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WINNING STRATEGIES FOR SUCCESSFUL SMALL BUSINESS LENDING

MANUEL SIA & DONNA NAILS

SHORECAP EXCHANGE

MESSAGE FROM EXCHANGE'S PRESIDENT

ShoreCap Exchange ("Exchange" or "SCE"), a non-profit sponsored by ShoreBank Corporation, was established to help build stronger local banks and microfinance institutions (MFIs) that serve the poor in developing rural and urban economies, primarily in Africa, Asia and non-EU Eastern European countries.

To achieve their goals, the ShoreCap companies bring together investment and capacity building for their partners. Exchange uses a blend of capacity building approaches to strengthen local banks and microfinance institutions ("MFIs") including:[1]

- Embedded technical assistance (TA) approaches (e.g. institutional needs assessment and TA planning, playing a role on bank boards, conducting evaluations);
- Direct one-on-one consulting services; and
- Banker to Banker Peer Knowledge Exchange Forums.

The Knowledge Exchange Forum activities among peer bankers are premised on our belief that entrepreneurs learn best from other entrepreneurs, and that providing opportunities for bankers at all levels to learn from their peers is a valuable, cost-effective and underutilized form of business services delivery.

ShoreCap Exchange conducted onsite visits with several successful small business lending institutions across the developing world. The purpose was to learn more about and share further some of the successful strategies these banks have adopted in developing strong small business loan portfolios. We also studied the practices that ShoreBank International has developed within its small business lending group and one of its innovative programs (the "Developing Enterprise Loan"). The findings from this work informed the in-person Small Business Credit Training that we ran in Manila, The Philippines for our partner banks. We also developed our small business lending toolkit at the time (which may be requested by emailing us at info@shorecapexchange.org).

We recently re-examined the information collected and developed this publication. While the practices mentioned here were first studied in 2005, they hold as much, if not more, relevance today.

We would love to hear from you on any thoughts, comments or suggestions about this paper and our various endeavors (see email below).

All the best,

Lynn Pikholz
President, ShoreCap Exchange
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[1] Exchange currently focuses its one-on-one technical assistance exclusively on ShoreCap International's investees. Exchange's knowledge exchange activities and banker- to- banker peer forums are inclusive of peer MFIs and banks that have not have received an equity investment from ShoreCap International

Acknowledgements

ShoreCap Exchange ("Exchange") is grateful to the following organizations which contributed to this publication from their experiences and hosted our team: ACLEDA Bank (Cambodia), Bank Rakyat Indonesia, BRAC Bank (Bangladesh), K-Rep Bank (Kenya) Inecobank (Armenia), Microenterprise Bank (Philippines, since merged into Planters Development Bank), ShoreBank International and Shore Overseas Azerbaijan.

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I.

Executive Summary

Small businesses account for more than half of all economic activities in developing economies and are a major source of non-farm income and employment. The continued growth of small businesses is essential to sustain over-all economic development.

There is no universal agreement about what is the definition of a small business. However, among the characteristics usually associated with small businesses are:

- Size of thirty employees or less.
- First loan usually under $50,000.
- Formal business license but may be incorporated;
- Usually family owned and employing mainly family labor, possibly including some hired help;
- Fixed place of business, either owned or leased, in contrast to ambulant vendors or market stall holders of micro enterprises;
- Limited capital base (i.e. starting capital generally provided from own savings supplemented by borrowings from relatives and friends);
- Simple financial recordkeeping including use of crude accounting and financial management tools. Family and business income and accounts are often mixed into one common treasury;
- Ownership and management are the same and entrepreneurial skills are generally low

The growth of small businesses has been historically impeded because of their difficulty in accessing financing from the formal lending sector. This inability to obtain needed financing is traceable to three major factors: 1) inability to satisfy collateral requirements because of small business' lack of assets; 2) lack of a verifiable credit history; and 3) perception of lack of credit worthiness.

A growing number of institutions are beginning to address the above challenges and develop profitable and sizeable small business lending portfolios. This publication presents the key strategies adopted by a group of these institutions that Exchange met with in 2005. It discussed some of the major challenges they faced and the solutions they found.

The successful small business institutions reviewed for this paper have attained all the following: 1) significant market coverage; 2) continuous volume growth; 3) low default ratios; and 4) adequate operating margins. They have done so by succeeding in five major areas:

- Designing appropriate lending products that fit the needs and expectations of borrowers and can be managed efficiently by the bank.
- Creating an organizational structure that balances efficiency, simplicity and swift loan approval with the oversight needs of the bank, and establishing training and recruitment policies that produce staff well-suited to the organization
- Formulating accompanying marketing and credit strategies in accordance with the characteristics of the local market, including establishing employee incentive programs that encourage aggressive but responsible loan recruitment
- Streamlining and standardizing procedures in order to reduce the risk of oversight error, and to minimize required paperwork and wait times before loan disbursal without raising credit risk
- Adopting an effective and pro-active account monitoring system to prevent the occurrence of problem accounts

These strategies form parts of a broader and comprehensive framework that cover important and crucial aspects of small business lending. With a well-grounded, thorough and comprehensive understanding of the specific market niche being targeted, small business lending can be a reliable and profitable business, in addition to providing financial access to a highly under-served sector.

II. Introduction

Small businesses account for more than half of all economic activities in developing economies and are a major source of non-farm income and employment. The World Bank estimates that small and medium businesses contribute an average 51.5 percent of the gross domestic product (GDP) in high income countries—but only 15.6 percent in low income countries.[2]

The continued growth of small businesses is essential to sustain over-all economic development. However, the growth of small businesses has been historically impeded because of their difficulty in accessing financing from the formal lending sector. This inability to obtain needed financing is traceable to three major factors: 1) inability to satisfy collateral requirements because of small business' lack of assets; 2) lack of a verifiable credit history; and 3) perception of lack of credit worthiness.

This scarcity of available financing for small businesses in developing economies presents a window of opportunity for financial institutions, especially those that are committed to delivering a social mission. Contrary to the view that lending to small businesses is highly risky, the experiences of a number of financial institutions show that small business lending can be a viable and profitable undertaking. The approaches, strategies, and lessons learned from financial institutions, that have successful small business portfolios, provide useful and meaningful insights to others who may likewise wish to profit from their experiences.

This paper presents the key strategies adopted by a group of successful small business lenders that enabled them to build a profitable and sizeable small business portfolio. It analyzes some of the key challenges faced and, more importantly, how they were able to overcome these impediments and constraints. We focus on:

- Definitions of terms, basic concepts and principles;
- Challenges and trends in small business lending;
- Summary of key success variables or 'winning strategies' that can be adopted or replicated.

The key elements of a proven successful overall strategy are based principally on the conclusions and findings of selected small business lenders in several countries.[3] These financial institutions discussed throughout the paper were chosen because of their success in building sizeable portfolios of small business loans with relatively low default ratios within a short period. Additionally, the paper discusses ShoreBank International's lending methodology called the Developing Enterprise Loan (DEL), which was developed in the 1990's and proved to be a successful methodology of small business lending.[4]

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[2] From Brookings Policy Brief#159 Beyond Microfinance: Getting Capital to Small and Medium Enterprises to Fuel Faster Development By David de Ferranti and Anthony J. Ody

[3] ShoreCap Exchange sent a team of consultants, who had been lenders themselves at financial institutions, to study the following institutions, which excel in lending: BRAC Bank Limited (Bangladesh), Bank Rakyat Indonesia (Indonesia), ACLEDA Bank (Cambodia), Inecobank (Armenia), K-Rep Bank (Kenya), and SOA Kredit (Azerbaijan). Annex A provides an overview of each institution.

[4] DEL is discussed in detail in Annex B.

III. Small Business Lending Fundamentals

There is no universal agreement about the definition of a small business loan. Certain environments define small businesses by specific characteristics including the size of loan amount, size of total assets, periodic turnover, or number of employees. However, the range of loan amounts to qualify as small business loans also vary from one country to another.

Size of Small Business Loans around the World
In Indonesia, loans of up to the equivalent of $500,000 are considered as small business loans whereas Cambodia considers loans of $500 as small business loans. In Azerbaijan, a small business loan can be up to $50,000. Based on internationally accepted conventions, loans of up to an equivalent of $1,000 are typically classified as micro finance.

