

FINANCIAL TECHNOLOGIES GLOBAL INITIATIVE

Briefing Notes

January 2002

Strategies for Profitable Small Business Finance

Introduction

IFC launched the *Financial Technologies Global Initiative* in 2000 to support banks in targeting small and medium sized enterprises (SMEs) profitably by capitalizing on proven innovations in financial technologies. The *Initiative* (also dubbed the “*E-Finance Initiative*”) addresses principal impediments to the provision of commercially viable financial services for SMEs. The *Initiative* is developing solutions globally, starting with six pilot projects with selected partner banks. This note addresses the following aspects of the *Initiative*:

I. Background

- Trends in Global Financial Markets
- Summary of the *Initiative's Objectives*
- Selection Criteria for Pilot Projects

II. Financial Technologies Pilot Projects

- Strategy and Business Plan Development:
Methodology and Approach
- Market Research
- Development of Strategic Options
- Business Plan and Milestones
- Best Practice and Leading Technology Providers

III. Supporting Initiatives:

- 2002 International Conference on Technologies in Small Business Finance
- Global Credit Bureau Initiative
- Shared Small Business Scoring Solutions
- Mobile Banking and Payment Systems
- Risk Management Integration
- Link to Securitization Strategies

IV. IFC's Role

- Investor
- Strategic Advisor and Coach
- Innovator and Catalyst
- Match-Maker

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I. Background

Trends

Today, small and mid-sized banks in emerging markets and countries in transition face new challenges brought forth by trends in globalization. Large international banks have moved swiftly to these markets in pursuit of their multinational clients; securities markets are increasingly facilitating direct access to financing, thus pushing credit margins down and increasing domestic competition; traditional retail banking is becoming more competitive and expensive to develop. To meet these daunting challenges, many domestic financial institutions have had to rethink their business strategies. A good number are beginning to explore the largely untapped market for financial services for SMEs, and are searching for ways to target this market profitably.

These trends are of great significance to IFC, given its substantial portfolio of mid-sized banks and commitment to increasing access, range and volume of financial services for the underserved. Drawing on its track record as a risk-taking financial investor, as well as a strategic advisor and technical assistance provider in emerging markets and countries in transition, IFC continues to develop strategies for supporting client FIs to meet these challenges and gain from budding opportunities.

Summary

IFC launched the Financial Technologies Global Initiative to support financial institutions to target SMEs profitably by capitalizing on innovations in financial, information, and communication technologies. These technologies include lending strategies that revolutionized the U.S. market for small business credit in the 1990s, particularly the application of consumer lending techniques, such as credit scoring, to small business finance. The United States is currently the most competitive small business finance market, with annual revenues generated from financial services to this market well in excess of US\$200 billion.

The *Financial Technologies Global Initiative* addresses principal impediments to the provision of commercially viable financial services for SMEs: high transaction costs and credit risks associated with small loan sizes, unreliability of financial information, and informal sector constraints intrinsic of the MSE sector. The *Initiative* takes a holistic approach to the operations of a financial institution, incorporating traditional and new distribution channels, products and services. At

its core, it promotes a package approach — not just focusing on credit, but also delivering a range of financial services (including savings, payment transfers, insurance) — which maximizes the profitability of the client relationship. IFC is implementing the *Initiative*, starting with six pilot projects with selected partner banks globally. The key focus is to adapt viable solutions and business models for small business finance to the pilot banks' internal infrastructure, business, legal and regulatory environments.

Selection criteria of pilot projects:

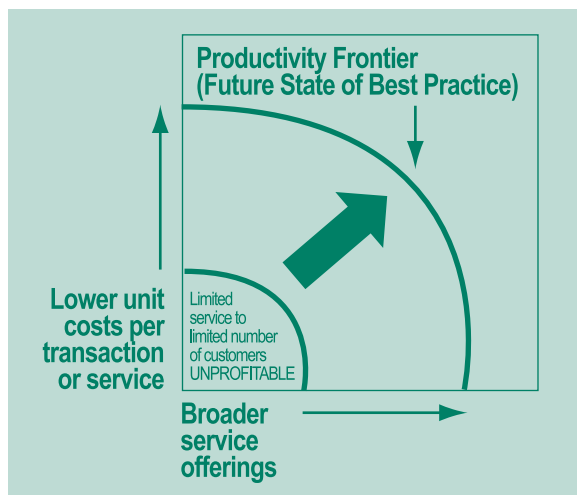
- **IFC investment opportunity:** The upside of the value creation that stems from implementation of the financial technologies pilot will be captured by IFC through some form of equity or quasi-equity investment. However, the partner bank is expected to pay an advisory fee (to be negotiated up front) to cover IFC's out-of-pocket expenses and direct costs.
- **Capacity to implement:** Strong management team that is open to innovation; bank must be current on banking technology and, preferably, with experience in retail finance.
- **Basic Parameters for small business loans:** Minimum portfolio of 10,000 to 15,000 loans; average loan size of US\$2,500 to US\$25,000.
- **Basic Parameters for SME loans:** Minimum portfolio of 500 to 1,000 loans; average loan size of US\$50,000 to US\$250,00.

The implementation of the financial technologies pilots with each partner institution entails three stages:

- **The commitment phase**, during which senior management demonstrates commitment to the project and appoints a leader, or 'champion', to lead the pilot.
- **The strategy development phase**, described below, is the most important project phase and requires the greatest contribution from IFC.
- **The implementation phase** builds on the planning and milestone setting of the strategy development phase, and links it to IFC's investment and monitoring activities.

II. Financial Technologies Pilot Projects

Strategy and Business Plan Development: Methodology and Approach



IFC's approach to developing a small business finance strategy takes a comprehensive view on the operations of a financial institution, including both traditional and new distribution channels, products, and service offerings. In order to make small business finance profitable, a financial institution must simultaneously reduce the cost of acquiring and servicing small business clients, while also increasing the profit contribution per customer by cross- and up-selling a range of financial services. This requires broadening the view from a one-product-only to a package approach, which combines savings, payment and transaction services, and credit, with certain value-added services. To achieve this, it is necessary to leverage financial, information and communication technologies which have proven to be successful in different parts of the world. These include market segmentation tools, customer relationship management systems, credit scoring and application processing solutions, light branches and kiosks, electronic banking, and remote banking networks.

For small business lending, IFC's approach centers around the three key factors that ensure sustained profitability:

- Operating Efficiency
- Asset Quality
- Growth

Operating efficiency has to address the constraints of small loan sizes, non-reliability of financial information, limited access of clients to financial services, and the limited track record of the bank's small business clients. To address these issues successfully, a bank has to move away from a relationship-based corporate lending style - with its costly requirements of individual credit analysis and risk assessment - towards a portfolio approach that allows the financial institution to "mass-customize" financial products and services. "Mass-customized" lending requires risk management systems - such as credit scoring - that allow the institution to keep control and improve transparency of **asset quality**. To achieve improvements in both operating efficiency and asset quality, the bank must meet certain **growth** targets that ensure sufficient volume of transaction units necessary for a portfolio approach.



In building profitable operations to deliver financial services to small business, success will be measured by the achievement of three interlinked goals:

- Increase the number of small business clients
- Increase the profitability contribution per client
- Increase client retention (adding further to the bottom line by amortizing acquisition costs and leveraging cross- and up-selling opportunities)

To achieve these goals, IFC will work with partner banks to develop a strategy and business plan, the results of which should be realized within a five-year time frame.



IFC's framework for strategy development takes a bottom-up approach, with the customers as the starting point. The strategy development phase entails three stages:

- Conducting *market research* to define the target market(s), existing or potential competition and client preferences.
- Developing *strategic options* for products and services, delivery channels, organizational requirements and investment needs.
- Preparing a *business plan*, setting targets for client number, products and profitability.

1. Market Research

The market research entails: (i) quantitative analysis (largely conducted through desk research) to define the target markets; and (ii) focus groups with potential clients of the respective target market segments in order to evaluate the needs and preferences of potential clients, and provide a basis for the design of products, services and delivery channels.

