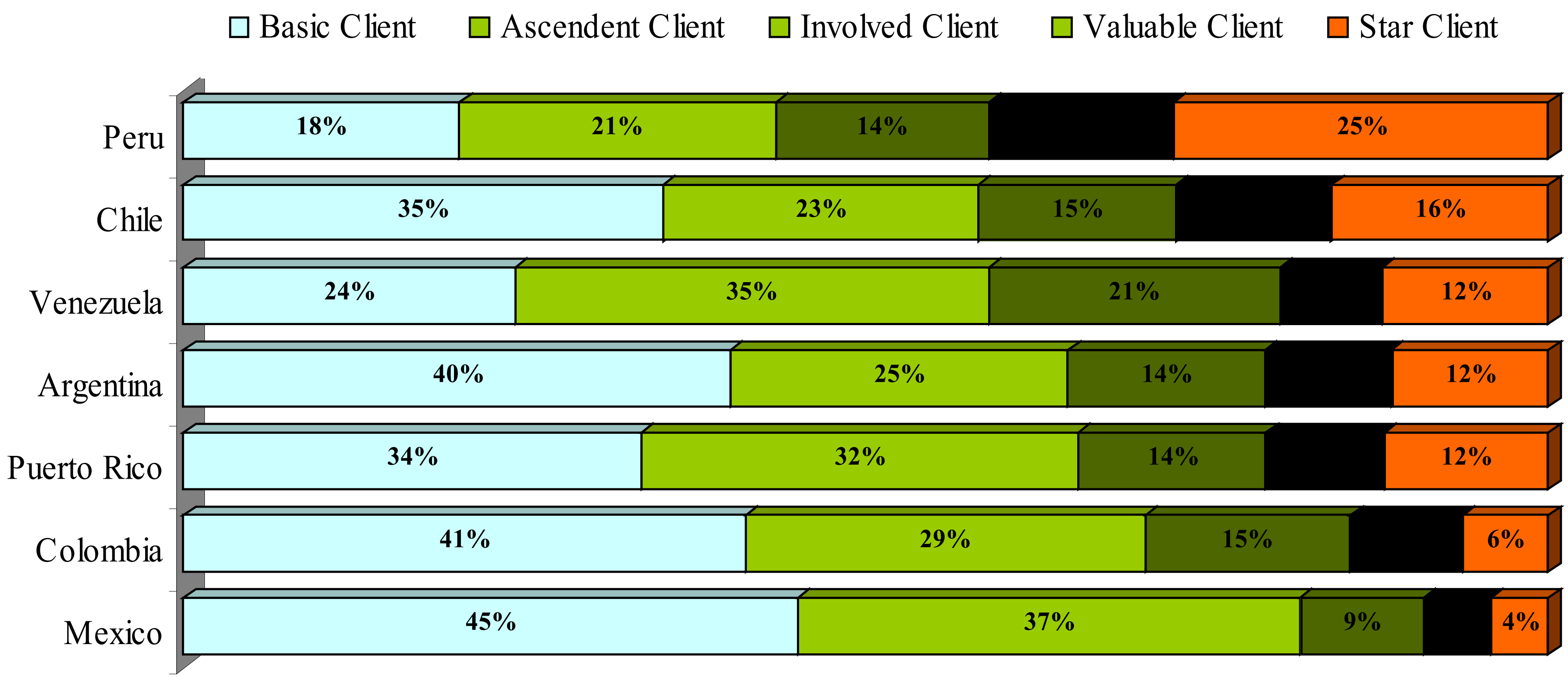
SME Side

Services and Other Products Used by SMEs (% of SMEs)

Services and other products	Argentina	Colombia	Chile	Mexico	Peru	Puerto Rico	Venezuela
Insurance	63.1	48.3	45.0	23.5	62.3	64.7	0.0
Payment of taxes	57.2	59.7	60.1	48.7	90.9		0.7
Payment of wages	52.7	45.2	23.8	37.5	12.4	37.6	8.2
Payment to suppliers or third parties	22.5	36.9	23.6	49.7	56.0	38.2	0.0
Other payments done at branch	49.8	36.3	26.2		45.8	34.1	
Internet banking	53.9	61.7	73.0	50.9	38.0	60.2	98.1
Transfer	49.8	53.2	35.6	36.1	92.0	36.5	0.6
Automatic debit	40.6	18.5	35.0	19.0	27.3	22.1	2.1
Debit card	28.6	20.3	29.2		32.2	22.2	1.1
Foreign exchange	16.4	10.0	17.1	12.7	22.0	2.1	1.6
Credit card for executives	14.0	13.5	14.6	9.6		26.2	0.1
Collection of receivables	13.3		4.9		5.8	4.7	
None	2.0	5.5	4.4	5.9	0.1	3.0	0.0

SME Side

SMEs' Degree of Involvement with the Banking Sector



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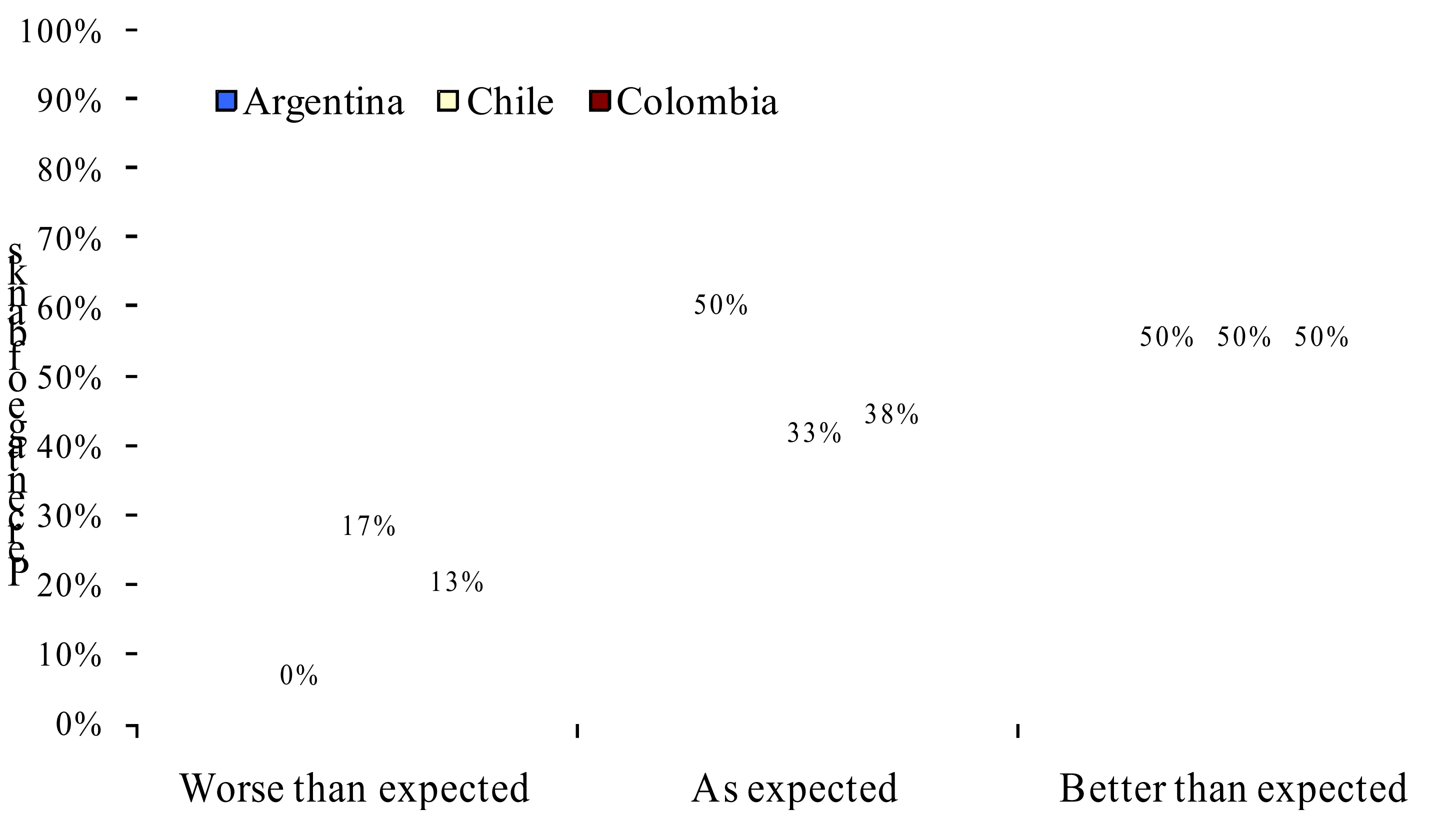
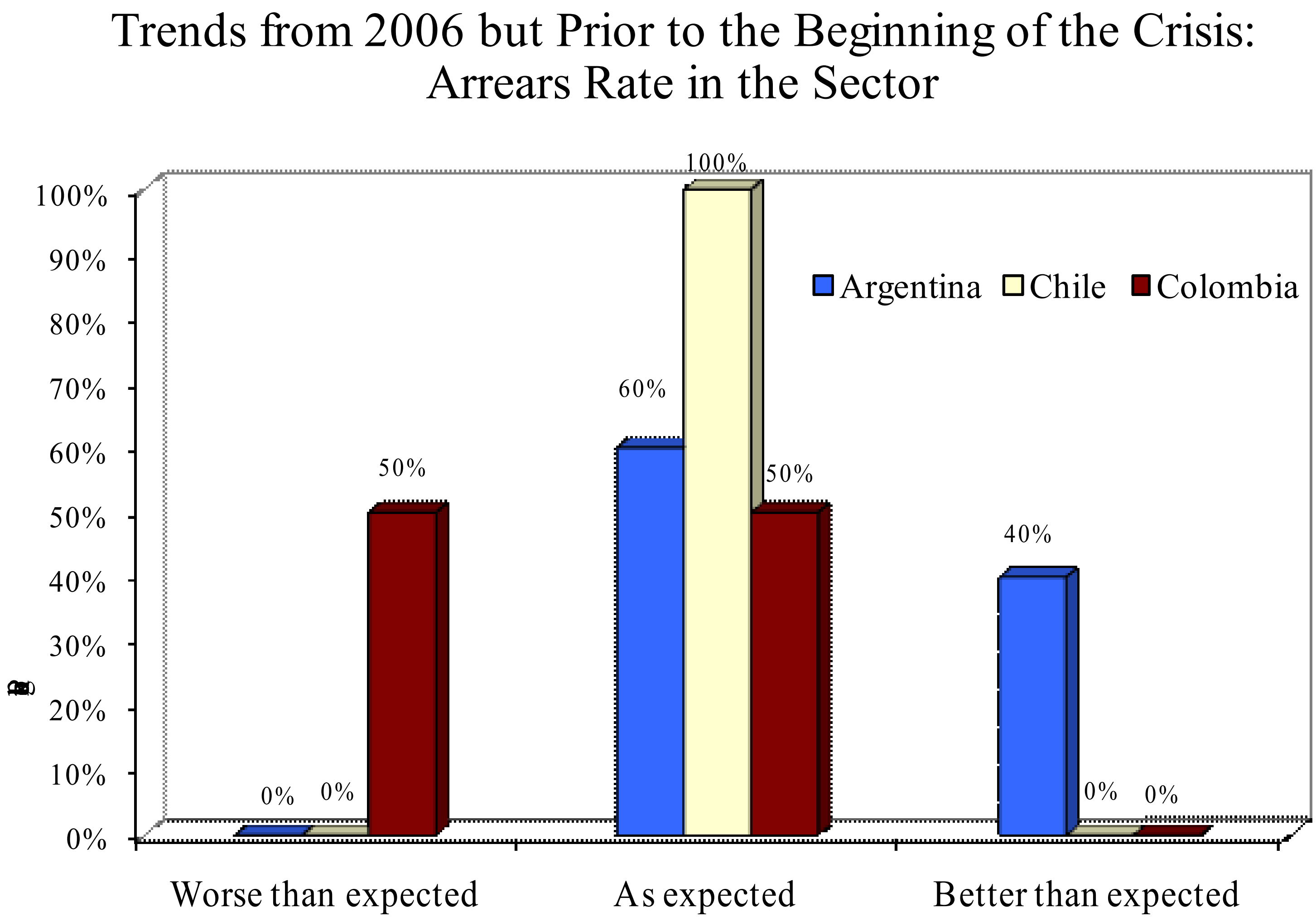
The Effects of the Crisis

