IPC GUIDE FOR
SMALL BUSINESS LENDING

CONTENTS

Introduction

OVERVIEW OF SMALL BUSINESS LENDING IN LATIN AMERICA

Ensuring sustainable access to financial services for small businesses remains an important issue with regard to fostering broad-based economic development in a given economy/region and ensuring the sustainability of commercial financial institutions.

Whereas access to finance is generally available for very small businesses (micro and small businesses) and larger businesses (high-end small businesses, medium and large enterprises), the group "in between" continues to face difficulties in accessing formal and reliable financial services on a sustainable and broad basis. At the same, it is these small businesses that have significant potential for enhancing sound economic development and growth. The reasons for the difficulties that especially small businesses encounter in accessing finance are numerous. In the Latin American context, the most important reasons include the lack of formality that typically characterizes small businesses as well as the lack of formalized and "bankable" collateral such businesses can provide. These aspects make it difficult for financial intermediaries (FIs) to assess loan applications and related risks and thus to protect themselves in case of default. At the same time, the loan amounts needed by such businesses can be so significant that the assessment methods typically used for micro-clients are insufficient in terms of credit risk assessment. Furthermore, these higher loan amounts make adequate loan security all the more critical. As a consequence, small businesses either have no access to formal finance, or they only have access to loan amounts and terms that do not correspond to their actual needs. SFIs have recognized the market potential represented by small businesses, but in many cases lack the expertise to provide adequate services to such clients.

Furthermore, successful small business lending may be a factor in ensuring the long-term viability and success of many SFIs. A number of SFIs (typically commercial banks)originally focused on high-end clients but have realized the limited market opportunities this focus represents for growth as well as the dangers of being dependent on a fairly limited potential client base. SFIs that originally focused on micro-lending (microfinance institutions (MFIs)) now face a situation in which their clients have "outgrown" the institution and switched to other financial service providers. While this may be part of the strategy of some MFIs, many need to be able to retain and continue to serve long-term and well-tested clients for long-term commercial viability.

SFIs have a clear interest in tapping the small business lending market, but frequently lack the know-how for doing so in a sustainable manner. This guide outlines the key conditions and steps SFIs need to take in order to set up and develop sustainable small business lending. These recommendations are based on IPC's substantial experience in assisting FIs in various regions around the world in implementing small business lending operations.

BASIC PRE-REQUISITES FOR SFIS: SFI PROFILE

In all cases, basic institutional soundness is a pre-requisite for sustainability. Only institutions which are already sound should undertake to venture into small business lending.

Small business lending on a sustainable basis has to be understood as adding a new business area, not as "just adding another product" or product line. It involves more than just developing a new product and providing sales training to staff. Internal processes and procedures will have to be adjusted, as loan assessment, decision-making and processing will differ somewhat from the procedures, processes, etc. used

SUSTAINABILITY				
Institution Building				
Organizational Structure	Processes	Products	Risk Management	Acquisition & Marketing
Staff & Training	Internal Communication	Distribution Channel	Treasury & Funding	MIS & System Support
Understanding Small Enterprises				

Table 1 Sustainable small business lending operations

for other client groups. Successful and sustainable implementation of small business lending will impact and involve the entire institution.

In order to deal with the new target group in a sustainable, professional and responsible manner, the following requirements must be fulfilled:

- *The SFI must be willing to learn about the specific characteristics of small businesses*
- *The SFI's management must be sincerely motivated to engage in small business lending and willing to expand its financial services to small enterprises*
- *The SFI must attain the expertise required for tailoring services to small businesses and assessing credit risk appropriately*