The quantitative research would include:

- market segmentation by size and industry
- competitive analysis of other sources of financial services to target markets, including a review of the main products and their terms and conditions
- regional mapping of market demand to define the partner bank's regional focus.

The focus groups would:

- assess the quality of current financial service offerings available to target markets
- test and review preferences for potential product/service offerings
- test and review preferences for delivery channels (including electronic and mobile banking offerings).

2. Development of Strategic Options

2a. Products/Services

Basing its strategies on market research findings, the partner bank would aim to optimize existing product and service offerings. The partner bank would also develop and introduce new financial product and service offerings, in both bundled and unbundled forms, for specific target segments. These offerings would include revolving credit products, deposits, checking accounts, foreign exchange handling, insurance and international payments.

IFC would assist the partner bank to develop products and services of superior quality by adapting the expertise of cutting-edge industry leaders and technology. To this end, partners and technology providers will be directly involved in shaping the product development phase by providing expertise during workshops held at the partner bank's headquarters. These workshops will provide the basis for the design of new products, services and delivery channels.

2b. Delivery Channels

In delivering new products and services, IFC and the partner bank would review the different distribution channel options including:

- *Traditional branches*, but with centralized back-office functions
- *Light branches* that leverage captive relationships with large corporates or company clusters to provide services to employees and suppliers, based on front-office staff only
- *Agent networks* that increase outreach to small business clients
- *Call centers*, both for client servicing, as well as for client acquisition
- *ATM networks* that may include broadened functionalities and/or are adapted to remote banking requirements
- *Electronic channels* using the Internet to provide traditional e-banking services, plus broadened offerings such as receivables management, e-procurement, small business information services.
- *Mobile banking channels*, using mobile phones to provide e-banking services via SMS or WAP technology, as well as future payment functionalities.

Delivery channels will be selected on the basis of their ability to achieve high operating efficiencies in servicing small business clients. IFC will assist clients to identify technology partners with expertise in designing and adapting them.

2c. Organization

IFC will review, with the partner bank, the current organizational structure and propose modifications deemed necessary for the execution of effective small business finance strategies. The guiding principle in organizational design will be to use *dedicated teams/divisions* responsible for distinct market segments/product lines. Of particular focus will be the development of a *centralized back-office* to free staff time in sales and service areas, as well as consolidate processes consistently across the organization. The best-practice partners involved in the product/services and delivery channel development will be engaged during this phase.

2d. Investments

A preliminary assessment of investment needs will be defined for one or more strategic options, based on requirements for analytics, technology, delivery channels and processing. The technology selection process for the different strategic options will also be determined. These assessments will be refined further during the development of the Business Plan.

3. Business Plan and Milestones

The main output of the strategy development phase is a Five-Year Business Plan, which would include an implementation plan and set specific quarterly performance targets for the client bank (e.g., number of customers acquired and retained, introduction of products and services, profitability by client category). The Business Plan will include projections and measurable standards to demonstrate potential success.

Best Practice Partners & Leading Technology Providers

Best practice partners are institutions from various countries that have demonstrated excellence in their fields and whose MSE finance strategies are deemed adaptable to emerging and transition countries. Best practice partners may be associated with IFC's efforts through formal or informal working relationships.

Leading technology providers: A reference list of leading technology providers and consultants is developed based upon their offerings and references. IFC has started discussions with a wide range of technology providers, among them leaders in credit scoring, systems integration, payment solutions, e-services providers, market research companies, as well as specialized technology developers and local consultancy companies.

III. Supporting Initiatives

Key supporting components of the *Initiative* are to (a) facilitate early dissemination of best practice from the pilots to a broader audience, (b) address the inadequacy of infrastructure critical to small business finance, and (c) identify new technologies and strategies that hold great potential for client countries.

■ **International Conference on Technologies in Small Business Finance:** In cooperation with the World Bank Institute and the Financial Sector Board of the World Bank, IFC will host the second international small business finance conference for financial institutions from emerging and transition markets to share its experiences of best practice in small business finance. The conference is scheduled for October 2002 in Washington, DC, and participants will include global leaders in financial technologies for small business finance.