Trends from 2006 but Prior to the Beginning of the Crisis:
Bank Involvement in the Segment

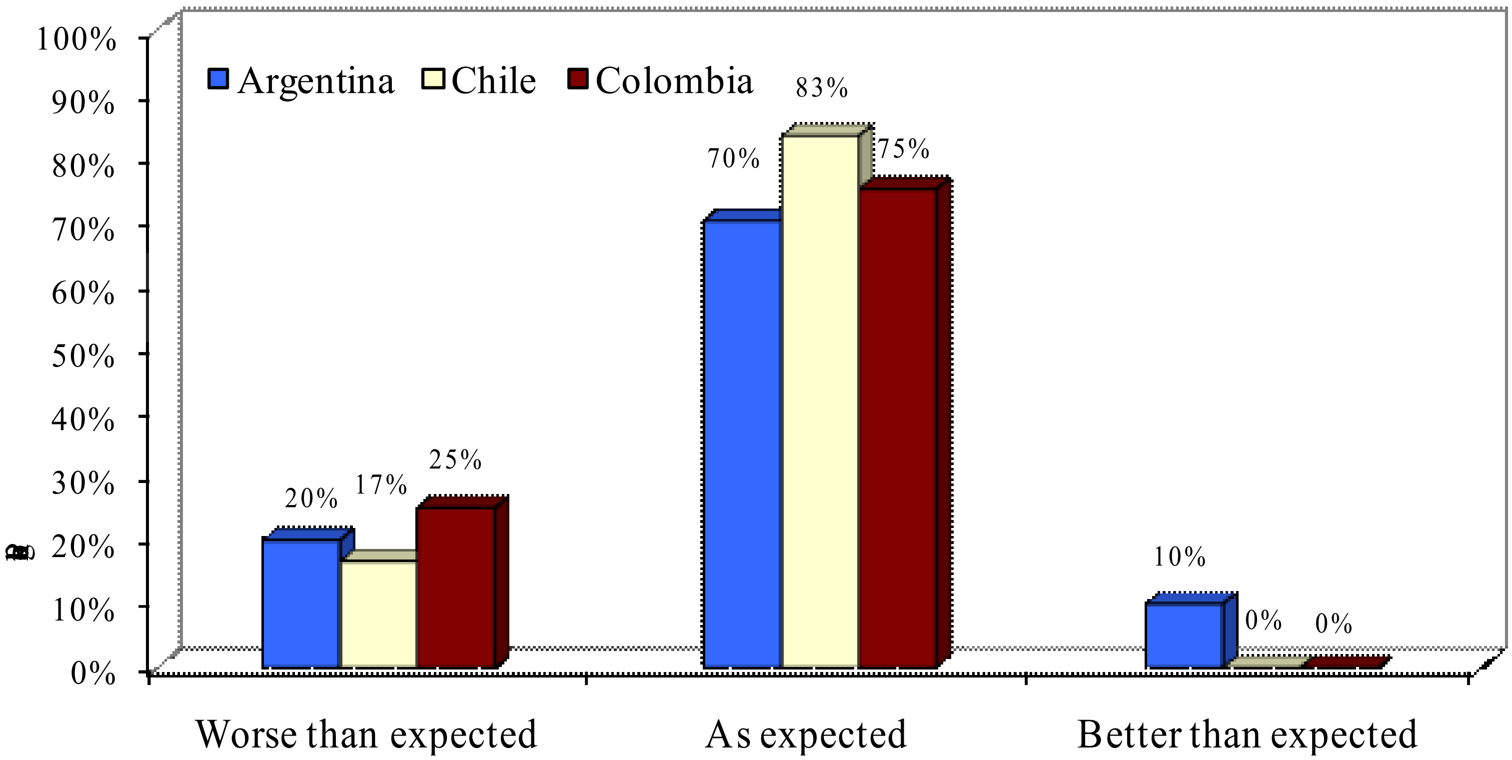


The Effects of the Crisis



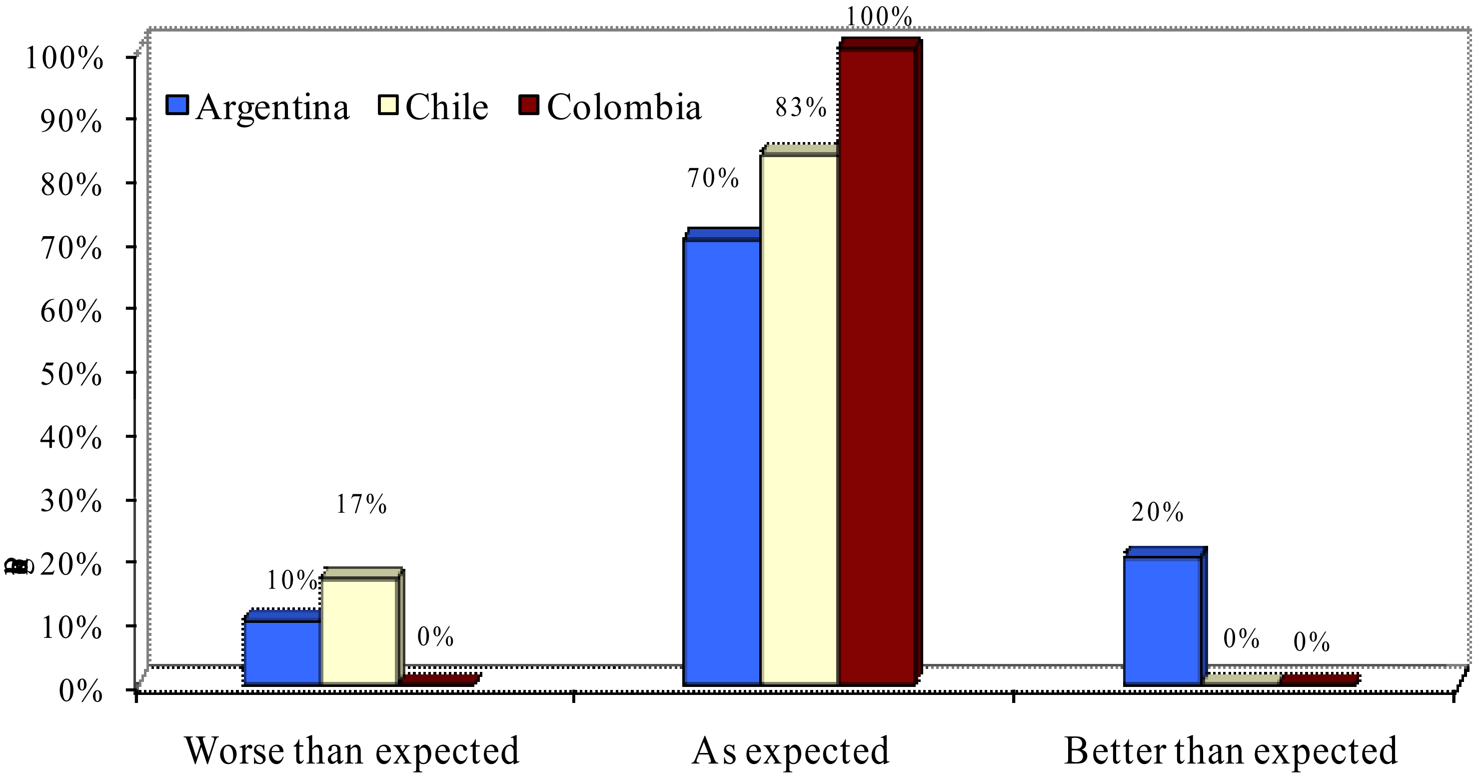
The Effects of the Crisis

Trends from 2006 but Prior to the Beginning of the Crisis:
Costs of Serving SMEs



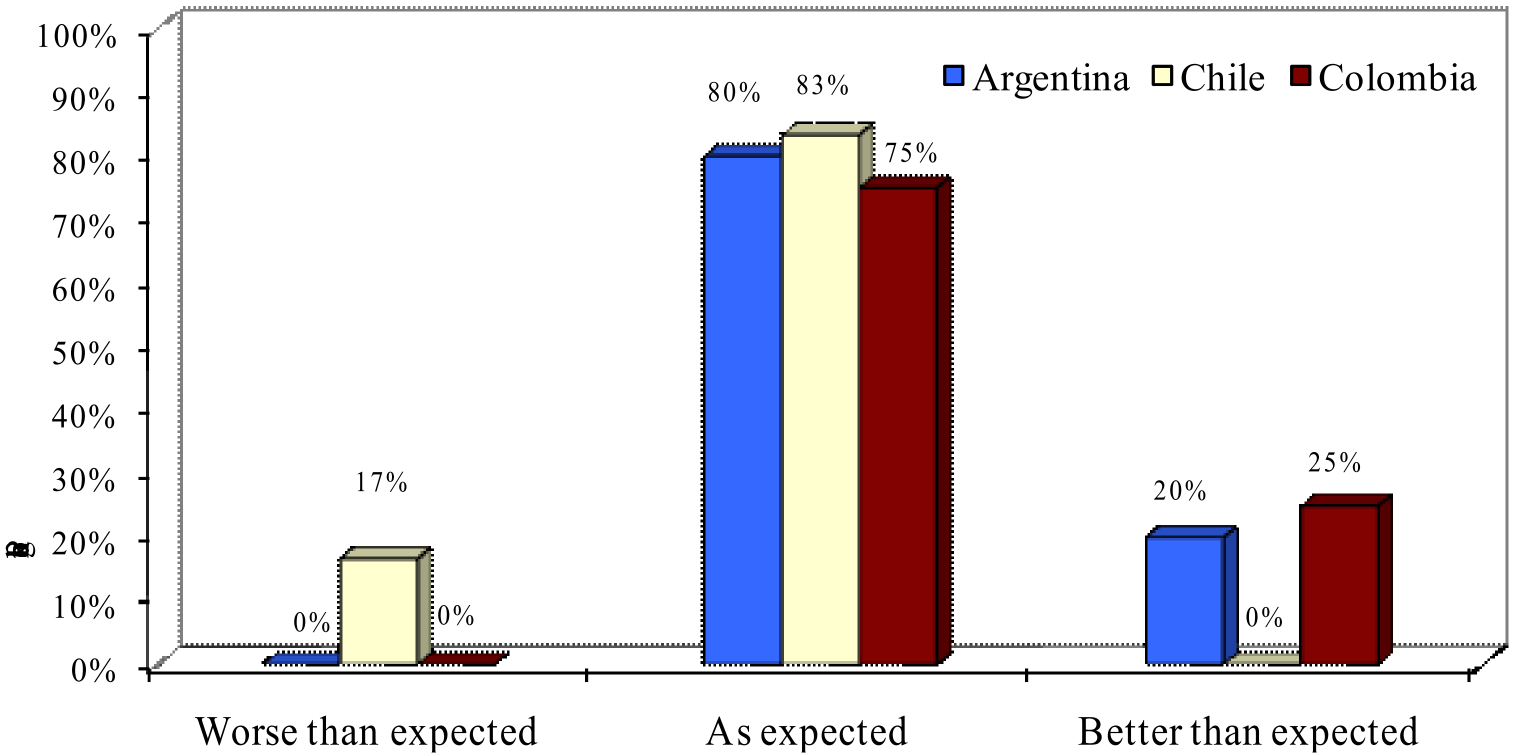