THE FOUR-PHASES CONCEPT

Small businesses in Latin America can be characterized as occupying a midway position between typical micro-enterprises and medium-sized or large companies. However, these businesses are closer to micro-firms by virtue of their ownership structure: they are usually family-owned businesses with natural person legal status and are often unregistered. Moreover, small businesses tend to have low accounting and auditing standards, including a lack of formal documentation, which accounts for their high degree of informality in comparison to large firms. It is also typical for small businesses to only declare a small portion of their revenues for tax purposes, which makes it difficult for lending institutions or other third parties to conduct financial analyses. In addition, small firms tend to be oriented to the local or domestic market and are hardly engaged in export-related activities. However, it has been noted that in certain Latin American countries small businesses play an important role in the supply chain of large firms and multinational corporations, as they often function as local providers of specific goods and services. Another feature that these small firms share with micro-enterprises is their low degree of management competency and staff qualification due to their tendency to employ unskilled workers. On the other hand, small businesses are more similar to medium-sized firms with respect to the scale of their operation, be it in terms of annual turnover, number of staff, or total assets. Also, like medium-sized enterprises, small businesses have more complex financing needs than micro-enterprises, ranging from (unpredictable) needs in the short-term and (multi-purpose) needs planned for the long-term. The problem that many small enterprises face is that their asset structure and the value of their assets do not correspond to the collateral requirements of many financial institutions.

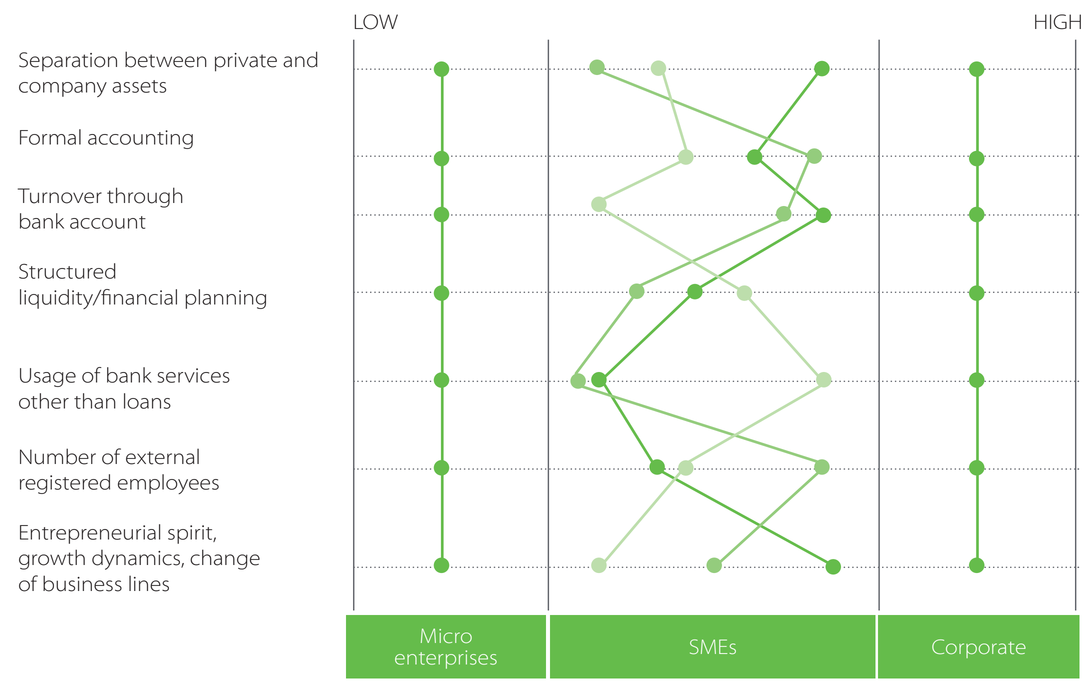

Table 2 Diversity of small and medium enterprises **Source: IPC**

Although most small businesses have a bank account, the majority of their business operations are managed in cash. This implies that they often do not require other sophisticated banking services, such ascurrent accounts, national/international money transfers, etc. Thus, the cross-selling potential is frequently overestimated, as small businesses typically require far fewer additional banking services than medium enterprises.

From this follows that deposit-taking and sound MFIs are just as well positioned as commercial banks, if not better positioned,with respect to being able – in principle – to provide the basic services that small businesses need. However, the more complex and sophisticated the client's business is, the more relevant access to other financial services and to more sophisticated and formal services becomes.

Hence, institutions that wish to retain their business clients in the long term will have to find solutions enabling them to cater to the changing needs of these clients over time. In the final instance, this may mean that MFIs will have to become fully-fledged banks. Alternatively, SFIs (MFIs) may take the strategic decision to purposefully cater only to small businesses up to a certain size and with certain limited needs in terms of financial services.