These varying definitions of a small business, by themselves, make it difficult to clearly identify the parameters of the small business lending market and, ultimately, make proper inter-country comparisons. Therefore, small business lending, in this paper refers to loans to businesses with the following characteristics:

a. Usually thirty employees or less;
b. First loan usually under $50,000;
c. Formal business license but may be incorporated;
d. Fixed place of business, either owned or leased, in contrast to ambulant vendors or market stall holders of micro enterprises;
e. Limited capital base (i.e. starting capital generally provided from own savings supplemented by borrowings from relatives and friends);
f. Simple financial record-keeping including use of elementary accounting and financial management tools. For very small businesses that can be defined as microenteprises, family and business income and accounts may be mixed into one common treasury; and
g. Ownership and management are the same and entrepreneurial skills are generally low.

'Small business loans' in this publication refer to loan products designed to address the financing needs of small businesses, as defined above, for their asset acquisition or working capital needs. Small business loans of financial institutions discussed in this paper, range from more than $500 up to $100,000. Small business lending refers to all the institutional activities that are related to creating, maintaining and expanding a portfolio of profitable loans to small businesses.

IV. Challenges and Trends

Making small business lending a profitable undertaking is challenging. Financial institutions are generally disinclined to increase their small business lending activities because of the perceived higher risk profile of the sector as a whole. This reluctance on the part of financial institutions to lend to small businesses creates a vicious cycle. Since a credit history or proof of repayment of a previous loan is often a requirement for most small businesses to obtain a loan, the lack of willingness to lend to the small businesses prevents them from developing the credit track record needed.

High Transaction Cost
One major challenge perceived by financial institutions is the high transaction cost of small business lending. Many small business clients have inadequate and inaccurate financial records and a loan officer is forced to take additional steps and improvise on the evaluation modalities, and sometimes even develop the financial statements to strengthen their analysis. This extra time increases operating costs. A number of the financial institutions visited by the Exchange team reduced transaction costs by streamlining the underwriting processes and forms, focusing only on important elements of evaluating a small business such as first form of repayment (cash flow), second form of repayment (collateral or guarantor), character analysis, and the site visit. Many financial institutions with 'express' loan products use an underwriting/approval analysis of five pages or less.

Many financial institutions believe that it is difficult to have a sustainable and profitable portfolio of small business loans. Even though inherent risks are relatively higher and the insufficiency of financial and credit information of the sector often makes proper risk assessment difficult, these constraints can be addressed, as our test group of small business lenders have proven.

Failure of Start-up Small Businesses
Some financial institutions have a perception that small business loans offer an increased risk of non-payment as compared to other loans, especially larger corporate loans. This view stems mainly from negative market perceptions about the sector including studies that as high as 75% of start-up small businesses fail during their initial operating period. This failure is attributable to a number of reasons including improperly assessed business risks, weak capital structures and poor entrepreneurial and management skills. Many financial institutions mitigate this risk by requiring that clients have two years of operating experience prior to applying for a loan.

Based on recent experiences of the financial institutions reviewed for this paper, some emerging characteristics and trends common to successful small business lending institutions are the following:

(1) ***Sustainable portfolio growth depends on both proactive marketing and sound credit judgment.*** Financial institutions interviewed demonstrated that it is achievable to simultaneously actively solicit accounts to build a sizable volume of loans and uphold basic credit principles to maintain acceptable portfolio quality. Therefore, small business loan officers should have a strong marketing orientation, understand basic business nuances and be adequately equipped to do credit risk analyses;

(2) ***Improving efficiency levels in all aspects of the loan underwriting process is critical.*** Because rising loan volumes are more often a function of number of accounts than the size of loans, simplifying product offerings and operating processes and procedures without neglecting essential control mechanisms will allow an institution to substantially increase loan volume;

(3) ***Use of technological improvements particularly in the area of transaction processing involving repetitive steps.*** Streamlining service delivery particularly in remote areas resulted from effectively harnessing technological advances in communications;

(4) ***Using credit scoring to deliver faster results.*** Some banks are using modified credit scoring systems as means to address the shortcomings of conventional risk analysis methods. A successful credit scoring model does need an extensive database of past loans including significant data on each loan. Therefore, financial institutions that are new to the small business lending market may not have the data needed initially to develop a sound credit scoring system. More often, financial institutions tend to use modified scoring systems where they use the experience gained on the ground to develop a quick and dirty set of loan assessment parameters for different groups of loans.

Corporate versus Small Business Loan Portfolios

The team noted that the small business loan portfolios exhibited, particularly during the financial crisis in Asia, a superior capability to weather systemic financial failures because of their more diversified credit risks. In contrast, corporate loan portfolios are composed mainly of larger loans to fewer borrowers. This greater concentration of risks raises the portfolio's comparative volatility and makes it more vulnerable to fluctuating global trends.

V. Winning Strategies of Small Business Lending Institutions

The successful small business institutions reviewed for this paper have attained all the following: 1) significant market coverage; 2) continuous volume growth; 3) low default ratios; and 4) adequate operating margins. Based on the team's observations of the practices used by these lending institutions, the general parameters of a meaningful overall strategy for developing a profitable small business loan portfolio involve five major components:

(1) Designing the appropriate lending product considering specific market needs and characteristics;

(2) Creating a suitable organization in terms of structure and adequately trained manpower to effectively deliver the product to the market;

(3) Formulating appropriate accompanying marketing and credit strategies and action plans to ensure market acceptance;

(4) Streamlining and standardizing procedures to enhance efficiencies in service delivery; and

(5) Adopting an effective and pro-active account monitoring system to prevent rather than cure problem accounts.

This publication will review each component and share successes as well as the struggles of the financial institutions.

Designing the Suitable Product

The team found numerous examples where either designing the right product assisted increasing profit, or designing the wrong product affected profitability and portfolio quality. The following are a few of the successes and lessons learned:

- In its early years, Micro Enterprise Bank of the Philippines's (MEB) had a standardized loan product that required the borrower to physically make the monthly payments at a bank's office. This payment model had been successful in other areas of the world. However, when MEB's portfolio quality deteriorated, MEB found that the standardized repayment terms did not match with the timing of the cash flows of the borrowers. Moreover, the local market was accustomed to having collectors who picked up loan repayments. When MEB began to provide modified payment terms based on the client's cash flow and go to the client's businesses to obtain payments, portfolio quality improved substantially.

- ACLEDA Bank's success in small business lending is also partly attributable to having an appropriate product whose features took into account what the market needed. Despite the difficulties and operating complexities of a multi-currency loan product, ACLEDA offered its small business loans in US dollars, Thai Baht, and Cambodian Riel, in response to market exigencies.

- Bank Rakyat Indonesia (BRI) is a large commercial bank mandated to serve the financing needs of small and medium enterprises. Since the government used BRI during its early years mainly to disburse rice production loans to farmers, the institution had little commercial orientation, which resulted in successive years of rising portfolio losses. After devoting time to study and understand market characteristics, BRI developed a simplified lending product that included the following lending characteristics that the borrower wanted: (i) appropriate interest rates; (ii) monthly repayments; (iii) maximum tenure of one year; (iv) prompt payment rebates. And, even though the loan product had higher than market interest rates, the loan portfolio grew rapidly because the clients were willing to pay more for a loan product that fit their needs.

Creating The Right Organization

Based on the team's findings, two elements are the most important when developing a successful small business lending department: 1) structure; and 2) staffing.

The **structure** of a small business lending department can create the base for a successful loan portfolio. Since small business borrowers are more time-sensitive and demand quicker decisions than larger borrowers, especially in a market where small business borrowers have choices, a borrower will select a financial institution that provides the best and fastest service. Therefore, a structure that works efficiently and effectively is critical.

Two different structures have proven to be successful. One structure is to have a separately managed small business lending unit within a larger organization. Institutions such as BRI, BRAC Bank, Ineco, SOA Kredit and K-Rep Bank have this type of structure and have found that it allows them to design tailored solutions in the areas of:

1) Policies, guidelines, documentation requirements and credit standards;
2) Underwriting templates;
3) Autonomy in credit decisions exercised through appropriately delegated credit approving authorities;
4) Marketing and portfolio quality targets;
5) Monitoring, collection and problem loan handling;
6) Portfolio management tools;
7) Training

One example of a small business lending tailored approach includes developing the ability of a loan officer to work with the client to review or develop true financial information when audited financials are not available. One institution also realized that it needed to develop specific training material to refocus the microfinance loan officers, who were to become small business loan officers, from a 'character only' lending judgment, as used for many microfinance lending decisions, to one that highlights first (cash flow) and second (collateral or guarantor) forms of repayment when making a small business lending decision.