The Effects of the Crisis

Trends from 2006 but Prior to the Beginning of the Crisis:
Profitability of Loans to SMEs



The Effects of the Crisis

Trends from 2006 but Prior to the Beginning of the Crisis:
Profitability of Services to SMEs



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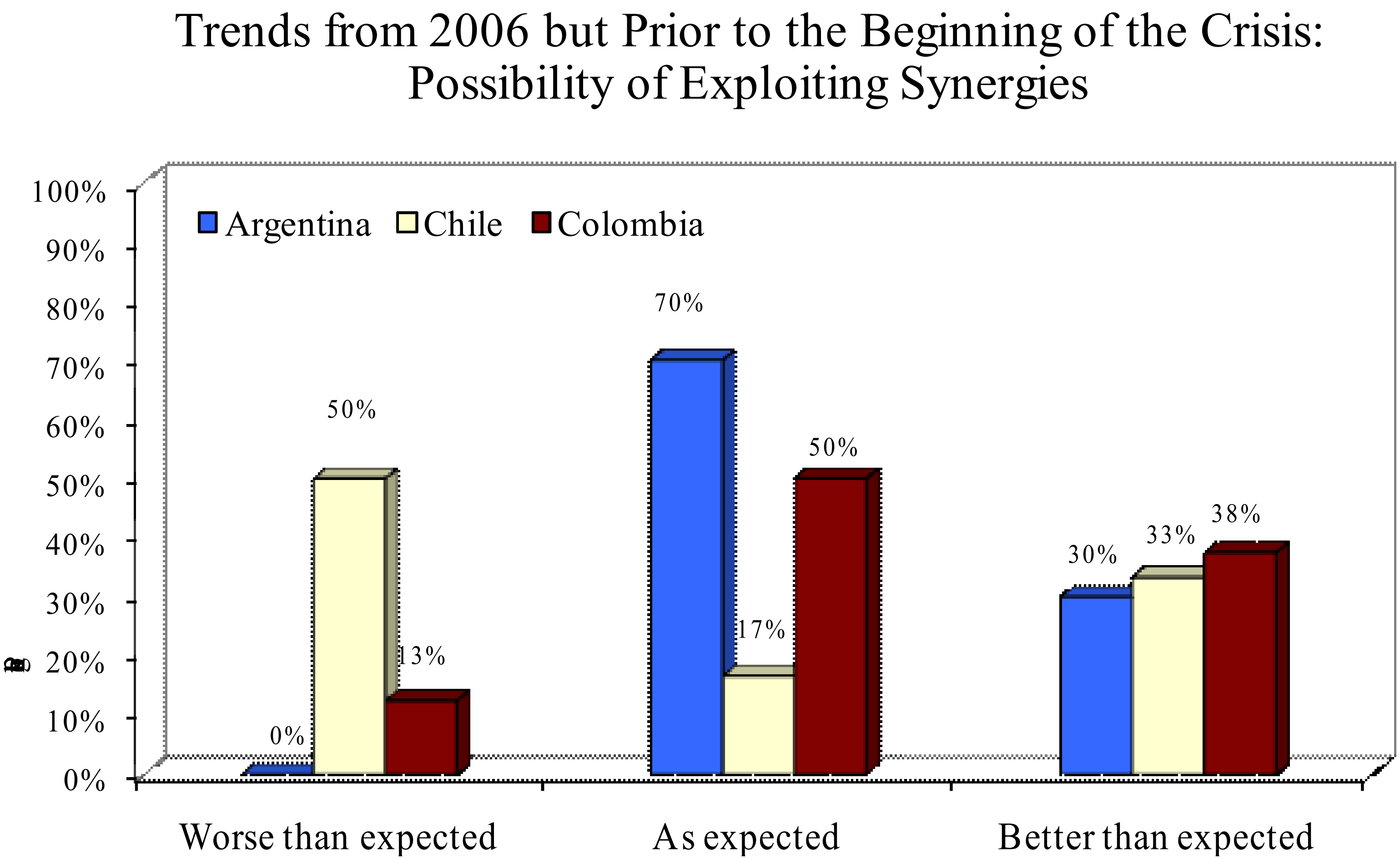