Based on this analysis, we propose a four-phase approach. Phases I-III focus on planning, initiating, and expanding small business lending operations at a FI. Phase IV focuses on laying the foundation for upgrading the institution and offering more sophisticated services by transforming it into a fully-fledged bank.

Phase I

ANALYSIS & PLANNING

The first step for the successful introduction of small business lending operations consists of analyzing the market and planning the market entry. Experience shows that the importance of this step is frequently underestimated by financial institutions. However, extensive knowledge of the market is essential for a) defining realistic goals with regard to the new business segment and b) designing a strategy that is tailored to market needs.

With this in mind, the institution should gather information about the market in terms of size, growth potential, the extent of (unmet) demand and the target group as such.

Understanding the target group is a precondition for successfully tailoring financial services to small enterprises.

Analyzing the competitive conditions is another important step as it will provide information on competitors' strengths and weaknesses in terms of strategy, products, customer service, delivery channels, etc. Based on this data, the SFI will be able to identify its competitive advantages in terms of branch network, staff, image, service culture, etc., including identifying priority sub-segments with unmet demand. The analysis should also include a review of the regulatory environment and requirements with relevance to servicing the target group. In the course of preparation it is of the utmost importance to understand the characteristics and financial needs of the target group, as this should constitute the starting point for designing an adequate lending technology, organizational structure, products, distribution channels, etc.

Introducing successful small business lending operations is a process, not a one-time event– so careful planning is crucial.

INSTITUTIONAL STOCKTAKING

Based on the findings of the market study, the institution's management should formulate a vision and define objectives, i.e. create a strategic mission statement, with regard to a market positioning in the small business lending segment.

Management attention is essential for successful implementation of a new business line..

For this purpose, a business plan is the most suitable instrument for demonstrating how the management's strategy will be put in place. The plan enumerates the resources that are required to achieve the objectives, such as staff, system support, products, organization, processes and funding; these should be identified and planned. With a view to achieving sustainability, calculations on the expected income, costs and profitability should be included.

Therefore, the institution should conduct a gap analysis in order to identify potential bottlenecks, such as insufficient IT equipment, software, and space as well as areas requiring strengthening, such as MIS, legal capacity and credit risk assessment technology. The analysis will lay the foundation for planning the necessary hiring and training activities, as well as for identifying procedural adaptations and other needs (e.g. outside expertise). A detailed implementation plan will outline the steps and timelines of the implementation process and define how the market entry should be executed. This should include the concrete steps for the preparation and launch of operations as well as for the testing of the new approach, product(s), procedures, and processes. The plan also helps to clearly designate responsibilities for every department that will be involved in the implementation phase.

At this stage, the institution should make sure the necessary budget for the implementation process is available.

Phase II

THE PILOT PHASE

As mentioned before, successful small business lending operations is a process, not a one-time event. The establishment of small business lending operations takes time and requires the involvement of the whole institution. Moreover, the development and/or adaptation of processes, procedures, organizational set-up, MIS, IT system, hiring and training of staff involves significant investments. Therefore, the initial set-up should be tested on a small scale – in a pilot branch – before expanding it to the whole institution. We recommend starting in one or two branches and then adding a few more pilot branches in other cities or regions.

Moreover, starting with a pilot phase allows the institution to generate internal know-how so that staff who performs well during this phase can serve as multipliers for training the subsequent generations of small lending staff.

Successful implementation requires commitment to the institution building process from the very beginning.

SETTING UP SMALL BUSINESS LENDING AS A NEW BUSINESS AREA

Emphasizing the importance of small business lending and its status as separate business area in the organizational set-up of the institution is crucial for the success of this new area. This includes clearly assigning responsibility for the business area to a senior member of management, who will report directly to the management board. This manager should have the decision-making authority and qualifications to lead the implementation of the new business line. Business support structures should be setup both at head office and branch level. The concrete organizational set-up will depend on the overall structure of the FI, as this is of key importance in ensuring that small business lending will form an integral part of the FI's operations.

The institution should make sure that small business lending structures are integrated into the overall organizational set-up.

