Commercial Bank Downscaling – Lessons from Experience

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1. Introduction

Access to finance is often raised in World Bank Enterprise Surveys as one of the top three constraints. This constraint is particularly acute for small businesses. As a result, small businesses finance investments mostly through internal funds and commercial banks are used only marginally.

Many banks managers argue that lending to this sector is not profitable enough: small businesses are too risky (because they have no reliable financial statements and traditional collateral) and too costly to serve (because of the small value per transaction). However, this note will discuss experiences of commercial banks that have overcome these obstacles and profitably increased their number of loans to small businesses.¹

2. Downscaling: origins, results and challenges

Origins of “downscaling” and results achieved. The commercial bank downscaling approach was initiated by the Inter American Development Bank (IDB) in the early 1990s in Latin America. The IDB designed programs that provided credit lines to selected commercial banks for the purpose of on-lending directly to microenterprises, i.e. to go “down” market². These programs also included technical assistance (TA) for each partner bank. The success of downscaling in Latin America prompted the European Bank for Reconstruction and Development, KFW, the European Commission and the US and Japanese governments to invest in similar operations in Central and Eastern Europe and the Commonwealth of Independent States, starting in Russia in 1994. Selected data on the results achieved are presented below.

<table>
<thead>
<tr>
<th>Country</th>
<th>Project</th>
<th>Start Date</th>
<th>US$ amount of loans outstanding</th>
<th>No. of loans outstanding</th>
<th>US$ average loan amount</th>
<th>Portfolio at risk &gt; 30 days</th>
<th>No. of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>SELP</td>
<td>Oct-00</td>
<td>61,787,550</td>
<td>14,714</td>
<td>4,199</td>
<td>1.82%</td>
<td>3</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>KSBP</td>
<td>May-98</td>
<td>594,004,018</td>
<td>54,332</td>
<td>10,933</td>
<td>1.00%</td>
<td>6</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>Kazakhstan Loan Fund</td>
<td>Dec-05</td>
<td>18,949,576</td>
<td>20,672</td>
<td>917</td>
<td>0.06%</td>
<td>1</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>MSEFF</td>
<td>Apr-02</td>
<td>43,508,592</td>
<td>23,440</td>
<td>1,856</td>
<td>0.95%</td>
<td>6</td>
</tr>
<tr>
<td>Poland</td>
<td>EU/EBRD SME Finance Facility</td>
<td>Apr-00</td>
<td>123,071,600</td>
<td>7,373</td>
<td>16,692</td>
<td>1.69%</td>
<td>5</td>
</tr>
<tr>
<td>Russia</td>
<td>RSBF (inc KMB)</td>
<td>Aug-94</td>
<td>874,391,116</td>
<td>71,239</td>
<td>12,274</td>
<td>1.52%</td>
<td>9</td>
</tr>
<tr>
<td>Russia</td>
<td>(KMB Only)</td>
<td>Nov-98</td>
<td>602,441,619</td>
<td>42,548</td>
<td>14,159</td>
<td>1.19%</td>
<td>1</td>
</tr>
<tr>
<td>Ukraine</td>
<td>UMLP (inc ProCredit)</td>
<td>Sep-98</td>
<td>764,704,802</td>
<td>116,736</td>
<td>6,551</td>
<td>0.82%</td>
<td>6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>(ProCreditOnly)</td>
<td>Feb-01</td>
<td>234,913,292</td>
<td>35,586</td>
<td>6,601</td>
<td>0.86%</td>
<td>1</td>
</tr>
</tbody>
</table>

Downscaling programs have been implemented also in large state owned banks to help transform loss making branches into profit centers. For example, the turnaround of the Agricultural Bank of Mongolia (now Khan Bank) was centered on the implementation of a successful downscaling program. Thanks to this program, Khan Bank was able to maintain its 402 branches and to become highly profitable (36% return on equity as of 31 December 2005³).
Khan Bank was first established in 1991 from the assets of the former State bank with the specific goal of serving the rural sector. After being placed under receivership in 2000 the bank was recapitalized and put under a restructuring plan. A large component of the latter was a downscaling program. The Bank was successfully privatized in 2003. From December 2001 to June 2006, the loan portfolio grew from USD 9 million to USD 149 million equivalent. As of 2006, 76% of the loan portfolio was in rural areas, business loans accounted for 45%, customer loans for 28% and agricultural loans for 26%, the Portfolio at Risk over 30 days was only 2.5%.