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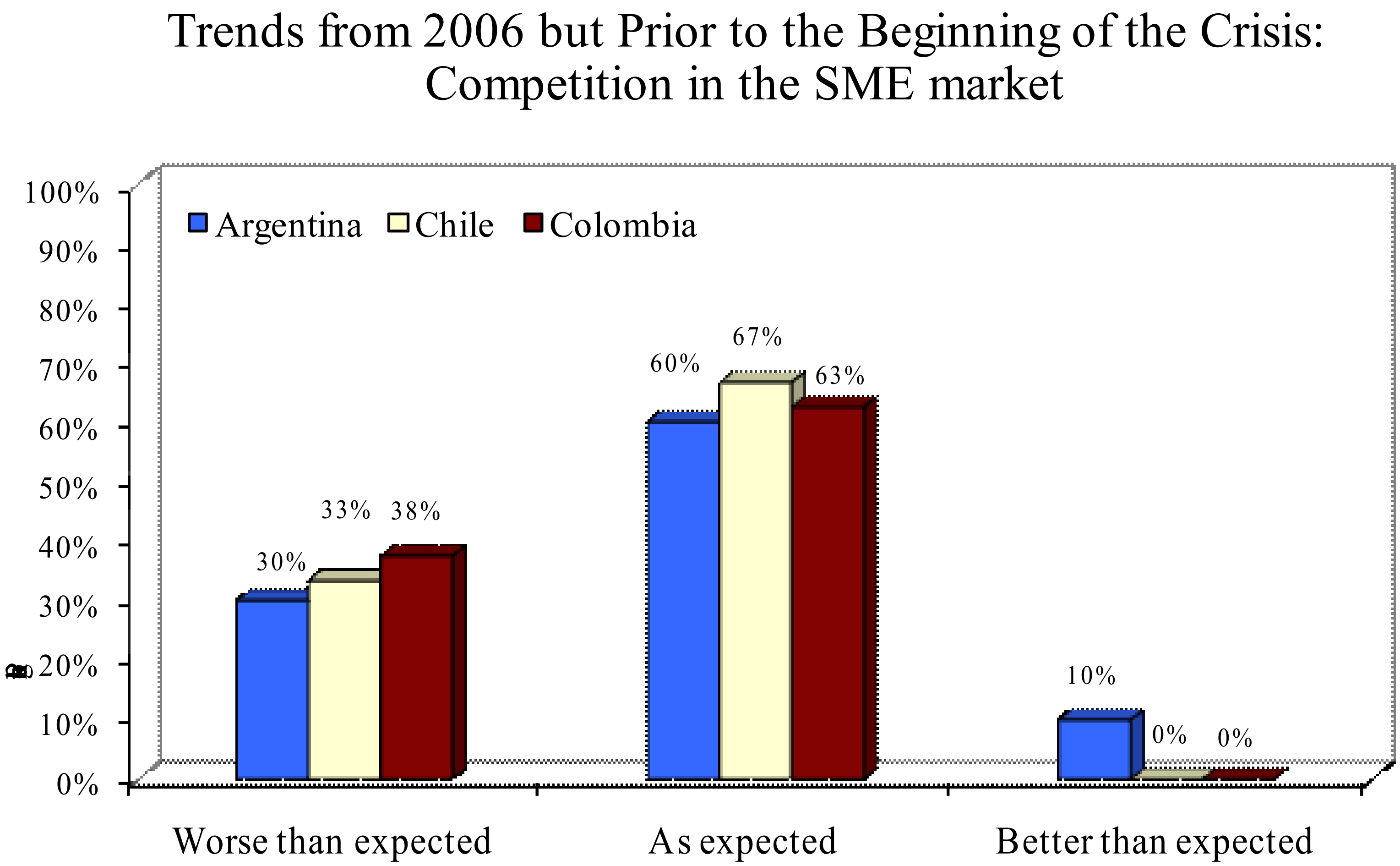