DEVELOPING PRODUCTS

Based on the previous assessment of the new target group's needs, the institution should define a preliminary limited product range, i.e. one or two basic products that will cover the main share of demand. Only at later stages, i.e. once a sound basic capacity for small business lending has been built up in the institution (including know-how, a sufficiently large team of qualified personnel, efficient processing, efficient reporting and information system support), should the institution increase the product range.

The initial products should be straightforward, simply designed and easy to understand by staff and clients.

ADJUSTING THE LENDING APPROACH

Small business lending can only succeed on a large scale if clients are analyzed and served on an individual basis. Given the amounts in question, it also requires a more formalized approach to assessing the client's creditworthiness and to securing the loan than does "micro lending". In order to overcome the small businesses' typical absence of formal documentation and lack of bankable loan security, we recommend using a cashflow-based lending approach. In conjunction with this, we also recommend investigating ways of broadening the range of loan securities that is acceptable to the institution.

The institution's lending methodology for small business should be geared towards the specific characteristics of the target group. It should help to bridge the gap between FIs and small businesses, improve mutual understanding and reduce informational asymmetry. As a result, loan security and documentation requirements can be designed in a more flexible manner so that clients who were previously not eligible for loans can become eligible.

A proper assessment of a potential borrower's situation requires an analysis of his/her real assets, cashflows and profit levels.

DEVELOPING POLICY, PROCEDURES AND PROCESSES

Based on the initial analysis as well as the requirements of the new or adapted lending approach to accommodate the needs of small business lending, the institution should develop a clear lending policy and procedures for processing small business loans. Procedures should clearly assign functions and responsibilities to respective staff positions while ensuring a system of rigorous control overthe entire lending process. They should also establish the appropriate interaction of the small business lending department with ancillary departments of the institution.