On the other hand, smaller institutions that do not cover the wider spectrum of business enterprises, like MEB and ACLEDA, have simpler structures and do not have separate units exclusively for small business lending. However, under this type of structure, the loan officers have a thorough understanding of the differences between the products offered by the financial institutions.

Regardless of appropriate structure, an institution should always consider minimizing layers that create inefficient bureaucracies. The common element found within the successful financial institutions that are mentioned here is that all have small business units that are simply organized and relatively flat. This type of structure significantly reduces the steps involved in completing a typical transaction without simultaneously neglecting essential control points.

Streamlining the Closing Process

The time needed for closing, which starts at the time of approval to disbursement, varies at the institutions reviewed. On an average, the closing time takes 1-3 days. One financial institution reviewed received numerous complaints from clients that the time from approval to disbursement took 5-7 days. The institution completed a mapping chart of its closing procedures, and was able to decrease the closing process to 2-3 days by streamlining the process and reducing inefficiencies.

Ineco has developed a streamlined closing process for its express loans that is only 1 day. Shorebank International's DEL product has proven, in practice, that the closing process for some small business lending programs need only take 1-2 days for repeat clients, without compromising in any way on the gathering of pertinent information, credit analysis or portfolio quality .

The second major factor with creating a strong institution is **staffing**. Small business financial institutions need a substantial number of trained field personnel who spend most of their time visiting existing and potential customers. This is especially relevant as sustained volume growth depends largely on deeper market penetration through active and direct account solicitations. These marketing-oriented staff members are the prime drivers of loan volume.[5] They understand the customers' businesses and their financing needs. Successful banks all empower their loan officers without compromising on risk by ensuring adequate training, control and motivation.

The critical elements of staffing are clear responsibilities, appropriate recruiting and tailored training.

Throughout all small business lending departments reviewed for this publication, the responsibilities of loan officers were similar and included the following: (a) marketing products; (b) discussing loan requirements with borrowers; (c) evaluating the credit request and preparing the appropriate recommendations; (d) monitoring repayments; and (e) collecting overdue installments.[6]

Additional Responsibilities of Loan Officers

Some small business loan officers will often play an additional role of small business advisor. At ACLEDA Bank, K-Rep Bank and SOA Kredit, the loan officers often also assist and guide prospective borrowers in completing their business plans and other documents to support their loan request. Unlike commercial lending departments, where marketing, underwriting, and collections responsibilities are separate, a small business loan officer must often be able to complete all the tasks of finding clients, obtaining the required information, completing and presenting the loan appraisal to the approving authority, and following up with delinquent payment for their clients.

[5] These are called Customer Relations Officers (CROs) in BRAC Bank, Credit Officers in BRI, Loan Officers in ACLEDA, MEB, SOA Kredit, and K-Rep Bank.
[6] Includes personal loans of employees of government and private institutions in the area payable via salary deductions.

Recruitment of small business loan officers is important not only because of the necessity of finding people who can successfully complete all the tasks outlined above but also because many institutions need staff who are willing to accept field assignments and relocation. In BRAC Bank and BRI, trainees may also be relocated to unfamiliar areas. BRAC Bank first gives a brief orientation on the bank and then sends new recruits on training in the field, and only after they demonstrate ability and willingness to handle work in remote locations are they given another round of training and then allowed to assume loan officer responsibilities. Alongside recruitment is an institution's willingness to reassign trainees or loan officers when needed. In one institution, an operations person was being trained to become a small business loan officer. However, during the training it became obvious that the trainee did not have the personality to effectively market and interact with small business clients. Management quickly made the decision to reassign the person to operations. A quick decision saved time and money on retraining this person. Additionally, the institution was able to hire a person to assume the loan officer slot.

Recruitment

Due to high competition in getting staff with the appropriate education and the right amount of experience, the lowest educational level that BRI recruits from is that of the Diploma (2-3 years of college study); university graduates are preferred. It also follows a policy of promoting entry level staff through the years as they demonstrate competence and this builds loyalty as well. MEB initially hired graduates from prestigious universities to become loan officers and, after training for the particular assignments, found that they did not stay very long at the bank. Apart from increasing training costs, the frequent loan officer turnovers adversely affected established relationships with customers, which is a very important factor in small business lending. K-Rep Bank hires many small business loan officers from its microcredit department. Therefore, their loan officers already have an understanding of the bank's culture and processes.

The last element of a strong small business lending department is having adequately-trained loan officers. The interesting fact is the small business lending institutions visited have different training systems, which range from on-the-job training to formal training programs. The key common element in all these systems is that all new loan officers are monitored closely and mentored. A successful small business lending department must have a strong mentoring program and the willingness of senior and more experienced loan officers to assist junior loan officers.

Training

BRI has a continuous recruitment and training program for future loan officers. New recruits are initially hired as tellers or loan administration personnel in order to give them sufficient product and market exposure and are initially trained in one of the six regional training centers of BRI. After gaining adequate on-the-job exposure for about five years or so and assuming performance is acceptable, they become eligible for promotion to credit officers. In contrast, BRAC Bank directly hires applicants for the CRO position. Their training program is relatively short, i.e. one to two weeks, after which the trainees are assigned to the field as "shadows" to regular CROs. This incubation period lasts for an average of three months. Refresher trainings are also conducted at regular intervals.

ACLEDA also recruits credit officers directly. New hires undergo in-house formal training for three weeks, of which almost four days are spent in the field. Other senior officers of the bank serve as trainers. Employment contracts are given only after successful completion of the training program. New recruits are then further exposed to actual –on-the-job training for at least three months before being appointed as credit officers. ACLEDA's training budget is approximately equivalent to 2% of the bank's total operating expenses for a given period[7].

K-Rep Bank decided that a class room training program was not providing the training results required for its small business lending department. The program was deemed a success. More recently, a new six-week program was developed and implemented by the bank, which includes 3-4 weeks introduction on the ground, where experienced staff members provide dedicated support to the trainees. After introduction on the ground one week of class room training in SME lending plus training on the Banks core banking system is provided. Thereafter, loan officers report to their respective branches. With support of experienced officers they start to underwrite and monitor clients. After four months smaller deals are independently appraised under supervision of senior loan officer or lending manager.

Formulating the Accompanying Policies and Strategies

The third element of a successful small business lending program consists of the appropriate policies and strategies related to marketing, credit and operations. These specific strategies are not to be taken independently, but rather as essential components of a larger strategic framework for successful small business lending operations. It is important to note that many of these policies and strategies require additional cost or effort. The key to success is in implementing them in a cost-effective manner, i.e., by ensuring realized gains exceed associated costs.

[7] The American Society of Training and Development statistics range from 2.34 % to 3.2% for training as a percentage of salary expense for companies that are considered best in class. These companies typically have thousands of employees so there is some economy of scale. ASTD expenditures include learning and performance staff salaries, travel costs, administrative costs, non-salary development costs, outsourced activities, and tuition reimbursement. Expenditures do not include learner's travel expenses, costs of participant's conference attendance fees and travel, cost of lost time while engaged in learning activities.

Market Outreach

Many of the institutions reviewed increased market outreach by increasing the number of branch offices. For example, because they brought the products closer to their target market by establishing many compact units in many locations, BRAC Bank and BRI experienced significant volume expansion within a short period.

Description of Branch Structures

BRI's typical unit office is composed of four persons including: the manager who is responsible for all credit decisions, credit officer, teller and the deskman, who takes care of customer service and handles only one loan and several savings deposit products. Each unit office reports to a branch although it has a relatively high degree of autonomy.

BRAC Bank established unit offices all over the country in order to broaden its outreach.[8] A unit office in BRAC Bank handles only small and medium business loan products and cannot service nor accept deposits. Each unit office has on average four to five CROs. Several unit offices comprise a Zone and their operations are directly supervised by a Zonal Manager (ZM). Zonal Managers have credit approval authorities while CROs cannot approve loans regardless of amount. A group of zonal offices belong to a Territory headed by a Territory Manager (TM).