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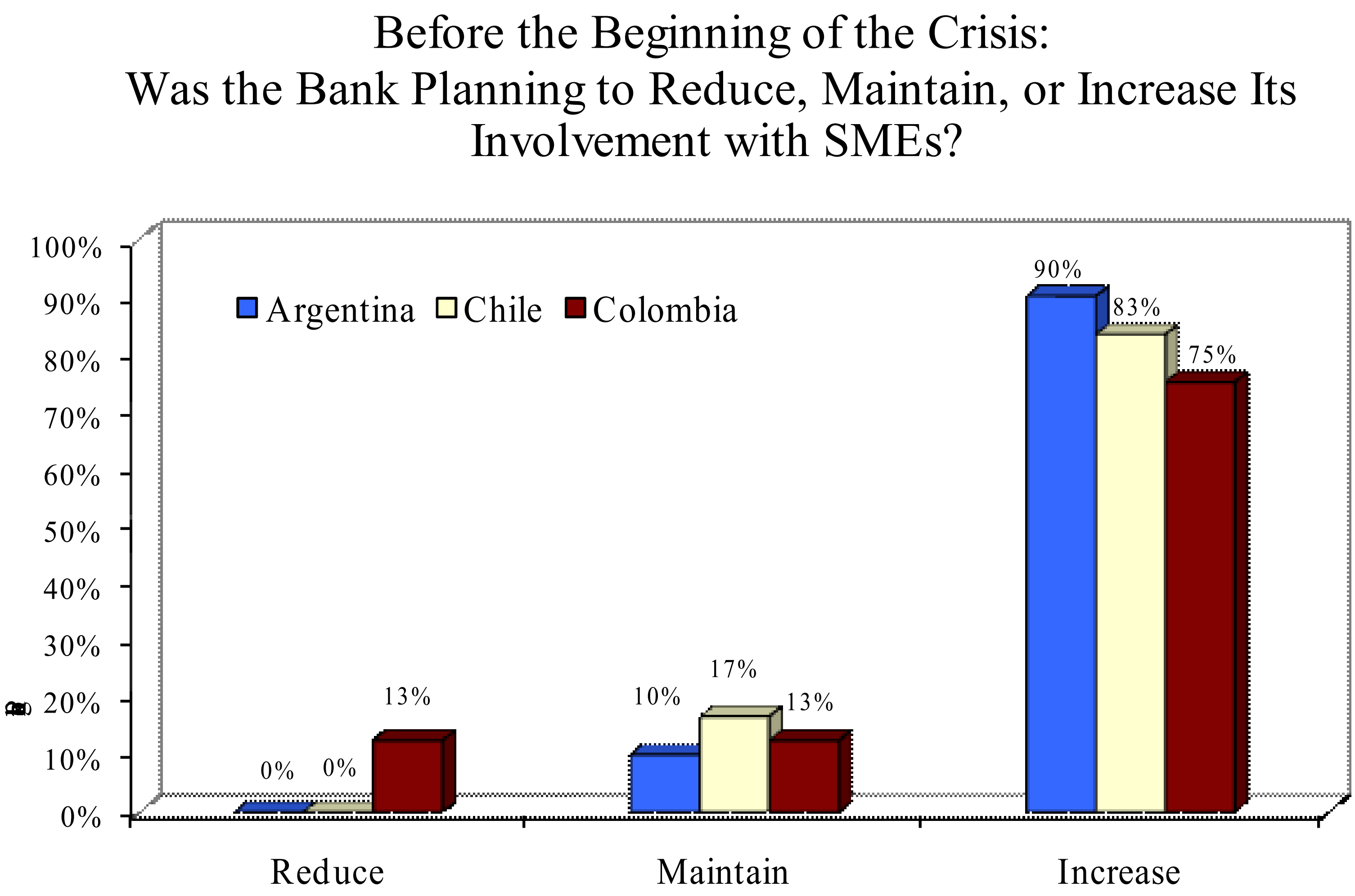
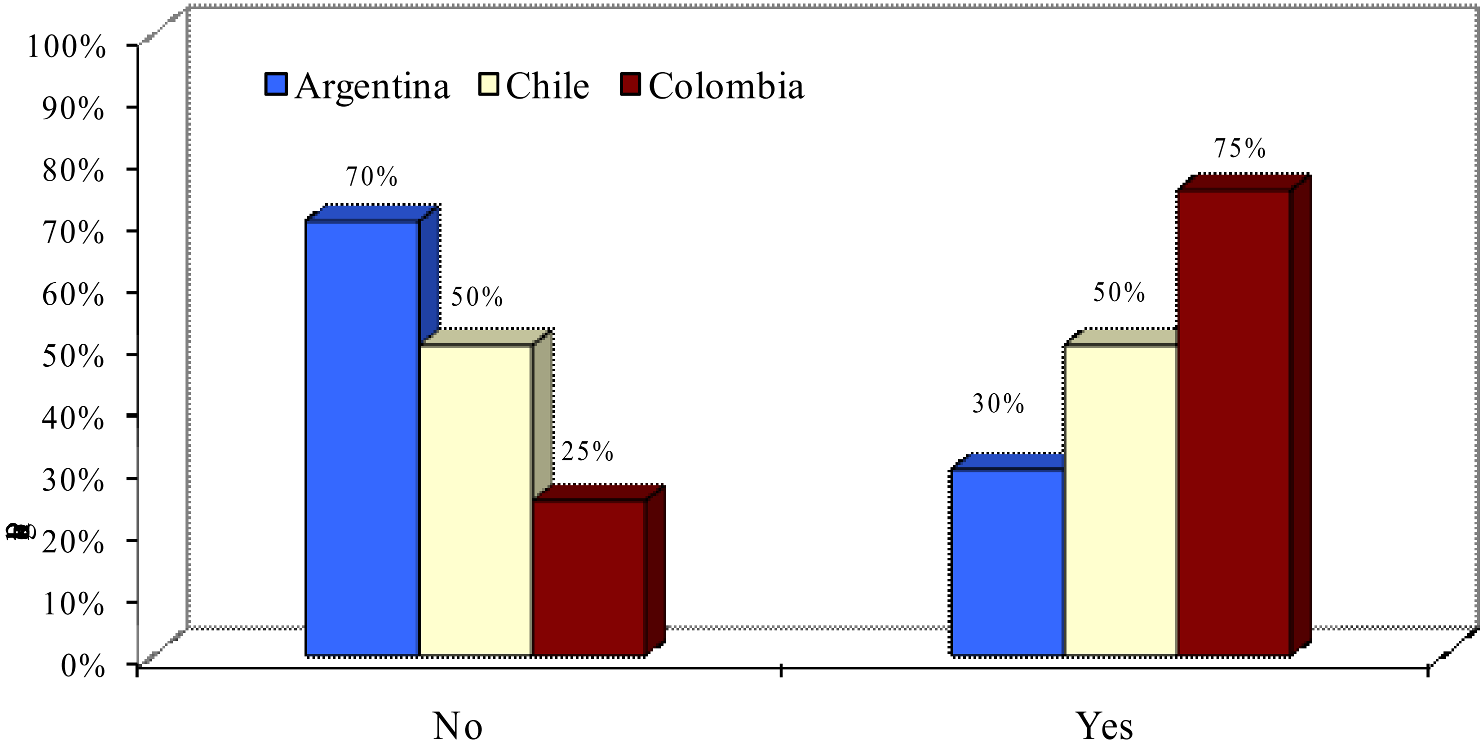


The Effects of the Crisis

Before the Beginning of the Crisis:
Was the Bank Planning or Implementing Changes in Its Organizational Structure in Order to Increase Its Involvement with SMEs?



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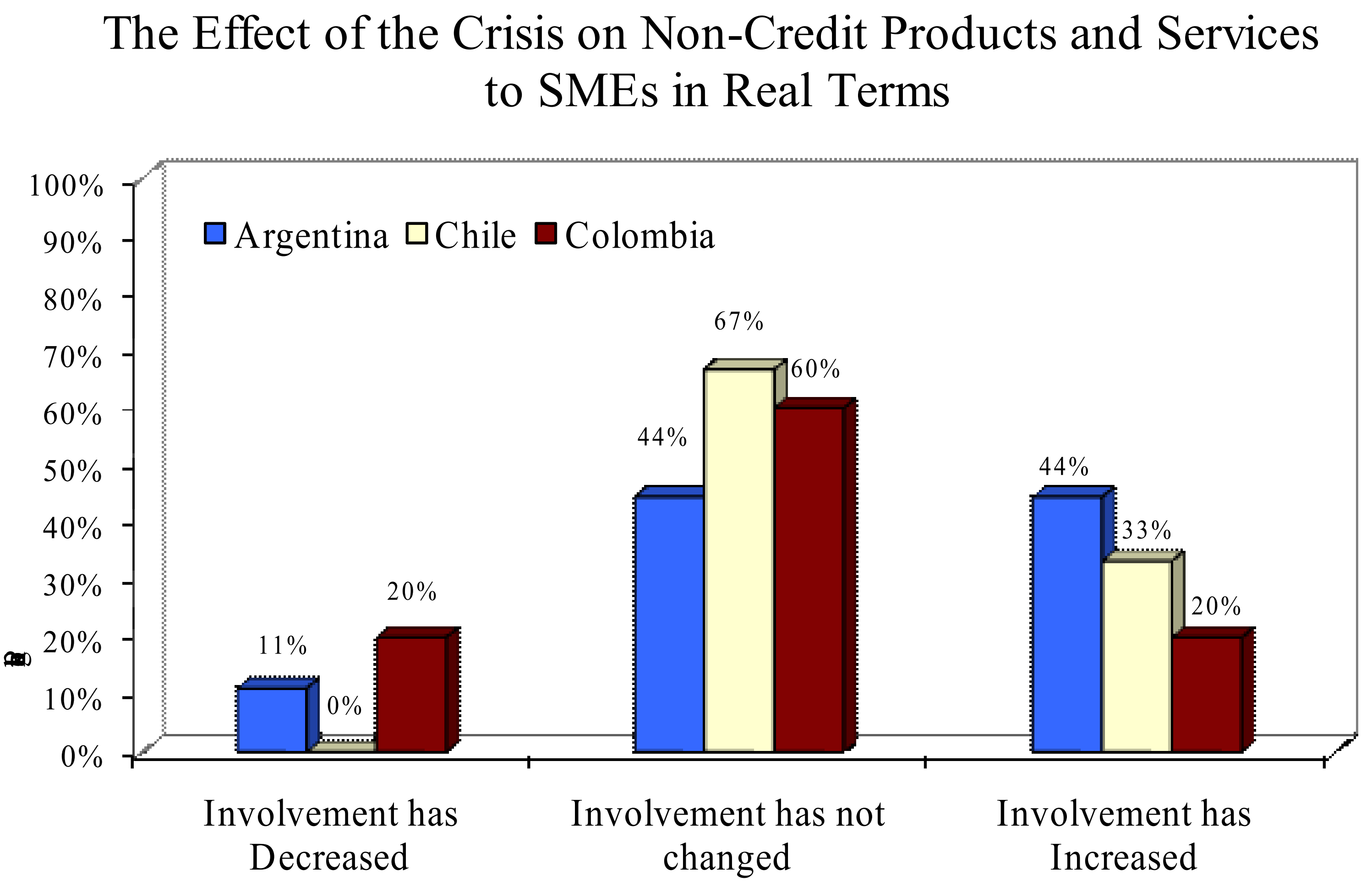
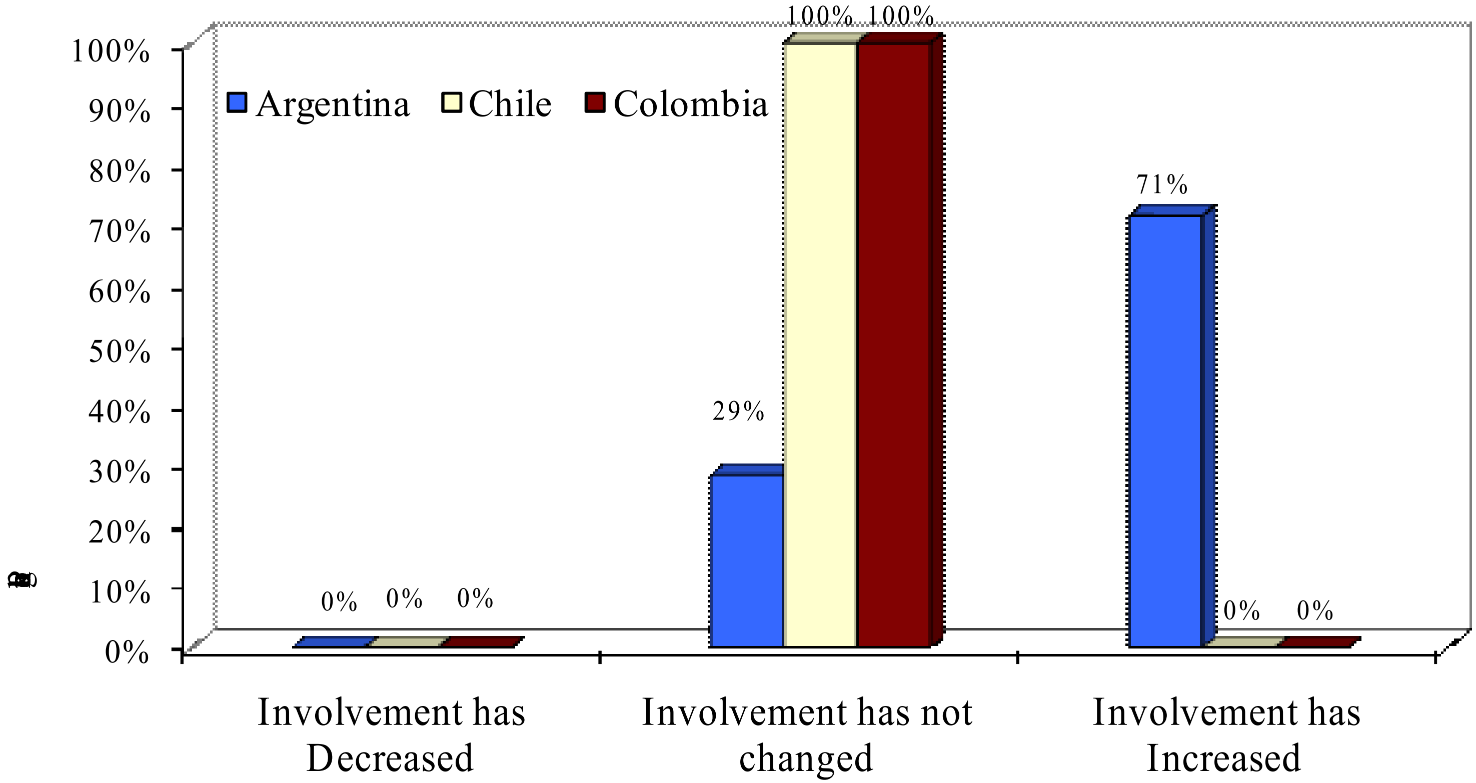