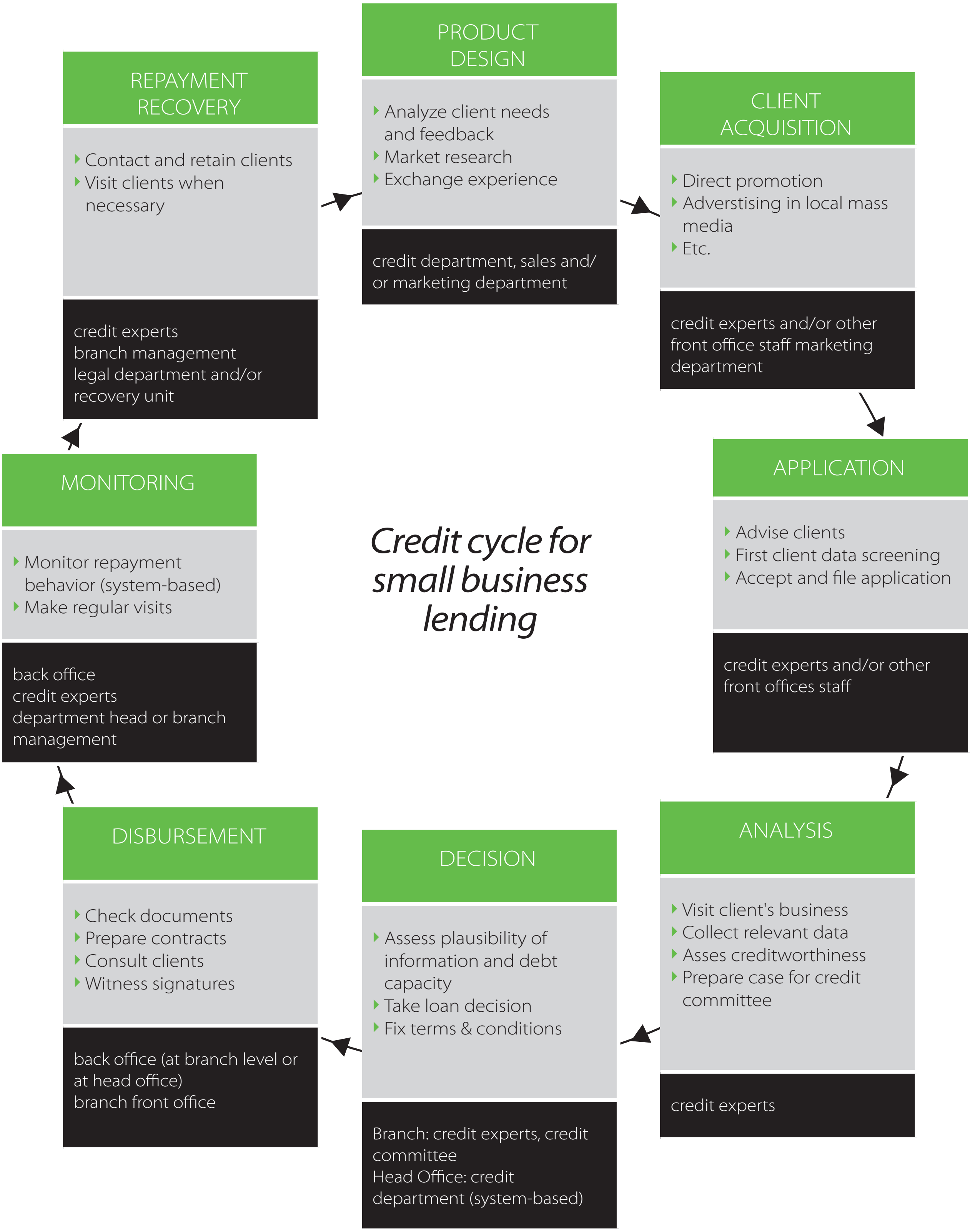

Table 3 IPC´s credit cycle for lending to small businesses [01]

01 The concrete organizational set-up, procedures and processes depend on a variety of factors, such as strategic orientation, current internal structures and capacities of the FI and its local market conditions. In this respect, the FI needs to decide whether to separate its front- and back-office functions (business and credit risk assessment).

ENSURING INFORMATION SYSTEM SUPPORT & MIS

Efficient loan processing is of the utmost importance for achieving sustainable results. Moreover, the availability of accurate, timely and complete information lies at the heart of sound management and control. Therefore, successful, large-scale implementation of small business lending requires adequate information system support. This involves designing the system in such a way that it reflects all steps of the lending process in a timely manner and allows the generation of meaningful reports for staff and management both at head office and branch level. Equally important, it involves training personnel in the appropriate and disciplined use of the system.

SELECTING AND EQUIPPING THE PILOT LOCATIONS

In addition to the above mentioned aspects, the institution should identify the first pilot locations. This selection should be guided by a number of parameters, such as vicinity to and convenience for the target group, available space for staff, condition of the premises, etc. The institution should screen available locations with a view to either identifying suitable already existing locations or acquiring or renting new locations. This decision will depend on the current situation of the institution and its goals regarding the target market.

SELECTING STAFF

Previous assignments have shown us that the selection of staff is one of the most crucial factors in ensuring success and that its importance is frequently underestimated by FIs. This is not only a crucial step but also one of the most difficult for an institution that is up- or downscaling its services to small enterprises. Similar to the characteristics of small enterprises, the set of skills and personality traits characterizing successful small business lending staff lies somewhere in between those of staff who successfully serve micro clients and staff who serve larger clients. Typically, small business lending staff requires a higher level of communication and analytical skills than micro lending staff.

In a first step, the institution should decide on whether appropriate lending staff can be identified among current staff or whether the institution should recruit externally. This decision will depend on the level of qualification and personality profiles of available staff, the business development goals of the institution and other factors. However, it is critical to select only personnel suited to the task.

The best micro credit expert is not necessarily a good small credit expert, because the qualifications and personality profile for these two segments differ considerably.

TRAINING STAFF

In our experience, well-trained staff is one of the most decisive factors for successful small business lending. FI staff should be able to deal with the specific characteristics of small enterprises.

The institution should provide staff with thorough training before implementation. This should include training on the credit technology approach, procedures, the IT system and products as well as training in other areas, such as enterprise accounting, basic legal issues, the economy of the country/region, etc.,to name the most important. Where applicable, training should also include modules on other services/ products of the institution to maximize cross-selling potential. The exact training curriculum and format of training will depend on the local situation, type of FI and initial target clients. In particular, training should focus on qualifying a core team of staff to set up small business lending operations at other locations and train staff at these locations accordingly.

