Banking SMEs across countries and bank ownership types

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Motivation: conventional wisdom

- SMEs account for a significant share of employment around the world (approx. 60%).

“Conventional wisdom”:
- SMEs receive inadequate financing
- Lack of financing rooted in “supply-side” factors
**Motivation: conventional wisdom**

Several reasons are provided to explain supply-side view:

1. SMEs are opaque. Have unknown capacity and willingness to pay.

2. SMEs are more likely to be informal (have significant contingent tax liabilities, senior to bank debt).

3. SME lending is based on “relationship lending”, which relies on “soft” information gathered by the loan officer through direct and repeated contact with the firm.

4. Large and foreign banks are not interested or have a disadvantage in SME lending because they rely on arms length financing technologies.

5. Capital markets cannot compensate lack of bank finance.
Berger and Udell (2006) argue that large and foreign banks can have a comparative advantage at serving SMEs through different arms length technologies (asset-based lending, credit scoring, factoring, leasing, etc.)

However, so far there is little empirical evidence supporting this new paradigm.

Furthermore, little is known about the business models currently applied by banks to serve SMEs.
Research objectives

1. Characterize the nature of banks’ involvement with SMEs.

2. Empirically assess the validity of the new paradigm: investigate to what degree foreign and large private banks’ involvement with SMEs is different than that of other banks.

3. Examine differences in SME financing across countries.
   The literature on credit market development suggests that differences in the economic, institutional, and legal environment can yield significant differences in credit market development across countries (see Djankov et al. 2007) and these differences seem to disproportionately impact SMEs (Beck et al. 2005, 2006, 2008).
Background papers

   - Case study approach
   - Information gathered through face-to-face interviews.
   - Survey data for 37 banks in Argentina, Chile, Colombia, Serbia.
   - Survey data in 11 banks in 8 countries (Australia, Brazil, India, the Netherlands, Poland, Thailand, the UK, the US)
   - Annual SME surveys in 7 countries (Argentina, Chile, Colombia, Mexico, Peru, Puerto Rico, Venezuela)
Background papers


   - Survey data for 91 banks from 45 countries
   - Information gathered through standardized questionnaire
   - 11 banks from 7 developed countries and 80 from 38 developing countries
   - 32 foreign, 42 private, and 17 government owned banks

Note: research findings are pre-crisis (2006/7) but will also discuss updates since the crisis.
Banks’ involvement with SMEs
Evidence from country case studies

Banks with SME clients

<table>
<thead>
<tr>
<th>Country</th>
<th>With SME clients</th>
<th>Without SME clients</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>93%</td>
<td>7%</td>
</tr>
<tr>
<td>Chile</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Colombia</td>
<td>100%</td>
<td>12%</td>
</tr>
<tr>
<td>Serbia</td>
<td>88%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Percentage of banks
Banks’ involvement with SMEs
Evidence across 45 countries

Banks with SME clients

Total Responses Developing Countries: 80
Total Responses Developed Countries: 11
Banks’ perceptions of SME market
Evidence from country case studies

Size and prospects of the SME market

- Argentina
- Chile
- Colombia
- Serbia

Percentage of banks

<table>
<thead>
<tr>
<th>Market Type</th>
<th>Argentina</th>
<th>Chile</th>
<th>Colombia</th>
<th>Serbia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small market/Bleak</td>
<td>31%</td>
<td>25%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Big market/Bleak</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Small market/Good</td>
<td>0%</td>
<td>0%</td>
<td>63%</td>
<td>69%</td>
</tr>
<tr>
<td>Big market/Good</td>
<td>100%</td>
<td>50%</td>
<td>38%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Banks’ perceptions of SME market
Evidence across 45 countries

Size and prospects of the SME market

- SME market is small and prospects are bleak
- SME market is small but prospects are good
- SME market is big but prospects are bleak
- SME market is big and prospects are good

Total Responses Developing Countries: 78
Total Responses Developed Countries: 11
Factors driving banks’ involvement
Evidence from country case studies

Drivers of bank involvement with SMEs

- Perceived profitability
- Relations with large clients
- Strategic sector
- Competition in other segments
- Exposure in other segments
- Social objective

Argentina
Chile
Serbia

Percentage of banks

0%  20%  40%  60%  80%  100%
Factors driving banks’ involvement
Evidence across 45 countries

Drivers of bank involvement with SMEs

- **Perceived profitability in the SME segment**: 81% (9) in Developed countries, 72% (55) in Developing countries.
- **Intense competition for large corporates**: 9% (7) in Developed countries, 0% in Developing countries.
- **Intense competition for retail customers**: 9% (1) in Developed countries, 1% (1) in Developing countries.
- **Excessive exposure to large corporates**: 0% in Developed countries, 1% (1) in Developing countries.
- **Excessive exposure to retail customers sector**: 0% in Developed countries, 3% (2) in Developing countries.
- **Possibility to seek out SMEs through existing relations with large clients (e.g., reverse factoring)**: 9% (1) in Developed countries, 5% (4) in Developing countries.

