Editorial: SME lending – why did we neglect you for so long?

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I HAVE TO START THIS PIECE with a declaration: I've been a member of the editorial advisory board of this august journal since its inception in the late 1980s. I was also one of those who was a little concerned when a decision was made to change its name from *Small Enterprise Development* to *Enterprise Development and Microfinance*. I recognized that, at the time of the decision, microfinance was definitely in vogue in development circles, and SMEs didn't seem to have as much cachet. But I worried that the new branding would take the focus away from SMEs, and from SME finance in particular. Even though this was pre-financial crisis, in the middle of quite a boom time in both developed and emerging markets, it didn't seem to me that we were taking adequate care of this key sector, particularly in emerging markets.

How the world has changed in a few years! The financial crisis hits, the Arab Spring occurs, Andhra Pradesh's rural credit crunch gets major world airplay … The World Bank now tells us that more than 200 million people are unemployed in the world today, with young people 2.5 times more likely to be out of work than older people, and that more than 620 million young people worldwide are neither working nor in training. The Bank's World Development Report on Jobs estimates we must create another 600 million jobs in emerging markets over the next 15 years just to keep employment at current rates.

And so development fashion shifts – suddenly almost no one wants to talk about microfinance. This is also a shame, because neither the 'micro' nor the 'finance' was the problem. Rather, it was the excessive focus on the credit part of microfinance as a panacea for poverty alleviation … So maybe the migration to 'financial inclusion' will put us on a more sensible track, as the poorer the household, the more likely it is that other financial services, particularly improved savings and payments facilities, are going to be of help, and the less clear it is that more credit moves one forward. And it's heartening to see that it's other financial services that seem to be driving the inclusion discussions.

At the same time, everyone now seems to want to talk about SMEs. Small wonder, as it's been understood all along that they account for the vast majority of jobs everywhere, and in particular in poorer countries. The interesting thing is, when SMEs are asked what they consider their biggest obstacle to growing and creating more jobs, getting credit is always near the top of their list – and the poorer the country they operate in, the higher in general credit problems figure on their lists. The International Finance Corporation and McKinsey estimate the total credit gap for formal SMEs alone in emerging markets is over US$1 trillion. The OECD's SME Finance Scoreboard tells us that only one of its reporting countries from Europe

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has restored SME credit to 2007 levels (the Czech Republic, though Germany is still not reporting to the OECD Scoreboard). Both in emerging and developed markets, credit, the key resource for SME growth and job creation, is in scarce supply. Yet our *EDM* attention has been on other matters and, as one of our authors ably demonstrates, typical microcredit techniques and institutions aren't up to the challenge of serving SMEs, not even the bottom 'very small enterprise' segments of this market.

But this issue is not about gloom and doom. It's about the new dawn of SME finance, in which we re-focus attention on two very different, and very non-exclusive approaches to this market that are finding cleverer and cleverer application in more and more markets. The first is what I call 'good old shoe' SME lending. This is based on how smaller, more community-focused banks have always worked in developed countries. Fundamentally it wears out the shoes of a growing cadre of well-trained loan officers in travelling to metaphorically 'kick the tyres' of their clients. This shoe destruction overcomes the absence of key financial and business information within the bank or easily retrievable through a credit bureau or other national data source. The loan officers find good clients by going out to the market and physically checking out their operations, and they manage their portfolios in the same way.

Tough on shoes, but it works. It is *not* the way conventional microfinance works, even in many institutions that track individual borrowings, because it requires a basic appraisal of the business by the loan officer, not just confirmation of character references from peers. On the other hand, it is the way a number of institutions such as the ProCredit banks work, who wisely rode the microfinance wave to garner further support for country expansion, while more quietly pointing out to those who looked in more detail that they really were not about 'microfinance', they were about building universal banks that served local businesses. As Hishigsuren et al. point out in their article in this journal, the typical microfinance institution getting into this individual lending for larger (though still small) firms does so at its peril unless it realizes the changes this will require. This article provides an excellent overview of the types of changes to roles, responsibilities, and procedures that accompany successful moves into this new market, and that have always underpinned the way the 'greenfields' like the ProCredit banks and similar franchises operate. Narita et al. examine the additional challenges facing MFIs wishing to deal with larger, women-owned enterprises. These firms pose different challenges, from needing a wider range of products (and different products from those that men entrepreneurs might require, in many instances), to needing a different range of non-financial support services, delivered in a different way (more peer learning, for example).