Experience shows that classroom training should be supplemented by on-the-job training.

DESIGNING INITIAL MARKETING MATERIAL

Prior to the launch of lending activities at the first pilot locations, the institution should prepare marketing material to support the launch of the new business area and products. Translating the knowledge about the target group (previously gathered in the market survey) into target group-adapted material and advertisements will ensure that the marketing campaign is well prepared and likely to be successful.

IMPLEMENTING AT PILOT LOCATIONS

Once all of the above mentioned preparations have been completed, actual lending operations can be launched at first pilot locations. It is advisable to do a "soft opening", i.e. start on a small scale to test procedures, processes, equipment and systems, and generate a manageable inflow of applications. This will allow the institution to conduct on-the-job training, resolve any "hiccups" and gain experience on how best to approach the client group and process loan applications. This "soft opening" should be accompanied by low-key marketing measures (canvassing, selective direct promotion). As mentioned above, we recommend starting at one or two branches and then adding a few more pilot branches one at a time. Throughout this pilot phase, the focus should be on identifying shortcomings and possible solutions as well as on training staff on the job.

The length of the pilot phase will depend on the respective situation and priorities of the institution. Typically, the pilot phase should not be less than three months. During this testing and initial training phase, all issues,problems and feasible remedies should be identified as along with additional training requirements.

RAISING AWARENESS THROUGH INTERNAL COMMUNICATION

In conjunction with setting up the small business lending department/unit, the institution should also publicize changes of the mission within the institution, explain the purpose of the department and organize awareness-raising measures for all staff. This will help to integrate the new business into the FI's operations, which is a precondition to ensuring successful external communication.

REVIEWING AND ADJUSTING SMALL LENDING OPERATIONS

Based on the findings of the pilot phase, the institution should adapt its training, credit technology approach, procedures, processes, products, etc. where required. The focus should be on identifying obvious gaps or shortcomings. The institution should also use the results of the pilot phase for fine-tuning the business plan, if required. The institution should pay particular attention to aligning resources and goals, i.e. provide all necessary resources, above all qualified staff, to support the business objectives and ensure the generation of demand.

Excellence can only be achieved via learning from initial experience and constantly reviewing and adjusting the processes. However, *overly frequent revision may cause confusion among staff and clients and have negative* *implications for management, risk control and the image of the institution, whereas too infrequent revision may result in customer dissatisfaction and frustration among staff.*

The institution must take care to choose appropriate intervals for revising its small business lending operations.

Phase III

THE ROLL-OUT

The goal of the roll-out phase is to expand small business lending operations to the entire institution. The speed of expansion will depend on the resources the institution has in place or is willing to invest, i.e. its personnel base and funding. The initial business planning should have taken these resources into account.

However, expanding small business lending operations does not only mean offering small business lending at additional locations; first and foremost,this process requires strengthening the institutional set-up so that the new business line can be managed in a sustainable manner:

- New generations of small lending staff should be selected and trained according to the business plan before the next branch is launched
- In accordance with the institution's management, the small lending department at the head office, which shall serve as the central co-ordination authority, should
    - enhance its capacities in order to support decision-making processes
    - increase the number of small loan applications
    - accompany and monitor branch expansion
    - broaden the product range
    - establish arrears and portfolio management capacities
    - ensure high-quality training
    - co-ordinate with other small business lending-related departments
- An internal control department with the aim of identifying procedural deficiencies and potential risks stemming from failures by the FI to comply with the small business lending approach that has been agreed upon should be established(or strengthened if it already exists
- The FI must ensure adequate and timely availability of lending funds at competitive pricing
- Expansion should be accompanied by a process of regular review and adaptation of procedures to further optimize processing
- IT and MIS capacities should be reviewed regularly to ensure that they are adequate to support business development

- Adequate pricing of small business lending products should ensure profitability of the business line but allow for reaching set business targets at the same time

Achieving significant and sustainable outreach requires close co-operation and co-ordination between several departments.