ACLEDA Bank's expansion and outreach strategies are similarly based on enlarging its network. It has several service distribution channels to market and generate loan accounts. These are branch offices located in major provinces and cities, sub-branch offices and/or district offices and service posts. The latter are offices situated in smaller communities and are composed of about 7 to 10 persons.

One issue with establishing distribution channels closer to where small businesses are predominant is that the financial institution has to ensure that costs are effectively controlled. Thus, conducting market research prior to establishing a new branch office is essential. Another issue is a poor and inadequate telecommunications infrastructure that might hamper the smooth delivery of services to customers.

Using Technology to Increase Communication

BRAC Bank took advantage of advances in technology to overcome some of these constraints above by using wireless communications through the ubiquitous mobile phone. Through short message services (SMS), BRAC Bank improved communications among unit offices, head office and borrowers and maintained uniform service delivery standards even in the remotest areas. BRI dealt with communications issues by installing a fully automated on-line or stand-alone system. Thus, certain infrastructural limitations did not prevent BRAC Bank and BRI from looking for alternative ways of extending their service reach.

One factor that contributed to the growth of many of the financial institutions was incentive programs.[9] Incentive programs motivate staff to deliver or perform beyond expectations. These

[8] BRAC Bank had the special permission from Bangladesh Bank (the Central Bank) to establish these offices with lesser documentary and regulatory requirements compared to establishing a regular bank branch.

[9] See Annex C for an example of an Incentive Program

worked well with credit officers in BRAC Bank, BRI, SOA Kredit and MEB. Incentive plans have costs but these are generally variable. Most plans give incentives only after fully covering the fixed costs of maintaining the marketing staff. Ineco found, at one time, that its small business lending program brought less revenue per loan officer than its other lending programs. After investigation, Ineco successfully implemented an incentive program to have its loan officers increase the volume of small business lending.

Easy to understand and expeditiously administered incentive plans are most effective. A good incentive program can also assist with keeping loan officers. One institution learned the hard way that incentive programs are important as it lost 25% of its small lending staff to a competitor who offered a higher salary and incentive program.

Incentive programs are (primarily) either volume-based or profit-driven as described below:

- **Volume-based Incentive Programs:** BRAC Bank, SOA Kredit and MEB's incentive plans are varieties of volume-based incentive plans. BRAC Bank's incentive program for its customer relations officers was a major contributory factor to the rapid growth in its outstanding small business loans during the last two years. This program motivated its loan officers to introduce its small business loan products to as many potential borrowers as possible. SOA Kredit's incentive program is based primarily on two factors: 1) portfolio health measured by portfolio at risk ratio, which must be below 1.5%; and 2) amount of loans disbursed.

- **Profit-driven Incentive Programs:** BRI distributes a certain percentage (currently 6 per cent) of each unit office's profit every year to all its staff members. The maximum amount received by each staff member is equivalent to one to two and a half months' salary depending on job title. Since growth in loans outstanding and minimal bad loans are the main drivers of profitability, this bonus program works as an incentive to expand loans without endangering quality and profitability.

Improperly-designed Incentive Programs

Improperly designed incentive plans can, however, bring about unwanted consequences. For example, the initial incentive program in one of the financial institutions studied was purely volume-based and did not consider portfolio quality. The unqualified emphasis on disbursements tempted loan officers to extend loans in amounts greater than necessary or required in order to meet monthly disbursement targets. The financial institution is currently reviewing its loan officers' incentive program to address these issues. The same situation was observed in another of the banks, which designed its initial incentive plan based principally on loan volumes. The financial institution did not factor in acceptable portfolio at risk ratio or arrears level in its incentive formula. Thus, loan officers pursued volume relentlessly in order to qualify for the attractive incentives. The financial institution subsequently revised its incentive plan by taking outstanding amounts, portfolio quality and number of accounts in the incentive equation, which is increasingly a set of criteria being used by financial institutions.

Credit

Credit extension involves risk-taking, but a judicious analysis and evaluation of loan requests effectively minimizes these risks. Because of this, the tendency has been for loan officers to seek more information than necessary or available resulting in a lengthy evaluation and decision making process, which is the complete opposite of what the small business loan client wants. The financial institutions covered in this study understood this very well and developed a simplified and more customer-friendly loan evaluation process that was developed keeping in mind existing market limitations. The financial institutions took a calculated risk by reducing some standards and evaluation steps in exchange for greater market acceptance and faster disbursements, leading to sustained growth in outstanding loans, while maintaining elements key to ensuring sound credit.

All the financial institutions covered in our review evaluate loan requests based on traditional credit principles and criteria (i.e. the five C's of credit with strong emphasis on reasonably determining capacity and willingness to pay).[10] However, the following are some specific elements to underwriting analysis and file documentation:

- **A simplified financial analysis calculates cash flows and repayment capacities.[11]** The extent of financial analysis completed depends on the amount of loan requested. Small business borrower's financial statements are often either non-existent or unreliable and, in some cases, not required. Instead, the loan officers prepare and complete a simplified income or cash flow statement template jointly with the borrower. The institutions have also developed acceptable guidelines so that the loan officers are able to quickly establish if the borrower is a viable client for that specific institution.[12]

- **Character assessment to determine willingness to repay debt is done on two levels: personally and professionally.** On a personal basis, the loan officer may conduct neighborhood checks to assess the borrower's standing in the community. Subsequent visits to the residence and a crosscheck with the community leaders and neighbors serve to reinforce or support the judgments. On a professional basis, the loan officer verifies their relationships with suppliers (i.e. volume of purchases, paying habits and length of relationship, etc) or even employees. In instances where the place of business is rented, lease payment history of the borrower is also verified. The loan officer may also assess the character of the borrower based on the following factors: educational background, length and depth of business experience, and managerial skills. These assessments are highly subjective but have proven to provide pertinent information regarding the borrower's repayment behavior. In a review of some default cases, it was found that the loan officer ignored information gained in the character assessment during the credit decision that highlighted a borrower's questionable behavior.

- **The loan officers make a site visit to both the place of business and the residence of the borrower.[13]** K-Rep Bank loan officers are required to draw a map of the location of the business and/or residence if either is located in an area that does not have addresses. The map is included in the loan file and could be used to find the borrower in the future.

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[10] Five C's include capacity to repay, character, collateral, conditions and capital (equity).
[11] In most markets, business transactions are done on cash basis and, thus, income equals cash.
[12] Annex D discusses repayment methodologies of the institutions.
[13] Annex E is an example of a site visit report.

Credit Scores and Risk Rating Tools[14]

BRI subjects all small loan applications to an internally developed credit score card. However, unlike the credit scoring system used in more advanced environments, BRI's credit score card is not used as a credit decision-making tool in lieu of the conventional financial analysis but is essentially used as a credit screening tool. The credit score card has a number of pre-determined attributes against which a specific score is tabulated. The specific attributes are not weighted according to their relative importance. The scoring system considers both non-financial and financial factors on a 54%-46% basis. The total score determines how the credit evaluation is to proceed. A range of score is assigned a certain color i.e. white, black or grey. Accounts whose aggregate score results in a 'white' category are considered good and can therefore be processed by the credit officer proposing the loan. On the other hand, if the total score lands within a 'grey' range, processing can continue but must be done by a higher group of analysts and not by the proposing credit officer. Those falling in the 'black' category will not be processed further.

K-Rep Bank uses a risk rating matrix, which has grades 1 to 8 with 1 being the highest. The individual risk rating for a small business loan is based on the following criteria: management/credit history; debt service coverage/cash flow; collateral; ability to produce financial statements; and Balance Sheet; industry/market competitive advantage. The risk ratings assist K-Rep Bank to establish the amount of monitoring needed for the client. Additionally, the risk ratings are reviewed annually or when a client's situation deteriorates. With the ongoing updating of risk ratings, K-Rep Bank is able to an average risk rating as a credit risk portfolio tool.

It appears that institutions use these tools more successfully when they are used to support decision-making versus being the sole basis for decision-making. Used consistently, these tools can also help support pricing decisions.