Total Responses Developing Countries: 76
Total Responses Developed Countries: 11
Banks’ setup to serve SMEs

Organizational structure to serve SMEs

- Argentina
- Chile
- Colombia
- Serbia
- Developed countries
- Developing countries

Percentage of banks

With dedicated SME units

- Argentina: 77%
- Chile: 88%
- Colombia: 100%
- Serbia: 100%
- Developed countries: 83%
- Developing countries: 0%

Without dedicated SME units

- Argentina: 8%
- Chile: 0%
- Colombia: 0%
- Serbia: 13%
- Developed countries: 0%
- Developing countries: 17%
Key features of banks’ involvement with SMEs

Summary

1. Most banks have SME clients.

2. They are serving the sector because they perceive it as profitable.

3. They have setup dedicated units to attend to SMEs.

4. They approach SMEs in an integral way, offering them a variety of products and services.
Differential bank involvement with SMEs
Evidence from country case studies

Main players in SME market

<table>
<thead>
<tr>
<th>Percentage of banks</th>
<th>Argentina</th>
<th>Chile</th>
<th>Colombia</th>
<th>Serbia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large banks</td>
<td>100%</td>
<td>100%</td>
<td>88%</td>
<td>75%</td>
</tr>
<tr>
<td>Public banks</td>
<td>92%</td>
<td>50%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Niche banks</td>
<td>62%</td>
<td>38%</td>
<td>13%</td>
<td>0%</td>
</tr>
<tr>
<td>Other financial intermediaries</td>
<td>54%</td>
<td>38%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Small banks</td>
<td>23%</td>
<td>13%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>
Characterizing bank involvement with SMEs

<table>
<thead>
<tr>
<th></th>
<th>Developed</th>
<th>Developing</th>
<th>Foreign</th>
<th>Private</th>
<th>Public</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of SME lending (%)</td>
<td>7.10</td>
<td>8.72</td>
<td>9.40</td>
<td>7.02</td>
<td>8.21</td>
</tr>
<tr>
<td>SME Loan approval (%)</td>
<td>73.35</td>
<td>77.99</td>
<td>77.60</td>
<td>75.30</td>
<td>85.79</td>
</tr>
<tr>
<td>Share of SME loans for investments (%)</td>
<td>70.13</td>
<td>43.24</td>
<td>45.70</td>
<td>45.15</td>
<td>51.01</td>
</tr>
<tr>
<td>Fee (% of SME loan amount)</td>
<td>0.39</td>
<td>1.11</td>
<td>1.03</td>
<td>1.19</td>
<td>0.76</td>
</tr>
<tr>
<td>Interest rate on SME loan (%)</td>
<td>4.87</td>
<td>11.44</td>
<td>10.02</td>
<td>11.50</td>
<td>10.47</td>
</tr>
</tbody>
</table>
Testing for differences in SME financing across banks and countries