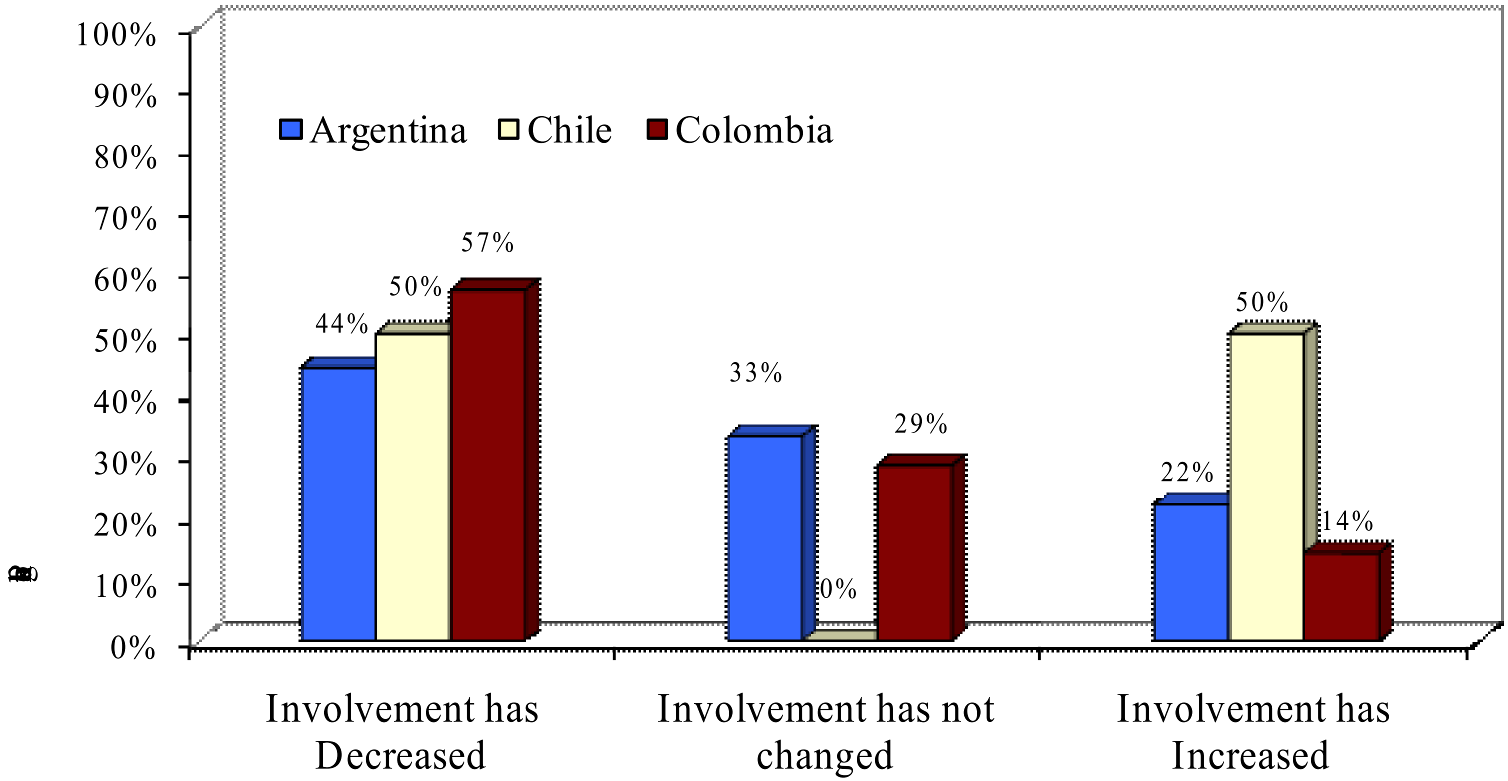
The Effects of the Crisis

The Effect of the Crisis on Non-Credit Products and Services to SMEs in Relative Terms (with Respect to Large Firms and Individuals)