Phase IV

LAYING THE FOUNDATION FOR TRANSFORMING MFIS

Generally, it can be said that as the businesses of clients grow, so will their financial needs – not just in terms of loan amounts, but also in terms of the types of financial services they will require. If MFIs wish to retain such clients over the long term, they will eventually have to find ways of catering to these needs. In the long run, this will mean transforming themselves into fully-fledged, full service financial institutions.

At the same time, some MFIs may opt to serve only particular market segments, i.e. micro and small businesses, and consciously accept that this means that they will – eventually – lose clients and that theirhigh-end clients will use not only the services of the respective MFI but use those of other financial institutions as well.

The aspects outlined below apply to SFIs (MFIs) that have decided to pursue the path of eventual transformation.

PREPARATIONS AND PLANNING

Once an SFI (MFI) has decided to pursue the goal of transformation, it should formulate a clear strategic plan for this transformation and allocate the required resources. The transformation process should be headoffice-driven, centralized and systematic. Furthermore, management should share this decision with staff and prepare them for and during the process.

A key part of this planning process includes understanding the regulatory framework, conditions and pre-requisites for successful transformation and identifying the gaps that need to be filled at the current institution.

BRINGING OPERATIONS IN LINE WITH BANKING REGULATIONS

Adjusting the Organizational Structure and Designating Qualified Managers

At an early stage the institution should adapt the organizational structure to reflect the envisioned future scope of operations. This includes defining clear reporting lines, functions and responsibilities. While this naturally does not entail hiring all personnel that will be needed in the future at once, it does require manning key management positions fairly early in the process. These managers should then play a key role in implementing and supervising the transformation process as it relates to their respective areas.

Broadening the Product Range

SFIs should continuously review and, where indicated, adapt or add additional products (both loan and non-loan products). The management should also make sure that the introduction of new products is well prepared in terms of IT support and internal and external communication.

Upgrading the Branch Network

On a step-by-step basis, the existing branch network should be adjusted to meet regulatory requirements as well as the conditions for offering the planned lending services. This may include remodeling and upgrading locations as well as closing certain locations or adding new ones.

Developing Human Resources at the Institution

In order to "get the institution ready" on time and in line with planning, the SFI (MFI) should dedicate sufficient time and effort to closing the personnel gap and building the capacities needed to operate as a fully-fledged banking institution. Typically, this involves a combination of improving the qualifications of existing staff, retraining existing staff and hiring external specialists for those areas and functions new to the institution.

Upgrading System Support and MIS capacities

Increased reporting requirements due to more complex banking regulations and the scope of additional services need to be supported by an efficient IT & MIS team. At the very least, this will entail adding system components, but more likely will require a complete migration to a new system or new systems. In conjunction with this, the institution should also take care to acquire appropriate hardware so that processing capacities are in line with expected needs.

Ensuring Funding

Ensuring adequate and timely availability of funds at competitive pricing is a pre-condition for growth and expanding the loan portfolio. It also has implications regarding the image of the institution, especially when a FI is in the transformation process.

/ I	/ IIA	/ IIB	/ III	/ IV
ANALYSIS & PLANNING	INITIAL DESIGN AND PREPARATIONS	TESTING: PILOT IMPLEMENTATION	EXPANSION	TRANSFORMATION
• Understand potential market • Perform institutional stocktaking • Develop a business plan • Develop an implementation plan	• Set up the small business unit • Develop initial product design • Define lending technology • Develop processes and procedures • Ensure system support • Select pilot locations • Select and train appropriate staff • Develop initial marketing material	• Equip pilot locations • Set up small business lending at pilot locations: "Soft opening" • Raise awareness among all staff • Review and adapt processes • Identify additional training needs	• Open additional locations • Strengthen central small lending unit • Establish internal control department • Ensure funding resources • Enhance IT & MIS capacities • Adjust pricing • Establish regular review and adaptation process	• Prepare and plan transformation process • Adapt organization and structure to banking regulations

Table 4 Phase I-IV: Setting up sustainable small business lending operations at SFIs

Organized by:

Multilateral Investment Fund
Member of the IDB Group

Internationale Projekt Consult GmbH

In cooperation with:

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Microfinance Investment Managers

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