<table>
<thead>
<tr>
<th>Share of SME lending (%)</th>
<th>SME Loan approval (%)</th>
<th>Share of SME loans for investments (%)</th>
<th>Fee (% of SME loan amount)</th>
<th>Interest rate on SME loan (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing</td>
<td>0.802</td>
<td>-28.113</td>
<td>0.712</td>
<td>6.899</td>
</tr>
<tr>
<td>[0.47]</td>
<td>[0.28]</td>
<td>[4.11]***</td>
<td>[4.42]***</td>
<td>[8.80]***</td>
</tr>
<tr>
<td>Small firm lending</td>
<td>-2.227</td>
<td>-1.983</td>
<td>0.149</td>
<td>1.026</td>
</tr>
<tr>
<td>[1.37]</td>
<td>[0.56]</td>
<td>[0.44]</td>
<td>[0.81]</td>
<td>[1.08]</td>
</tr>
<tr>
<td>Foreign bank</td>
<td>0.964</td>
<td>-4.674</td>
<td>0.322</td>
<td>-0.41</td>
</tr>
<tr>
<td>[0.42]</td>
<td>[1.64]</td>
<td>[0.73]</td>
<td>[1.84]*</td>
<td>[0.38]</td>
</tr>
<tr>
<td>Private bank</td>
<td>-0.982</td>
<td>-7.897</td>
<td>0.396</td>
<td>1.635</td>
</tr>
<tr>
<td>[0.41]</td>
<td>[1.93]*</td>
<td>[1.19]</td>
<td>[1.48]</td>
<td>[1.40]</td>
</tr>
<tr>
<td>Constant</td>
<td>8.707</td>
<td>76.737</td>
<td>-0.029</td>
<td>3.688</td>
</tr>
<tr>
<td>[3.65]***</td>
<td>[7.31]***</td>
<td>[9.75]***</td>
<td>[0.13]</td>
<td>[3.26]***</td>
</tr>
<tr>
<td>Observations</td>
<td>94</td>
<td>110</td>
<td>136</td>
<td>127</td>
</tr>
<tr>
<td>Pseudo R-squared</td>
<td>0.01</td>
<td>0</td>
<td>0.02</td>
<td>0.03</td>
</tr>
<tr>
<td>F-stat:</td>
<td>1.1</td>
<td>0.16</td>
<td>0.43</td>
<td>0.09</td>
</tr>
<tr>
<td>Foreign=Private</td>
<td>0.3</td>
<td>0.69</td>
<td>0.52</td>
<td>0.76</td>
</tr>
<tr>
<td>P-value:</td>
<td>0.3</td>
<td>0.69</td>
<td>0.52</td>
<td>0.76</td>
</tr>
<tr>
<td>Foreign=Private</td>
<td>0.3</td>
<td>0.69</td>
<td>0.52</td>
<td>0.76</td>
</tr>
</tbody>
</table>
Testing for differences in lending technologies across banks and countries

<table>
<thead>
<tr>
<th></th>
<th>Use of scoring</th>
<th>Use of hard information</th>
<th>Share of SME loans secured (%)</th>
<th>Decentralization of loan approvals</th>
<th>Decentralization of risk management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developing</td>
<td>-0.007</td>
<td>-0.248</td>
<td>27.4</td>
<td>-0.459</td>
<td>-0.613</td>
</tr>
<tr>
<td></td>
<td>[0.03]</td>
<td>[0.79]</td>
<td>[2.82]***</td>
<td>[1.58]</td>
<td>[1.80]*</td>
</tr>
<tr>
<td>Small firm lending</td>
<td>0.364</td>
<td>-0.056</td>
<td>-2.291</td>
<td>0.248</td>
<td>0.206</td>
</tr>
<tr>
<td></td>
<td>[2.00]**</td>
<td>[0.27]</td>
<td>[0.35]</td>
<td>[1.47]</td>
<td>[1.13]</td>
</tr>
<tr>
<td>Foreign bank</td>
<td>0.003</td>
<td>0.363</td>
<td>3.727</td>
<td>-1.205</td>
<td>-0.981</td>
</tr>
<tr>
<td></td>
<td>[0.01]</td>
<td>[1.25]</td>
<td>[0.45]</td>
<td>[4.89]***</td>
<td>[3.65]***</td>
</tr>
<tr>
<td>Private bank</td>
<td>0.105</td>
<td>-0.399</td>
<td>-17.033</td>
<td>-0.838</td>
<td>-0.229</td>
</tr>
<tr>
<td></td>
<td>[0.43]</td>
<td>[1.36]</td>
<td>[2.02]**</td>
<td>[3.72]***</td>
<td>[0.96]</td>
</tr>
<tr>
<td>Observations</td>
<td>167</td>
<td>164</td>
<td>137</td>
<td>173</td>
<td>168</td>
</tr>
<tr>
<td>Pseudo R-squared</td>
<td>0.01</td>
<td>0.05</td>
<td>0.02</td>
<td>0.08</td>
<td>0.08</td>
</tr>
<tr>
<td>Chi² test:</td>
<td>0.26</td>
<td>10.79</td>
<td>7.18</td>
<td>3.55</td>
<td>13.81</td>
</tr>
<tr>
<td>Foreign = Private</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>P-value:</td>
<td>0.61</td>
<td>0</td>
<td>0.01</td>
<td>0.06</td>
<td>0</td>
</tr>
<tr>
<td>Foreign = Private</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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, 4 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

2) 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

3) 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

4) Large and foreign banks are not at a disadvantage
   - 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: SMEs and the Crisis

- Structural nature of engagement means SMEs still of interest

- But, SME demand for financing has dropped.

- Banks are increasing oversight but not cutting back financing in general.

- This applies to both domestic and foreign banks.

- Banks are not changing the business models or general lending practices.
Thank you