During the initial “downscaling” phase, Khan Bank focused on simple and standardized products. Khan Bank piloted new products and procedures in selected urban branches and then rolled-them out to the existing branch network. This quick roll-out was facilitated by a gradual delegation of authority and training of trainers approach. Over time Khan Bank has increased its product range and now offers a wide range of loan, deposit and fee services. Loan products range from Express Micro Loans, SME loans, Crop and Herder Credits to Pension Advances, Consumer Loans and more recently larger Corporate Loans.

A downscaling project was also recently launched in China with the assistance of the World Bank and KfW. The China Micro and Small Enterprise Finance Project started in December 2005 and, as of August 2006, two banks had joined the program. In the first nine months, USD 9.5 million equivalent have been disbursed to 1,507 small businesses while portfolio at risk over 30 days for the small business loan portfolio is less than 1%.

A regional downscaling project is being developed in Africa by the IFC (the Africa MSME Finance Program). Under this program, which has been launched in 2006, the IFC intends to work with 15 commercial banks across Africa by the end of 2006 to support them (through lines of credit and intensive technical assistance) to expand their lending to micro, small and medium enterprises.

Challenges in downscaling. When commercial banks are asked why they do not lend to small businesses, they generally cite three main reasons: small businesses are higher risk; they lack reliable financial statements; and they lack collateral. However, when banks that have developed successful small business lending operations are asked the same question, they identify efficiency, developing customer orientation and managing cultural changes as the real challenges. It is indeed possible to develop lending methodologies that allow commercial banks to make loans (that will be repaid) to businesses that do not have financial statements, or traditional collateral (e.g. land titles). However, the difficulty lies in implementing those methodologies by managing cultural changes within the bank (i.e. shifting from a culture of serving corporate clients to small entrepreneurs), developing customer orientation (i.e. a focusing on meeting the needs of one’s market segment) and at the same time increasing efficiency in the lending operations (i.e. loan officers productivity).

Large volumes, efficiency and quality are key to profitable small business lending. Because of the high costs involved in making small loans, banks need to make many good loans. As in other lines of business with small margins, commercial banks need to increase revenue – i.e. they need to make many loans – and at the same time decrease expenses – i.e. they have to increase loan officer productivity and avoid bad loans.

3. The downscaling model: transforming the way banks operate

Building a large, high quality portfolio of small loans, requires significant change in the way commercial banks traditionally operate. Implementing lending methodologies that are suitable to small business lending requires substantial changes in banks' organizational structure, human resource management, products and procedures. Technical Assistance plays a crucial role in this process: it foments best practices and allows partner banks to leap frog instead of painfully reinventing the wheel and making costly errors. In addition, Technical Assistance plays an important role in supporting the required internal reforms and in convincing top management to take difficult and sometimes controversial decisions (such as decentralization of decision making, new incentive scheme for loan officers, increase in marketing expenses, etc). The main changes introduced in downscaling programs in terms of organizational structure, human resource management, products and procedures are presented below.

Organizational structure. Often banks participating in downscaling programs create a specialized small business unit. This permits a dedicated small business staff both at the head office and branch level. Specialization is needed to allow faster and more efficient implementation of new procedures. Moreover, having specialized loan officers increases lending efficiency, customer orientation and ensures faster expansion of small business operations.

Human resources. Selection of the suitable small business loan officers is crucial for the downscaling bank. The selection process must therefore be very thorough. The bank can choose to hire "fresh" loan officers from outside or also open the recruitment to inside loan officers. However, small business lending requires loan officers to forget the "old ways" and to assume an entirely different approach to lending; not all loan officers are able to make this shift. Once loan officers are selected, the downsizing bank needs to develop a specialized training curriculum for small business lending, such as training to efficiently reconstruct the financial statements of potential clients. This training includes both class room modules and on the job coaching.
Moreover downscaling programs introduce incentives for loan officers to make a large number of good loans, as this is key to achieve profitability. Hence the base salary of loan officers is often complemented by monthly bonuses that take into account both the productivity of the loan officer and the quality of his/her loan portfolio (monitoring Portfolio at Risk over 30 days).

**Products.** When they start lending to small businesses, banks often offer the same products that they offer to their corporate client, but with smaller loan sizes. However, a downscaling bank needs to understand and segment the small business market and to offer targeted loan products to each segment. For example, micro businesses are often very sensitive to the time it takes to obtain a loan. Hence downscaling banks have developed a tailored product to the “micro segment” (loans between US$ 200 and US$ 2,000), which does not require registering collateral (this speeds up the approval process) and with a fast disbursement process (one day). Although the credit decision is based on the repayment capacity of the business, downscaling banks usually ask for collateral for larger loan size, but they usually accept a wide range of items (from cars to inventory to land or buildings), instead of relying solely on prime real estate formalized by a land title.