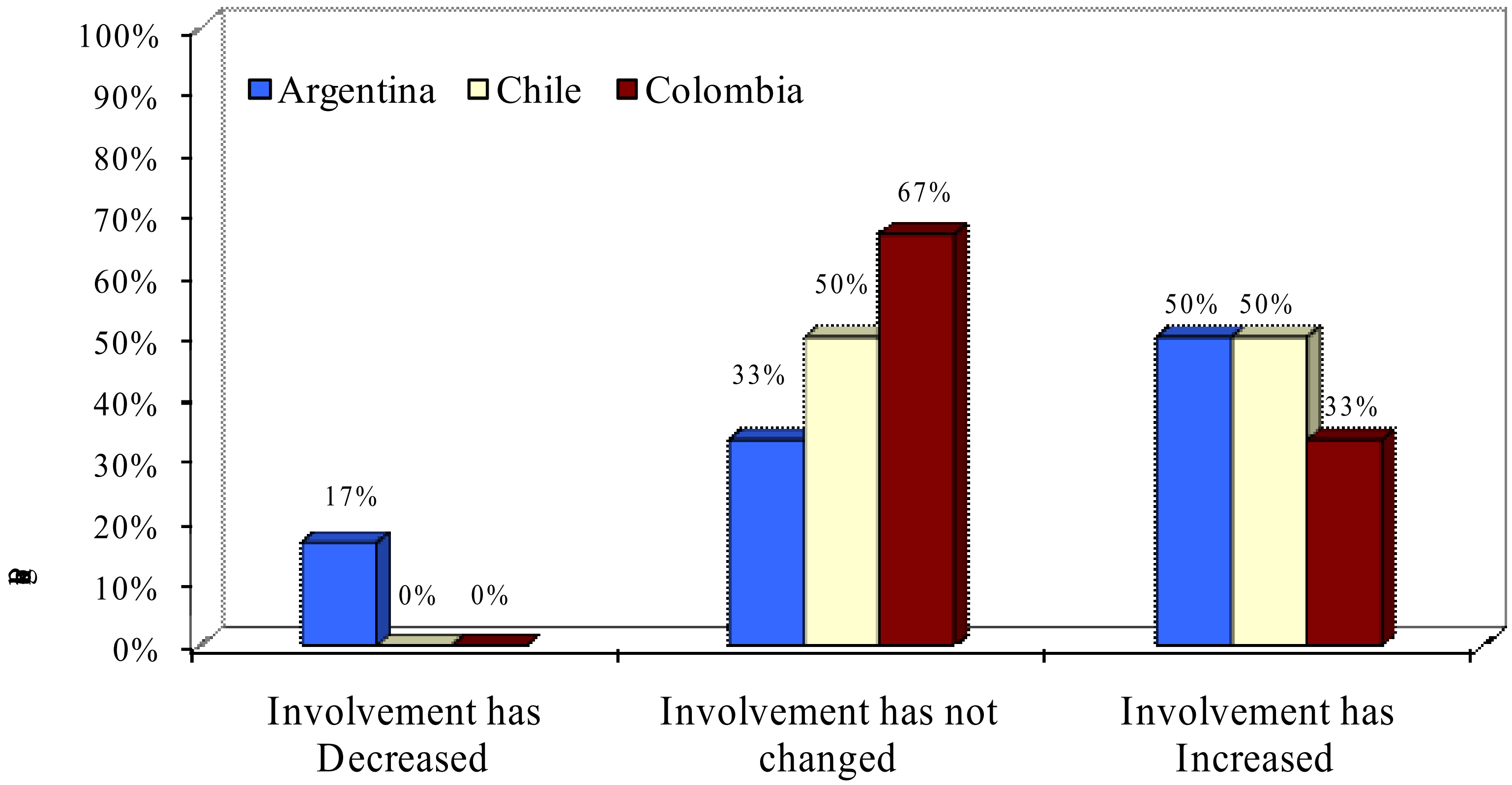
The Effects of the Crisis

The Effect of the Crisis on Loan Products to SMEs in Real Terms



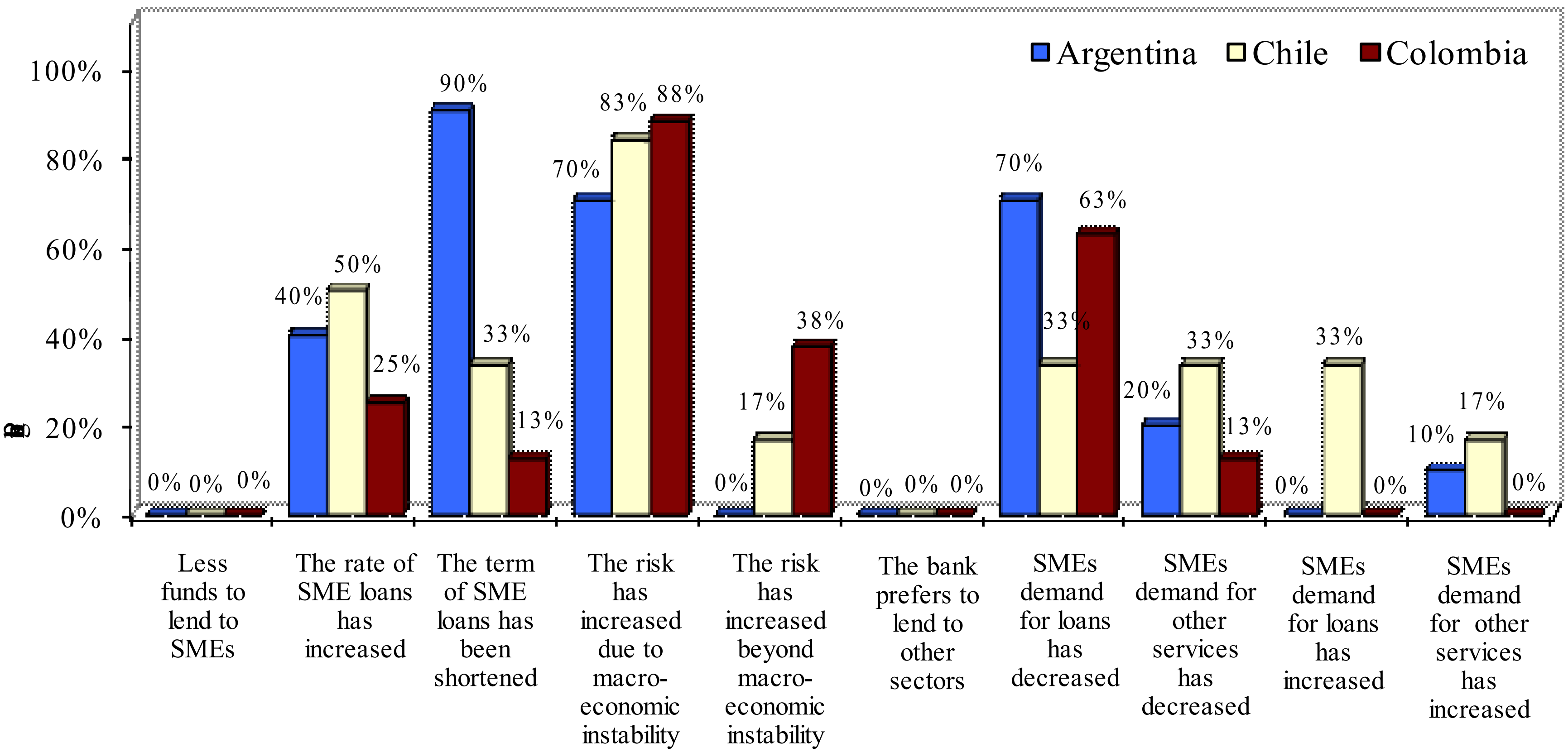
The Effects of the Crisis

The Effect of the Crisis on Loan Products to SMEs in Relative Terms (with Respect to Large Firms and Individuals)



The Effects of the Crisis

Other Changes Concerning the SME Business
as a Consequence of the Crisis



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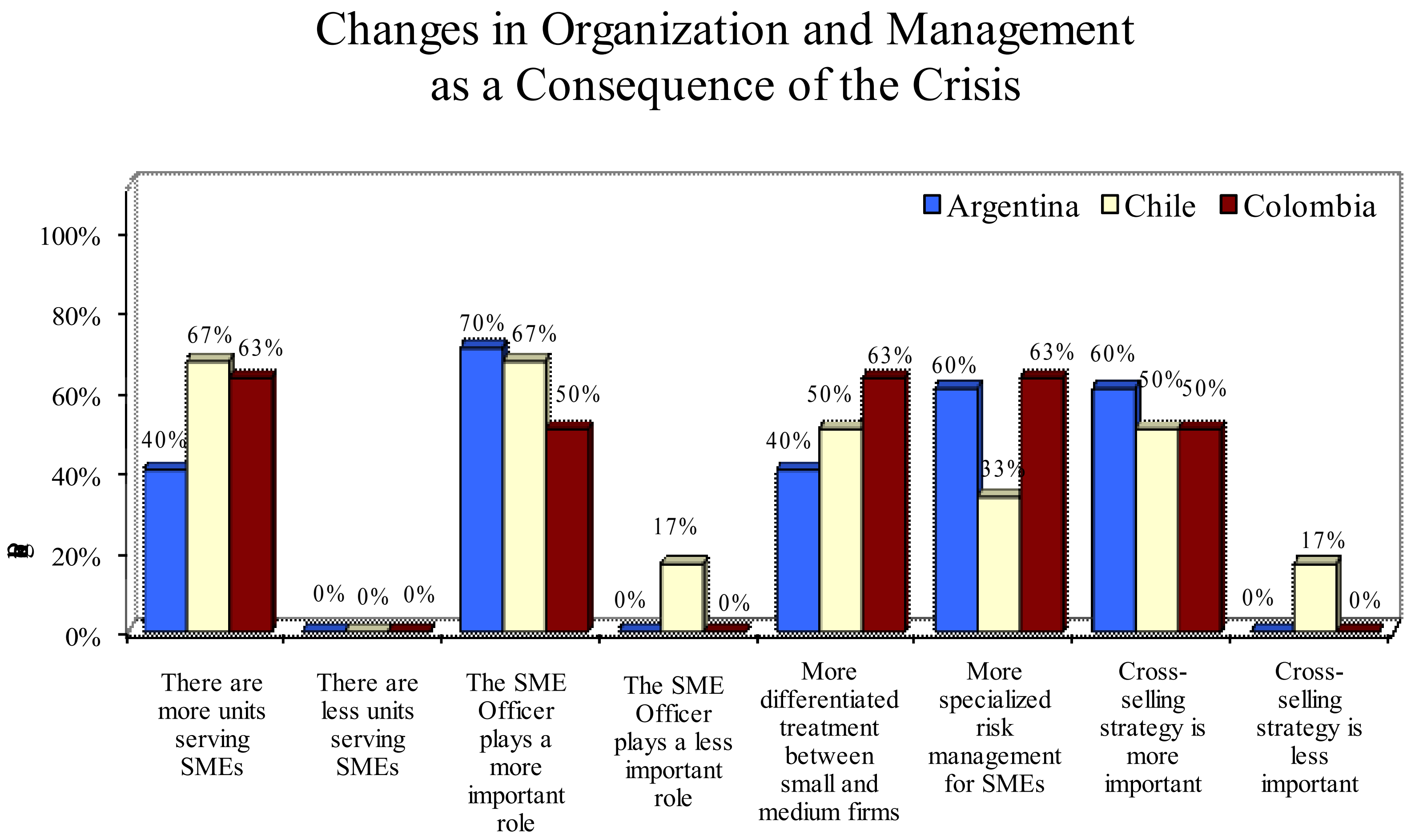