■ **Global Credit Bureau Initiative:** As credit information — in particular, consumer credit reports — is critical in small business lending, IFC and the World Bank are joining forces to promote and facilitate the development of efficient credit bureaus. While the World Bank is providing advice on the regulatory framework and best practice for regulations, including privacy and data protection laws, IFC is advancing discussions with leading international credit bureaus to define investment opportunities in priority countries.

■ **Shared Small Business Scoring Solutions:** One of the key success factors in improving operating efficiencies and asset quality in small business lending is the use of credit scoring. While banks are hesitant to shoulder the full costs of small business scoring systems, they recognize the usefulness of these decisioning systems and appreciate the robustness of shared scoring models. To serve this need, IFC has started developing opportunities for shared small business scoring solutions in different countries. Shared small business solutions have proven to be successful in advancing small business lending in countries like the US, Australia, and Italy. For example, the Small Business Scoring System in the US (developed in the early 1990s with data from 17 banks) is currently used by over 300 US lenders and generates almost 1 million small business credit

decisions annually. Such a system can be developed for a single small business lending product - such as a small business credit card — or for a number of small business lending products, including equipment leasing, installment and investment loans.

■ **Technology Practice Area — Mobile Banking and Payment Systems:** Since mobile phone penetration is rapidly growing in emerging markets, and is one of the first investments for entrepreneurs and small business owners, IFC is currently reviewing mobile technologies and their potential for the delivery of financial services to small businesses. Under review are the following mobile technology applications:

- ◆ *Mobile banking for SME clients* — either SMS- or WAP-based solutions to offer traditional e-banking offerings, such as money transfer, account information, cash management — all critical for the management of small businesses;
- ◆ *Remote banking capabilities for loan officers* to increase client reach and provide comprehensive and quick service to microfinance customers;
- ◆ *Mobile payment systems* to facilitate non-cash payment options for small businesses, reduce cash handling risks, and expand formal financial sector penetration.

■ **Risk Management Integration:** Small business finance underwriting and portfolio management techniques provide the basis for a seamless integration and compliance with the new Basle guidelines. A careful review of lessons learned from European solutions will pave the way for future replication in client banks.

■ **Link to Securitization Strategies:** By introducing consistent and largely automated underwriting procedures and processes, credit portfolios will be suitable for securitization strategies, both in terms of synthetic securitizations where the assets remain on the books, and well as true asset-backed transactions.

IV. IFC's Role

In order to successfully implement the *Initiative's* projects, IFC must expand its role beyond the traditional investor functions by leveraging its analytic skills and experience to become a pro-active partner in developing sustainable FIs serving the MSE market. IFC is expanding its investor role to invest in global partnerships and in companies that provide financial infrastructure services, such as credit bureaus, shared scoring solutions, and payment systems. In addition to its traditional role of investment, three distinct areas of contribution define IFC's expanded role:

- IFC as **Investor**: IFC provides both debt and equity financing to support the implementation of its pilot projects, and may also provide structured financing, such as securitizations of small business portfolios.
- IFC as **Strategic Advisor and Coach**: From the initial phase of building management commitment and throughout the strategy development phase, IFC provides guidance and eventually ensures the setting and meeting of milestones during implementation.
- IFC as **Innovator and Catalyst**: IFC is in the unique position to share knowledge of best practices, emerging technologies, MSE financing solutions, and to facilitate adaptations to emerging and transition market environments, e.g. developing standardized microfinance banking software, allowing for easy adaptation of credit scoring at a later stage.
- IFC as **Match-Maker**: By building partnerships with international leaders in microfinance and SME lending and providers of high quality technologies, IFC plays a crucial role in the transfer of proven financial technologies to partner FIs. This role enables IFC to facilitate the provision of high quality and more profitable services, especially by smaller FIs which generally lack access to these technologies.

IFC's Role

Investor at multiple levels

- Debt and/or equity in FIs and global partnerships

Strategic Advisor and Coach

- Advising on strategy development and coaching throughout implementation

Innovator and Catalyst

- Sharing global expertise across diverse markets
- Establishing and disseminating best practice

Match-Maker

- Facilitating partnerships between FIs and global leaders in strategies and technologies for MSE financial services