To raise the productivity of loans officers, efficiency is key, which means cutting transactions costs, both for the bank and for the client. One way to cut such costs is to offer a limited number of standardized products. For example, downscaling banks offer mostly term loans, even for working capital financing. Credit lines are reserved for more sophisticated borrowers who have demonstrated their capacity to repay term loans on time and who use their bank account for their business transactions.

Downscaling banks also apply microfinance “graduating” principles to small business lending. At the start, the client has a relatively small loan, with monthly repayment (both principal and interest) and short maturity. Once the first loan has been fully repaid, the client “graduates” to a larger loan with a longer maturity. Many clients at the lower end of the scale (between US$ 1,000 and US$ 10,000) have never borrowed from a bank before and this gradual approach allows the client to build a credit history and to grow with the bank.

It is also important to price the products correctly. Making small loans is expensive and the price structure needs to reflect these costs.

**Procedures.** As making small loans is expensive, banks need to design and implement credit procedures that reduce transactions costs, both for the bank and the client. The whole credit cycle needs to be re-analyzed and streamlined with the objective of cutting cost and time without jeopardizing credit quality. Collateral valuation and registration is often the source of high transaction costs for the client. Downscaling banks need to develop procedures that minimize such costs, such as in-house valuation (instead of relying on external valuers) or no registration of collateral for small loans. Delegating decision making to the branch level saves time and money.

A good management information system (MIS) is crucial. It allows the loan process to be monitored, from application, through analysis, approval, disbursement until the loan is fully repaid. Late repayments can be identified early for prompt action. Loan officers’ performance is also monitored through the MIS.

**4. Lessons from downscaling experiences**

Although most of the downscaling programs have been implemented in Central and Eastern Europe and the Commonwealth of Independent States, a few have been successfully introduced in Latin America. Moreover, although in its early stage, there are also initial signs of success in China. Hence, while products and procedures need to be adapted to the local specificity, the tenets of downscaling programs have proven to be applicable across a broad spectrum of countries. The main lessons learnt from downscaling experiences are listed below.

**Long term Technical Assistance plays a crucial role in ensuring the success of a downscaling program.** Technical assistance is needed during the preparation (market identification, development of loan products), the pilot test and the roll out of the downscaling program. Technical assistance plays a “hand holding” role and once a bank is about to make the “big jump” (i.e. start small business lending operations), it is comforting for the bank to know that if it faces difficulties with small business lending, it will not be alone. Good technical assistance is expensive. It is unrealistic to expect that a bank that has not yet enjoyed its benefits agree to pay such large sums for technical assistance. The technical assistance for the projects described in this article has been fully, or very heavily, subsidized by grants from KfW, the US or Japanese Government or the European Union. The IFC – under the Africa MSME program – is using part of its profits to finance the required technical assistance.

**Performance agreements are useful to maximize the benefits of the Technical Assistance.** Tripartite agreements are often signed by the partner bank, the Technical Assistance provider and the funder of the program identifying minimum targets to be reached. In particular, these agreements specify the number and volume of loans disbursed and outstanding to be reached by a given date, as well as portfolio quality indicator (Portfolio at Risk > 30 days less than 3%). Such targets are monitored on a monthly basis and actions are taken if the targets are not met.

**Careful selection of partner financial institutions is essential.** Not every bank can become a successful small business lender. The partner bank needs to demonstrate good financial performance as well as a strong motivation to reach the small businesses market. Other factors, such as the proximity to the target group, are also important. For example, the appearance and location of its branches should be compatible to small business lending.
**Buy-in from the top management is crucial.** Downscaling requires significant changes in the way the bank operates. Top management will only be willing to make these changes if it is truly committed to reaching this new market, as demonstrated by experiences in Russia and Ukraine. In these two markets, banks were initially not convinced about the value of reaching the small business segments and the first results were therefore disappointing. Commercial banks became interested in reaching small businesses in Ukraine only when they saw the performance of ProCredit Bank, a bank targeted at small businesses.

**The importance of an enabling legal environment.** Finally, although downscaling programs have shown that it is possible to profitably lend to small business in a context of weak legal framework and financial infrastructure, the weakness of the latter can be a hindrance to the development of small business lending. Regulations on asset classification and loss provisioning (especially if additional provisioning is required for loans secured with movable collateral), loan documentation (especially if requiring audited financial statements), interest rates (i.e. interest rate ceiling), collateral (i.e., if the regulations do not authorize the constitution of collateral on all types of assets, especially movable), and foreclosure on collateral and debt collection procedures (i.e. complex procedures in a weak judicial environment) play an important role. Moreover, efficient credit bureau and business/pledge registry can greatly help downscaling banks by facilitating access to information on credit history and businesses.