<u>Streamlining Pre-and-Post Credit Approval Procedures</u>

The goal in streamlining pre and post credit approval procedures is to enhance efficiencies in service delivery, but not at the expense of increasing risk. Many of the financial institutions visited developed simplified and standardized operating procedures from loan application to approval to disbursements with accompanying guidelines on standard times for completion. Streamlining procedures fundamentally involved the following:

1) **Pre-approval documents from borrowers are kept to a minimum;**

2) **Decentralized credit-approving authorities within certain limits are allowed to quickly facilitate loan approvals;**

3) **A check list of required documents to support disbursements of loan proceeds is used to minimize possibilities of errors due to oversight;**

4) **Loan proceeds are disbursed through bank accounts that borrowers have to open;**

[14] Annex F show an example of a general risk rating matrix.

5) Standardized procedures for small business loans are written in operating manuals. The same procedures apply to all small business loans originated from all unit offices.

> Innovative Ways to Streamline Operations
>
> The following are some specific ways that financial institutions streamlined operations:
>
> - BRI had pre-computed amortization tables that loan officers use to readily calculate maximum loan amounts for borrowers.
> - BRAC Bank developed an integrated application form that contains basic information about the borrower, a loan officer's worksheet and signature space for approving authorities. Thus, there was no longer a need to prepare a separate credit memorandum to formalize the credit request.

Instituting Pro-active Account Monitoring System

Regular monitoring of account performance is an important component of proper loan portfolio management. Reliable monitoring is more important and crucial in small business lending mainly because of the characteristics and nature of small businesses, which often have varying cash flow needs and a lack of prior experience with making regular loan payments. Because of these factors, it is important to recognize symptoms of emerging problems early. One common factor for an effective pro-active monitoring system is clustering of clients, which is defined as establishing physical boundaries of where a client can be located. Clustering of clients allows for loan officers to visit a number of clients in one-time efficient visits since they are located close to each other or even in the same market.

Effective monitoring will result in preventing rather than curing repayment problems.[15] As observed, the pro-active account monitoring system adopted by small business loan officers involved the following:

- BRAC Bank: Existing policy requires that each performing account is visited at least once a month to see how the clients' businesses are progressing. Accounts with overdue installments require more frequent visits. BRAC Bank's strict monitoring system centered on regular and periodic reports required from loan officers and center heads. The MIS department prepares a daily/weekly report highlighting accounts with unpaid installments. A centralized recovery unit composed of loan recovery specialists was organized to handle the most challenging problem accounts.

- ACLEDA: Account data is regularly updated in the system so that each loan officer has ready access to accurate and up-to-date information on the status of each account from all branches or outlets. Since monitoring payment performance of accounts is a major responsibility of credit officers, they rely heavily on the reports produced by the system in their follow-up and monitoring efforts. ACLEDA has regular daily, weekly, and monthly reports to support the account monitoring activities of their loan officers.

[15] Annex G is the DEL monitoring form.

- Ineco: There is a zero delinquency tolerance level for delinquency and the loan officers must call on a delinquent client when their loan is one day late. Ineco also developed a collections department where a loan that is over 60 days late is transferred.

- MEB: Each loan officer received a Personal Digital Assistant (PDAs) to facilitate account monitoring and collection of repayments. Every morning, the Loan Officer would upload a list of all accounts and amounts due for collection during the day from their central database at the head office. At the end of the day, the updated data about payments in the PDAs is downloaded, reconciled with actual cash turned over and entered into the computer. When defaults rose considerably, MEB was able to track this development in a timely way and created a specific group tasked to exclusively manage problem accounts. The group was composed of recovery specialists and had recovery targets.

- SOA Kredit: A monitoring policy was developed that stated the type of monitoring call report that must be completed and the frequency of monitoring for different loans. SOA Kredit also established a separate position for a monitoring officer who contacts most clients on a monthly basis. A monitoring worksheet was created to assist management and the monitoring officer was required to document each visit.

Importance of an effective MIS system

A dynamic and effective account monitoring system depends largely on having accurate, timely, and comprehensive information on the payment performances of the loans. A good and accurate loan management information system (MIS) is mandatory to effective monitoring. BRI, BRAC Bank and ACLEDA are constantly evaluating new systems to further improve their account monitoring efforts. K-Rep Bank recently upgraded its system since it found that its portfolio outgrew the previous MIS system and it was unable to easily produce the portfolio management reports needed.

Some organizations created a separate Monitoring and Problem Asset group; irrespective of the structure, it is important that the responsibility be assigned clearly to staff and accountability maintained.

VI. Summary & Conclusions

In the World Bank's "World Business Environment Survey" (WBES) of more than 10,000 firms in 80 countries, small and medium businesses worldwide, on average, named financing constraints as the second most severe obstacle to their growth, while large firms, on average, placed finance only fourth[16]. The demand for financing various needs of small businesses is large and is expected to continue to expand further, particularly in growing economies. However, certain inherent characteristics make this sector very different from both the traditional microfinance and corporate sectors, and prevent loan officers from seriously investing resources and expanding in this sector and being able to take advantage of these opportunities. As we saw in this publication, some institutions in various countries managed to overcome these impediments and become successful. Their experiences provide valuable insights on the specific strategies they formulated and implemented to address market and other constraints. As the financing gap in the sector becomes more obvious and development finance focuses on the importance of small business in generating livelihoods and alleviating poverty, other prospective small business lenders that wish to take advantage of the profit opportunities in financing small businesses can learn from these and adapt those applicable.

Successful small business lending means having a growing portfolio of loans with a manageable level of defaulting loans. Several financial institutions in our study achieved this through a judicious combination of marketing and operational strategies premised fundamentally on their comprehensive understanding of the needs, wants, characteristics and nuances of their target market. In general terms, the key elements of the winning strategies employed by successful small business loan officers include:

1) Designing the appropriate lending product considering specific market needs and characteristics;

2) Creating a suitable organization in terms of structure and adequately trained manpower to effectively deliver the product to the market;

3) Formulating the appropriate accompanying marketing and credit strategies and action plans to ensure market acceptance;

4) Streamlining and standardizing procedures to enhance efficiencies in service delivery; and

5) Adopting an effective and pro-active account monitoring system to prevent rather than cure problem accounts.

These strategies can not be viewed (or implemented) in isolation. Instead, these form parts of a broader and comprehensive framework that cover important and crucial aspects of small business lending. The underlying presumption in adopting these is a well-grounded, thorough, and comprehensive understanding of the specific market niche being targeted. Misreading can be fatal. It is likewise incorrect to assume that successful strategies in one country will automatically be effective everywhere else. The experiences of several successful lenders prove that small business lending can be a profitable undertaking. There is a growing demand for these products and services and

[16] From Brookings Policy Brief#159 Beyond Microfinance: Getting Capital to Small and Medium Enterprises to Fuel Faster Development By David de Ferranti and Anthony J. Ody

significant profitable opportunities exist. Properly harnessed, these can be transformed to a sustainable and profitable undertaking.

Annex A – Overview of Institutions

Please note that these are summary points about the small business lending programs run by these organizations. In the case of SAS DEL (express) loans, this refers to the program implemented by Shorebank International with several partners in E. Europe. Also, information for Micro Enterprise Bank of the Philippines was not included since it was merged into PlantersBank.

Process/Institution	**BRAC Bank**	**ACLEDA**	**BRI**	**SBI SME**	**INECO**	**SAS DEL (Express)**	**K-Rep Bank**	**SOA Kredit**
Standard SME Loan	USD 4.40k to USD 44.02k	$10k to 5% of ACLEDA Bank's net worth	$5k - $500k;	Up to $200k	Small: Up to $100k Small Business: Up to $300k	Standard Express loan $1k - $30k	Average loan size - $75k overdraft, term loans, asset finance	Up to $100k
Express Loan (Smaller loans and/or abbreviated analysis)	ANONNO loan Up to $14,674, Limited documentation requirement, 8 page loan application, No loan proposal-loan approved by loan application. Loans above $7,337 sent to headquarters for risk evaluation	Small loans up to $10,000, medium $10 - $70k, 2-3 days for loans to $4k	Micro up to $5k; salary loan option; application form, license, life insurance. Collateral docs; 7 days	Same application as standard; 1 week to assess; 6 months historical cashflow analysis;	Up to $6k; 1 day approval process; loan application takes 45 minutes	Only express loans	Salary loans within the limit of the branch are express loans.	No system as of time of interview. However, smaller loans are not required to have extensive financial analysis and are approved in an expedited fashion.
Credit Analysis 3Ms	Use of 5C's, Extensive character checks, but little weight in final decision; bad character kills deal	Use of 6C's for micro and small loans, and 7 step analysis for medium loans, Extensive reliance upon character check	5 C's; character and capacity dominate	Character check is a screen; interview concentrates on this; one year of profitable business in Baku required, collateral coverage; loan officers use banking contacts to check references of the borrower. Use of 5Cs;	Internal financial statements for small loans; rough data for express loans; 5C's used;	Character check dominates;	Use of 5 C's. Cash flow and collateral are main determinants.	Use of 5 C's. Cash flow and collateral are main determinants.