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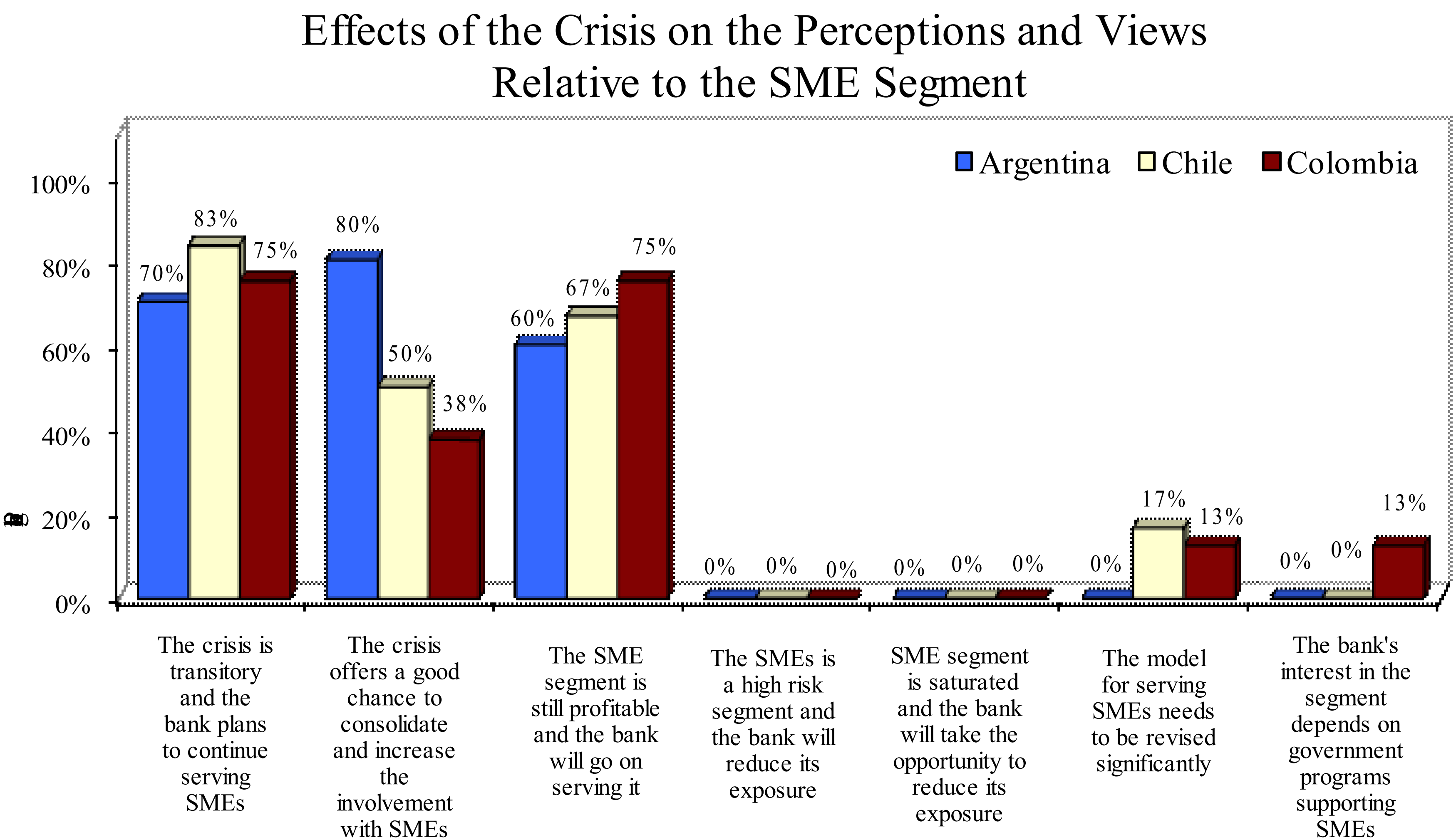

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Conclusions: Summary of Results

- Conventional view not supported by new data
- Different pattern of bank involvement with SMEs, beyond pure relationship lending
- Consistent facts across banks, countries, datasets
- Consistent with Berger and Udell (2006)
- Observable even in less developed countries
  - Where relationship lending expected to be more prevalent
- In particular, five main stylized facts

Conclusions: Summary of Results

1) Contrary to perceptions, most banks do want to serve SMEs and find them profitable
   - Margins in other banking markets narrow
   - Public sector and large firms access capital markets
   - Competition in the retail sector
   - Incentives to incur the switching costs to serve SMEs
   - SMEs have emerged as a strategic sector for most banks
   - Large and foreign banks, not just small and niche banks
   - SME market competitive, yet far from saturated.

Conclusions: Summary of Results

1) Relationship lending not the only way to lend
   - Transactional technologies facilitate arms-length lending
   - Credit scoring, standardized risk ratings and processes
   - Asset-based lending, factoring, fixed asset loans, leasing
   - Hard information and incentive-compatible mechanisms
   - Compensate for weaknesses in institutions
   - Weaknesses particularly matter for non-collateralized long-term lending
   - Mechanisms free banks from relying on government subsidies to lend to SMEs

Conclusions: Summary of Results

1) Lending just one part of a larger overall package
   - Wide range of profitable fee-based non-lending products and services (e.g., payments, saving, and advice)
   - Lending not always the main or the first product
   - Cross-selling at the heart of business strategy
   - Selling products and services deepens the engagement
   - Facilitate doing more lending while attracting other clients (like SME employees and owner's family)
   - For these products, institutional environment for contract writing and enforcing less of a constraint

Conclusions: Summary of Results

1) Large and international banks relative advantage
   - Benefit from economies of scale and scope
   - Compensate for fixed and switching costs of developing products and services to engage SMEs
   - Cover many SMEs with large services platforms and branch networks
   - Sophisticated business models and risk management systems
   - E.g., credit scoring, link to corporates, supply non-lending products and services
   - Leaders and relatively more aggressive

Conclusions: What This Means

- Relationship lending may still be important, but not the only way in which banks interact with SMEs
- SMEs seem yet unable to get crucial products
  - Some loans with certain collateral (e.g., inventories, equipment, cattle, intangible assets)
  - Long-term fixed-interest rate loans in domestic currency

Conclusions: SMEs and Crisis

1) Crisis has not affected interest and involvement
   - Post 2006, banks implemented changes in their organization and management to serve SMEs
   - Higher risks due to macroeconomic instability
   - Lower demand for loans by SMEs
   - No reduction in credit and non-credit products relative to large firms and individual, but less in real terms
   - Crisis temporary
   - Structural nature of engagement means SMEs still of interest, but pace of financial innovation?

Conclusions: Future Research

- More data on scope of countries
- Structural change vs. cyclical bonanza
- More data on revenues, costs, and risk-adjusted profits associated with SME business
- Consequences on the banking sector, including its structure
- Importance of information
  - Role of government
- Are SMEs receiving “adequate” financing?

Thank you!