The 'good old shoe' model is far from static, and Gerber et al.'s piece provides an excellent overview of some of the tassels and fancy buckles some innovative banks are employing to help loan officers go even further, faster in this approach. Their article includes examples of how careful value chain analysis identifies key information nodes providing critical data on many firms' behaviour and capabilities from a single source, essentially providing many tyres to kick in a single location. Many of the banks use agent networks as a more cost-effective way of extending their reach and knowledge. Some are employing electronic payments technology to lower the cost of transacting with their borrowers. Gerber et al. also discuss

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innovations in credit products, and an increasing number of examples of what used to be a textbook 'what *not* to do' in micro-credit, including significant non-financial services as part of the basic client offering.

The second model for SME lending has only recently started finding its way into emerging markets, though it's been growing in certain (not all) developed markets for years. This is the 'techno' model, based on tapping into electronic transactional and other data to find which firms can make best use of credit, and also to develop more finely tuned, even adjustable credit products that can move with changes in business cycles.

DeLuca et al. show how banks, mining just their own internal data on electronic transactions of their small merchant clients, can find abundant new lending opportunities that their traditional underwriting methods could not see. Given that more than 80 per cent of formal SMEs in emerging markets already hold accounts at formal financial institutions (albeit often only personal accounts), but far fewer are borrowing than their counterparts in developed markets, this seems a very low-hanging fruit to be plucked. Other data pools within and outside the banks, including e-commerce records, utility payments, and even social network behaviour capture more and more of the emerging markets SMEs every day, particularly as more and more entrepreneurs make use of mobile phone platforms for business activities. While we only present one 'techno' model in this issue, I'm hopeful the future will see many more articles on this theme, as this type of SME finance business can grow much faster than the 'good old shoe' model.

None of this should seem completely strange and new to banks, because they already have experiences with similar approaches in other markets. Their corporate lending approach is, in many ways, like the 'good old shoe' model, relying on key individuals thoroughly analysing clients. They tend to wear nicer shoes, and much of the tyres can be kicked by reading rating agency and other reports, but the trained relationship manager is the key. Their consumer lending has been 'techno' for some time, heavily automated. The trouble is, succeeding in the SME business requires figuring out how to balance the shoes and the technology, and much of the bad press about SME finance is from banks that tilted too far in either direction. If it was easy, more banks would be doing more of it. That's why interventions by policymakers, development banks, and other capacity-builders are essential, and our authors point out numerous opportunities in this regard.

While SMEs, being small, tend not to be big individual contributors to the global climate problem, collectively they are very much part of the problem. In general, they use older, less efficient technology than larger firms, and are less aware of opportunities for resource and energy efficiency improvement. Commercial banks can play a key role in bridging these gaps and creating win–win–wins for themselves (new business), their clients (cost savings/greater competitiveness), and their communities (lower emissions), as the Anzboeck and Couzinet article demonstrates. It recounts the significant terawatt hours and carbon emissions reductions achieved in Bulgaria and other central European countries through development bank-sponsored credit lines. The individual deals may have been smaller than those converting large factories and power plants, but their combined energy savings in

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Bulgaria alone equal the total household energy demand for three of the country's larger cities. The article also discusses the particular challenges facing smaller ticket energy efficiency and renewable energy deals for bankers, where establishing 'trusted technologies' is critical, and tools such as LEMES (lists of eligible material and equipment) can play a key role in building this trust.

So, readers, while I am not advocating more name changing, I hope that this issue will rekindle your interest in SMEs and small enterprise development, and in SME finance in particular!

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