Session/Concept	**BRAC Bank**	**ACLEDA**	**BRI**	**SBI Small Business Finance**	**INECO**	**SAS DEL (Express)**	**K-Rep Bank**	**SOA Kredit**
Monitoring	Use of cell phone messaging technology. Customer Relationship Officer (CRO) and all the supervisors at the unit office level visit monthly	Use of technology, frequent visits by lender, daily reports shared throughout the group	No set schedule, but continuous discussion-borrower pays loan at unit office;.	Monitoring schedule reflects perceived risk of loan; loan officers (LO) monitor the loan; dedicated monitoring officer and LO monitor performing portfolio;	Has a trained back office in monitoring and conducts monitoring of performing portfolio.	LO monitors according to specific schedule set at loan closing.	Monitoring officers in branches have established schedule. Individual Advances Officer are monitoring their respective sub-portfolios	Monitoring Officer has set schedule for new and existing loans.
Port. Mgmt.	Risk management department in place. 100% pre approval audit is being done.		On line weekly mgmt reports; Risk management department in place; risk rating for larger loans; not for micro, may be applied for medium;	Management information system in place for mgmt.	Tracks concentrations by product, industry and currency	Tracks concentrations by industry, has limits; port. Is risk rated;	Credit Officer monitors portfolio with a number of reports.	Extensive portfolio management reports including concentration reports.
SME Loan Portfolio as of December 2007	USD 279.93 Million	Medium loan $128 million, Small loan $73 million	$ 5.1 billion	Not applicable	Small: $9.4 million Small Business: $10.1 million	$3.5 million	$ 30.3 million	$4.8 million

Annex B - ShoreBank International's Developing Enterprise Loan (DEL) Methodology

SHOREBANK INTERNATIONAL

ShoreBank International's lending consulting services are based on working closely with the partner financial institution (FI) to determine the FI's needs and outlining an action plan to meet the agreed upon goals. Over the years ShoreBank International (SBI) has found that changes in some of the FI's existing policies and procedures, along with some new methods to analyze borrowers, provide a big step in meeting the defined goals.

SBI trains lenders to place greater emphasis in their loan analyses on the borrowers' real capacity and readiness to service commercial loans than on collateral. This is achieved through cash flow projections construction and analysis prepared by the loan officer based on client interviews, reviewing real books, and approaching the business from a 360 degree view as well as a "know your borrower" approach to the small business and its management. A properly constructed cash flow will reflect the borrower's *real* loan repayment capacity, a result that is not always evident in historical audited or accountant prepared financials due to poor accounting standards as well as practices that seek to minimize reported profits.

SBI also instills the importance of monitoring loans on a regular basis after the loan is funded, including onsite visits to the place of business by the loan officer on a monthly basis usually a few days before repayment is due. SBI consultants work to change loan officer behavior, transforming function-oriented analysts into client-oriented relationship managers.

Within this guideline SBI has established two types of products, the SME and Individual Loan, called the Developing Enterprise Loan (DEL). SBI saw the need to fill the gap between the formal banks and MFIs. The 'bridging gap' or 'missing middle' loan, called the DEL was created to encourage the formal banks to move downscale and the micro institutions to move upscale where they would eventually fill the financial access gap and serve a new type of client. The DEL allowed growing businesses formal financial access, shorten the time period from application to disbursement, and establish a simple system for less complex business financial needs to be fulfilled. Also, it was hoped that a growing business which was able to establish credit history with several DELs could eventually grow into a SME loan.

Developing Enterprise Loan

Organization and Structure of the Credit function

a. Identify specific points of responsibility in:

   i. Marketing – This function is carried out by all employees of the financial institution in their daily routines and dealings with clients, donors, other organizations, partners, etc. The client marketing function is primarily carried out by the credit officers and loan administrator. For this purpose, the credit officer develops a marketing plan each month or quarter which is reviewed with their supervisor before the start of the period. At the end of the period the credit officer fills in the marketing tasks completed and their supervisor checks it for thoroughness, completion of tasks and impact. Thus if the credit officer concentrated on cold calling yet only a small percentage of their clients actually were a result of cold calling, then the supervisor would change the marketing methodology based on the greatest impact.

ii. Initial screening – DEL clients can be screened in person at the financial institution or at the place of business, or by telephone, which ever is more convenient for the client. Since the credit officers spend most of their time in the field this function is usually carried out by a full time loan administrator or in some partner institutions by rotating credit officers who have one day per week or one half day in the office to cover this function. The screening is accomplished by completing a screening form which must include the basic eligibility for lending and questions about the business. This process is designed to make the institution more efficient by only taking eligible borrowers to the next step.

iii. Loan Analysis – The credit officer completes the loan evaluation using a preset form which prompts them to ask the pertinent questions. This form is completed at the time of the site visit to the business and usually takes a couple of hours including pouring over all the internal books of the client to complete the financials.

iv. Documentation and disbursements – From the first screening and site visit the credit officer begins a file on the client which includes as the first page a File Checklist. The File Checklist is a list of all the documentation needed to fulfill the loan conditions. It is listed in a specific order which has been predetermined by the FI and specific country's laws and regulations. A checklist makes it very easy for the credit officer and manager to quickly review the status of a loan from initial site visit, approval, disbursement, monitoring, to final repayment. It ensures that the records are well documented in an easy to read format and each item ticked off is actually in the file in the same order listed on the Checklist, with the date collected and signature of the person depositing it ensuring that there is a responsible party for completing it properly.

v. Loan approval – The credit officer is responsible for submitting loans to the credit committee which is made of senior management usually at least 24 hours prior to the credit committee's designated meeting time and day. In some financial institutions each level of authority (credit manager, branch manager, senior credit manager, deputy director, director, and board) has a maximum credit approval sum. This usually depends on first the capabilities of the managers to analyze and understand credit approvals and the communication sophistication level (i.e. have good, cheap telephone and internet connections). During this process the loan officer must present everything about the client and business including weaknesses, risks, and mitigating factors about which the credit committee can make an educated loan decision. Loan approval also involves setting the terms and conditions for the loan disbursal and repayment.

vi. Monitoring – SASI believes that monitoring is one of the most important aspects for promoting good loan repayment. A good loan can go bad with poor monitoring practices and a bad loan could go well with good monitoring. Monitoring involves two aspects. First is to build a good relationship with the client so that the credit officer will hear first hand from the client when there is potential for the loan to be in trouble and for marketing purposes. The current client will be the source of new clients if they like your institution and method. Secondly, the credit officer should be aware of the impact the loan has on the business and in general how the business is performing versus expectations in the financial cashflow forecast. During the disbursement process the credit officer and manager decide on the monitoring schedule for the specific client depending on prior credit history with the FI, loan type and size and other risk factors. Monitoring is completed at the business site and a monitoring form is completed for each visit.

vii. Recoveries and work-outs – Rescheduling is rarely used and only suggested in very severe cases. The credit officer is responsible for the recovery and workout stage of the loans in the DEL. Recoveries and workouts are accomplished by working together with the client to come up with a practical solution where the client can repay within the current repayment schedule or at a slower pace, but with penalties. The main point of recovery and workout is to make the client want to keep repaying something every month and not let them get too discouraged where they stop payment completely. Some institutions turn the loan over to a workout specialist after 30 or 60 days to separate the duties of the credit officer and recovery of loans as recovery of loans often is extremely time-consuming. In this case the credit officer is penalized for the turnover and workout specialist is rewarded for quick collection. The last important point regarding workout is that every client meeting and decision made must be very well documented in the file so that any person picking up the file could ascertain the recovery process and agreements made between the credit officer and client.