5. **Downscaling in rural areas: the next frontier**

The next frontier of downscaling is rural finance. Increasing competition in the small business lending segment has driven interest rates down, especially in urban areas where competition is fiercer. The challenge is now to reach clients in rural areas and developing profitable products and lending methodology for small farmers. Attempts in this direction have been made in a few countries, such as Kyrgyzstan and Georgia. Key challenges include: keeping costs low, while the density of the clients decreases, appraising agricultural activities and developing products with more flexible repayment schedules (which fit agricultural cycles). The examples below describe interesting initiatives in agricultural financing.

### The agroloan of the Kyrgyz Micro and Small Enterprise Finance Facility

The Kyrgyz Micro and Small Enterprise Finance Facility started piloting an agricultural loan product in December 2004. As of the end of September 2006, the product has been launched in all the six partner banks. Agricultural loan portfolio amounted to USD 5.9 million or 11% of the outstanding loan portfolio under the program. Average agricultural loan size was USD 1,800 and PAR >30 days for the agricultural loan portfolio was 1.6%. The agricultural loan portfolio accounted from 9% to 16% of total net profit of the participating banks as of June 30, 2006.

To serve this new market segment, loan officers with an educational background in agriculture had to be recruited and the traditional downscaling lending methodology had to be adapted. For example to cross-check the information received from clients and to understand whether or not clients observe the required agricultural practices, technological maps with information on seasonality and crop capacity have been developed.

The main challenges to scaling up the volumes of agro loans are twofold: first most private farms’ production capacity is limited, which constrains their loan repayment ability. Second, partner banks still have concern that agricultural lending is riskier than small business lending.

### The apple orchard loan of the Georgia Small Enterprise Lending Program

United Georgian Bank (UGB), a partner bank of the Small Enterprise Lending Programme started piloting micro and small loans to farmers in 2004. After a two year pilot, UGB decided to roll out agrilending products and as of September 1, 2006 it had 454 agriloans outstanding amounting to USD 670,842. The PAR > 60 days was 1.65%.

Raising staff productivity to the appropriate level has been the main challenge in agro-lending on account of the large distances between the branch and customers, poor infrastructure and low density of customer base. To meet this challenge a “cluster approach” has been developed, namely only villages with a critical mass of potential borrower for a specific crop loan product are served. For example UGB provides apple orchard loans to villages up to 15 kms from the Gori branch and that have at least 50 borrowers.

Concentration on one main crop has two main advantages: simplification of risk assessment in credit committee, as only one main crop is looked at, and shorter loan officer training. Minimum critical mass of borrowers per village is crucial for loan officer productivity. As a result agri loans can be processed within one or two days and loan officer productivity for agro-loans is the same as for traditional urban micro loans, or 23 agro loans disbursed per month.

On the other hand, the typical risk of cluster approach, risk concentration, is limited, as the exposure to a specific crop is quite small compared to the overall micro and small business portfolio.
1. To avoid debates around the multiple definitions of micro, small and medium enterprises, this note will focus on loan sizes. A micro loan is therefore defined as a loan below US$ 10,000 and a small loan as a loan between US$ 10,000 and 250,000.
2. Other models have allowed commercial banks to enter the microfinance market, such as the creation of specialized financial institutions or of service companies. However, these models will not be discussed in this note.
3. From www.themix.org
4. Portfolio at risk (PAR) rates measure the outstanding balance of loans that are not being paid on time against the outstanding balance of total loans. PAR for small loan portfolio is usually measured at 30 or 60 days.
5. When local circumstances do not allow financial bonuses, non-financial bonuses can be considered (such as trips or awards).
6. In extremely rare cases, the technical assistance provider or the partner bank can be removed from the program.
7. Downscaling projects in CIS countries, revisited, Internationale Project Consult GmbH (IPC), May 2006
8. Downscaling was initiated in 1997 in the Ukraine, however the early results were disappointing. In 2001, ProCredit was created, it demonstrated to the banking sector that small business lending was possible and profitable. Five commercial banks (in addition to ProCredit Bank) are now part of the downscaling program. The total outstanding small business loan portfolio (including ProCredit Bank) stood at US$ 569 million in April 2006 (Presentation of Ukraine Micro Lending Program to the World Bank, May 2006).