In ShoreBank's experience, DEL's target market typically falls within the following parameters:

Type of business: All economic sectors (trade, services, manufacturing, very rarely agriculture)
Age of business: Start-ups and growing companies less than 10 years old
Size of business: Two to 20 employees; $10,000 - $100,000 USD in sales per annum
Use of funds: Working capital, business acquisition, fixed assets, etc.
Collateral: Limited collateral and/or owner's equity

Typical Product Features
Loan terms: Six to 24 months
Loan size: Range of $1,000 to $30,000
Typical interest rate: Market rate, with adjustable risk premium

These parameters are not rigid and are meant to serve as a general guideline for the typical small business target market and product range. These may differ from country to country.

DEL: Step By Step Timeline

Steps	Days to Approval*
IDENTIFICATION AND INTRODUCTION OF A NEW CUSTOMER	
First client contact – screening with Loan Administrator	
Loan Officer aids the client in completing the Application in the office and reviews cashflow with client	
Loan Officer conducts site visit, completes checklist and initial cash flow together with the client	1 day
Loan Officer discusses client with the Manager and decides whether to proceed	Same day

or reject	
Loan Officer starts file for client	Same day
CREDIT ANALYSIS	
Loan Officer drafts Financial Statements	Same day
Loan Officer completes due diligence by carrying out reference checks of suppliers, customers and where possible, bank records of customer, and checks market and competitors	Same day
Loan Officer meets guarantors and checks collateral	1 day
Loan Officer completes Loan Analysis Form (describes the proposed loan, analysis of business, motivation to repay, risks and why it makes good business sense)	Same day
Loan Officer and Manager identify which outstanding issues remain and decide whether to continue with this client	Same day
Loan Officer analyzes final cash flow, income statement and balance sheet prognosis and structures the loan accordingly and completes analysis, write-up, and makes final documentation check and checklist is filled in	Same day
Manager reviews and comments and final version prepared for Credit Committee	Same day
Manager and lawyer review all final documentation and signs off on form after which Program Manager sends final loan analysis and signed form to SAS Credit Committee	Same day
APPROVAL AND DISBURSEMENT	
Submission to Credit Committee	1 day
If approved, signature on approval form with conditions	Same day
Client informed of loan decision	Same day
Loan Officer requests any additional documentation required to fulfill conditions and for closing	Same day
Client with the Loan Officer and Lawyer arrange collateral registration and insurance documentation	Varies according to client
Lawyer prepares loan and collateral agreements with Loan Officer's involvement	Same day
Loan Officer walks client through disbursal of loan proceeds at the bank	Same day
Loan Officer follows through on fulfillment of all conditions of loan disbursement	Same day
Loan Officer completes closing checklist	Same day
Manager checks all documentation and conditions and signs off on the Condition of Fulfillment / Disbursement Request	Same day

Documentation signed with client (and guarantor(s))	1 day
Repayment schedule provided to client	Same day
Loan disbursed	Same day
TOTAL # OF DAYS (not full working days) **	**3- 5 business days**

* Number of days is not necessarily full days spent completing each task.
** Disbursement conditions may prevent loans from being disbursed quickly due to client needing to collect documentation and lengthy legal and collateral processes in some countries.

Annex C – Example of Bonus Structure

I. General Provisions

- The performance bonus will be paid on a monthly basis. It will generally be paid on the 14th of the month following the end of the month to which it applies. If the employee leaves before the end of any month, s/he will receive the prorated share of the monthly bonus corresponding to period s/he has worked. The departing employee will then receive his/her bonus on the last working day after having settled all other advances and other matters with the financial institution. The bonus will not be paid if the employee does not give one-month notice or does not complete all outstanding assignments satisfactorily. **Bonuses will be based on data in the loan administration system.**
- *The bonus depends on three main factors— portfolio health, amount disbursed, and a management assessment regarding the quality of the employee's work and customer service.*

Loan Officer's performance bonus awarded to individual loan officer according to the following table:

Loan Amount Disbursed per Month per LO USD	**AZM**
$50,000	**XX**
$60,000	**XX**
$70,000	**XX**

The following standards must be met to be eligible for any bonus award. Failure to meet the minimum performance requirements two months in a row may result in termination of employment.

<u>Requirements</u>:

- PAR 30 may not exceed 1.5% as per report from loan administration system.
- Minimum loans made: 2 for Q1-2 and going up to 3 in Q3-4.
- Minimum of 1 new client per month.
- Marketing completed– to be determined by Manager.
- Monitoring completed- to be determined by Monitoring Officer.
- Special individual targets may be added by the Manager.

In addition, the quality of the credit officer's performance and participation during the month must have been satisfactory according to a determination of the CEO, Deputy CEO, and/or Manager. Areas for particular attention include the following:

- Loans must be monitored per the current Monitoring Policy and the monitoring form must be completed properly and filed each month. Monitoring forms must be delivered to the Loan Monitoring Officer by the due date.
- All disbursals must be physically monitored and documented in files within 3 days of disbursement (or when the proceeds are to be used) to check use of loan funds.
- The Loan Officer must undertake and document any necessary marketing visits to organizations, associations or agencies to discuss/present financial products each month. Each staff member must undertake any required targeted cold calls to individual

businesses and document them properly, and ensure that his/her portfolio has adequate representation of different types of businesses.

- Loan officers are responsible for completing required reports on time (per due date calendar), properly and accurately. Loan files should be neat, organized and complete.

Management reserves the right to temporarily withhold or withdraw a bonus. If all quantitative indicators are achieved, but the Loan Officer's quality of performance is unsatisfactory, the bonus will be denied or reduced and the CEO, Deputy CEO, and/or Manager will submit a written statement as to the reasons for denial or reduction of the bonus.

If a bonus is denied or reduced, a memo will clearly state the reason and will be approved by the Manager and CEO or Deputy CEO. The reasons may include, but are not limited to, poor performance of the LOs' overall portfolio (PAR30 % > 1.5) and any hint of malfeasance, misconduct or negligence which does not necessarily need to be supported by evidence. This can be a subjective assessment of performance but it provides management the ability to deny a bonus if such a decision is deemed to be in the overall interest in the company.

Annex D – Repayment Methodologies

Two basic methods were used by the financial institutions reviewed to establish a small business' ability to repay a loan:

- Income: For microenteprises, repayment capacity is developed by first calculating the borrower's total net income, which includes both the business' and family's total monthly income and expenses. Then, borrower's debt servicing capacity is determined as a percentage of estimated monthly income. Both BRI and BRAC Bank use an installment ratio of 75% of estimated monthly income to arrive at the monthly installment payment. The calculated maximum installment payment multiplied by the term of the loan (number of months) equals amount of loan. Ratio analysis and financial projections are not made. The lender's focus is to determine the correct amount of the business' and family's total income and expenses.

- Debt Service Coverage: K-Rep Bank and Ineco use a cash flow method where annual business cash flows are analyzed. The debt service coverage ratio, which is defined as total annual net business cash flows divided by total annual debt, must be in excess of a specific number. In the case of K-Rep Bank, the preferred debt service coverage ratio is in excess of 1.2. The DEL methodology also uses a debt service coverage ratio. If the financial institution is using projections to develop the debt service coverage, the justification for the amount of cash in and cash out must be explained in detail. Family expense and income are not used in this calculation.

Annex E – Site Visit Report Template

Business Site Visit

Date of visit?	
Who attended from the business?	
Description of the premises? Size? Condition?	
Level of activity / utilization of equipment during your visit?	
Current inventory levels (quantity and amount USD)? How did you verify this? Storage conditions?	
Business facility owned or rented? Rental contract through loan period?	
Amount of cash on hand? How did you verify this?	
Impression of management on the site visits?	
Customers present? Were they buying? Did employees attend to customers in a professional manner?	

Other comments:

Include additional information to which you wish to draw the credit committee's attention.

Personal Residence Visit

Date of visit	
Who attended from the family?	
Living conditions?	
Is the salary/income verifiable based on the living conditions?	

Annex F - Risk Rating Matrix Template

Grade	**1/Excellent**	**2/Good**	**3/Acceptable**	**4/Normal Monitored**	**5/Highly Monitored**	**6/Substandard**	**7/Problem Loan**	**8/Loss**
To add points and arrive at a credit letter grade, give the applicable box in each column the points indicated at the top of the matrix. Monitoring and reporting guidelines are reflected under Monitoring.			**Risk Rating Matrix: >7=1/Excellent, 8-14=2/Good, 15-21=3/Acceptable, 22-28=4/Normal Monitored, 29-35=5/Highly Monitored, 36-42= 6/Substandard, 43-49=7/Problem Loan, <49=8/Loss**					
Operating Margins/Cash Flow DSC = debt service coverage calculations are based on historicals or projections that include our loan using EBIT.	Highly profitable firm, repayment ability is unquestioned. Historical cash flow indicates no difficulty in servicing debts. Substantial margins exist to cover any contingencies. DSC is 2x or better for previous 2 years. Must have at least 3 years of operating history.	Profitable firm with a track record of servicing debt. Historical statements indicate that the firm will have little difficulty generating sufficient cash flows to service all debts including the new loan. DSC is a minimum of 2.0x based on historical cash flows.	Financials should clearly demonstrate profitability and ability to service all debt including ours. Previous year's results indicate firm can generate sufficient cash flow, with thin margins for contingencies. DSC is a minimum of 1.5 x on either a historical or projected basis	Improvement in financial performance is needed to improve debt service projections. Historical or projected DSC is at a minimum of 1.1 x. There is little to no margin for contingencies.	Borrower generally makes payments on time, but a late payment may be received from time to time. DSC is .9x or worse. All performing restructured loans will be graded as a minimum of a 5.	The likelihood that the loan will be paid from the primary source of repayment is uncertain. Loan has been restructured.	Borrower is unable to make loan payments. Primary source of repayment is gone. The process of legal recovery has begun.	Amounts recommended for Write Off. Classified as a loss because is it neither practical or desirable to defer full provisioning even though partial recovery may be possible at some time in the future.
Balance Sheet	Firm has strong financial ratios. Strong overall balance sheet with strength coming from annual capital injections from retained earnings.	Strong balance sheet with higher than average debt to equity ratio, satisfactory working capital, and significant net worth. Probability of serious financial deterioration is unlikely.	The firm has a higher than average debt to equity ratio, adequate working capital, and acceptable net worth.	Slightly higher than average debt to equity ratio (50%), average current ratio of 1.0, and little working capital. Occasionally has an unexpected need for working capital.	The firm has a high debt to worth ratio, negative working capital, and is slow in paying creditors.	Financial deterioration is under way and very close attention is warranted to ensure the loan is collected without loss. Loan is inadequately covered and paying capacity of the obligor.	Client is highly indebted. Negative working capital. Client is not paying creditors.	

Grade	1/Excellent	2/Good	3/Acceptable	4/Normal Monitored	5/Highly Monitored	6/Substandard	7/Problem Loan	8/Loss
Management/ Credit History/Character	Unquestionable character. 5+ years experience in the same industry. Excellent track record, financial performance and budgeting ability. The firm is well led, recognizes the value of a quality workforce and provides employee training, benefits and performance incentives.	Proven experience in the same business, who has management experience and a good track record. The business must produce adequate financial statements on a timely basis. The Managing Director or Owner demonstrates an ability to manage the firm's working capital and term financing.	Firm is under the control of a Managing Director or Owner who has the ability to manage firms of this type. Managing Director or Owner follows through with all promises or commitment made. Adequate management depth and no organizational shortcomings.	Firm is under the control of a Managing Director or Owner whose ability to manage firms of this type is unproven. Character flaws not noted.	The firm is under the control of a Managing Director or Owner has questionable knowledge or resources to help the company become more profitable. Managing Director or owner has not been totally honest. Serious organizational shortcomings are probable.	Management is inadequate, lacks depth, and there are serious organizational shortcomings.	Managing Director or Owner has lost control.	
Collateral/Secondary Source of Repayment	Strong collateral in the cash deposits, stocks, bonds, and cash equivalents. Discounted value greater than 120% of loan amount.	Discounted value of the collateral is a minimum of a 150% and easily realizable.	Discounted value of the collateral is between 100% - 150% and is undoubtedly sufficient to pay the loan, but delays and difficulties would be imminent through realization.	Discounted value of the collateral coverage is a minimum of a 100% and is perceived as adequate to pay the loan, but delays would be imminent through realization.	Discounted value of the collateral coverage is a minimum of a 90% and may not be adequate to pay the loan. Delays are in realization are imminent.	Discounted value of the collateral coverage is less than 90% and is inadequate to pay the loan.	Discounted value of the collateral coverage may be less than a 50% and is definitely inadequate to pay the loan.	

Grade	**1/Excellent**	**2/Good**	**3/Acceptable**	**4/Normal Monitored**	**5/Highly Monitored**	**6/Substandard**	**7/Problem Loan**	**8/Loss**
Industry, Market, Competitive Advantage	Business is operating in an environment that is enjoying good economic times. Most firms operating in this industry making good profits and profits would not be significantly impacted by recession.	This business is part of a profitable industry that is enjoying good economic health. It is not a cyclical industry and would not be significantly impacted by a negative economic trend.	This firm is part of a reasonably profitable industry that is presently enjoying good economic health, but is cyclical and would be somewhat impacted by a negative economic trend. This is a competitive industry and only the better-managed firms will get through downturns without suffering significantly.	This is a tough business in which to make a profit. It may be a fiercely competitive business, one presently experiencing an economic recession, or a cyclical business in which company profits would be significantly impacted by a negative economic trend.	Business has seen a downturn to due commodity prices, rate sensitivity, and has been significantly impacted by a negative economic trend.	There have been significant deterioration in market conditions and the borrower is highly vulnerable to these conditions.	Significant deterioration in markets has manifested itself in severe weakness in the borrower.	
Produce Financials	Audited Financial Statements with an unqualified rating and management accounts produced annually.	Compiled Financial Statements produced annually.	Client produces regular and adequate internal financial statements, including a budget.	Client does not always produce timely or fully reliable financials. Loan Officer provides assistance in the development of the financials. Client has stated that they are willing to produce financials in the future.	Client does not produce financials statements but does provide Loan Officer to financial information to understand situation.	Client does not produce financials statements but Loan Officer is able to obtain a minimal amount of financial information to make a decision.	Client has never provided financials and is not cooperative. Financials provided are unreliable and Loan Officer questions reliability. Bank has very little idea of actual company financial position.	
Monitoring	Minimum of annual monitoring with one visit.	Minimum semi-annual monitoring with one visit.	Minimum monitoring on quarterly basis with one visit.	Minimum monitoring on monthly basis (alternating between phone call and site visit.)	Clients will be monitored and visited on a monthly basis.	Clients will be monitored weekly and visited on a monthly basis.	Business unit will work closely with legal during the realization period.	

Annex G - Loan Monitoring Report

Loan #		**Name of Borrower**		**Amount of Loan**	
Loan Officer		**Company Name**		**% rate / Term of Loan**	

	Visit #:		Comments
	Visit Date:		
1.	Purpose		
2.	Borrower present at visit?		
3.	Quality of Financial Reporting (1=poor, 3=satisfactory, 5= superior)		
4.	Reporting month (i.e. 7/99)	/	
5.	Monthly Sales (Cash in)	$	
6.	Monthly Expenses (Cash Out)	$	
7.	Monthly Operational Cash (3 – 4)	$	
8.	Mo Operating Cash Forecast in CF	$	
9.	5 / 6 (< 90% check #17 and inform manager)	%	
10.	Current Inventory Level	$	
11.	Actual Cash in hand	$	
12.	Total A/P outstanding? Any significant difficulties?	$	
13.	Total A/R outstanding? Any significant difficulties?	$	
14.	Last Repayment on time without any penalties or delays?		
15.	# of days overdue (> 0 then #17)	Days	
16.	Liquidity or Value of Collateral Changed		
17.	Follow-up needed (fill in Problem Asset Report)		

Visit Results/Comments: (have the disbursement conditions been met – how? and any significant changes in the business such as: new competitors, customers, suppliers, premises; new capital expenditures; COGS changes; sales price changes; marketing; change in sales volume; economic conditions)