PROCEEDINGS

Bridging the Last Mile in SME Financing

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Panelist 3: Moses Gitau, Head of Business Banking, Co-operative Bank of Kenya Limited
Panelist 4: Sally Gitonga, Country Manager, Business Partners International

Executive Summary

"Bridging the Last Mile"[1] in SME financing is fundamental, considering the key role of SMEs in transforming economies. "Bridging the Last Mile" means focusing on the segments in SME finance that remain underserved. There are many. Sometimes there are geographic challenges because of the many countries and regions that are characterized by fragility, conflict and violence. Geographically, rural SMEs can also be difficult to target and serve. Gender is also an issue, as women-led SMEs tend to be underserved. Many developing countries have large numbers of very small enterprises and informal enterprises that also tend to be underserved.

IFC has provided support to several programs across Africa that have been proven successful in combining investment with capacity building. Some of the most frequent challenges that financial institutions face in dealing with SMEs include risk issues and understanding the customers and their unique approach to conducting business.

The SME Sector

- Many segments of SME finance remain underserved.
- The role of SMEs in the economy, specifically their contribution to gross domestic product (GDP) and employment creation, is quite significant. For example, in the financial sector, 70 percent of business comes from micro, small and medium enterprises (MSMEs), with around US$1.5 billion from microenterprises and $US4 billion from SMEs. At the same time, they are probably the most underserved segment of the economy because of the

[1] "Bridging the Last Mile" refers to the final and often expensive and time-consuming step in a process.

high levels of risk involved in SME lending. For SMEs, non-performing loans (NPLs) can typically reach 7-10 percent, which is very high compared to the corporate segment.

- Other than investment and finance, access to markets is another important requirement for SMEs. If a company does not have access to the market, it cannot be viable. Therefore, efforts should be directed to linking SMEs to markets through value chains or warehousing.
- Many SMEs, particularly those located outside of major cities, face challenges in gaining access to power and energy infrastructure.
- The SME sector must be organized, and appropriate legislation should be in place. SME capacity should be formalized, just like any other sector. Ultimately, this will make SMEs more bankable.

The IFC's Role

- IFC has been engaged in SME financing for the past 20 years. Its first SME loan in Africa was a single investment in 1976 with the KCB Bank Kenya Limited. In 2005-2006, IFC launched the Africa MSME Program to enable banks to provide financial products and investment and advisory services to this untapped market. For each of the more than 20 investments that were made over a 5-6-year period, a resident advisor worked directly with each of the banks to develop a SME department with all the necessary tools.
- In recent years, IFC has focused on securing more resources to sustain SME development in terms of de-risking, first-loss, pricing incentives and capacity building. One of the programs for the Global SME Finance Facility, funded by British Petroleum (BP) and others, raised US$200 million to address these issues.
- International Development Association (IDA)18 has allocated US$2 billion to the IFC to sustain its investments with banks serving SMEs. Of this amount, US$1 billion is destined for de-risking and local currency financing because some banks that manage risk on the balance sheet can accept dollar funding, but ideally local currency is needed.
- Banks need to have proper information to lend to SMEs. In China, ten years ago, no collateral registry existed. IFC provided support to update the database with millions of entries in just 3 years.
- In 2016, IFC provided US$2.8 billion to the financial sector, but direct investment is around US$5 billion, with 60 percent of that amount going to SMEs. In Africa, the SME portfolio for banks is about US$1.7 billion, with more than 10 financial institutions. In addition, US$34 million is directed to 33 active MSME advisory service projects. A significant portion of this money is also destined to digital financial services (DFS), reducing the cost of involving more smaller customers. DFS can potentially do what mobile telephones did for telecommunications in Africa.
- One of the hallmarks of IFC's Africa Program is the focus on SMEs and the recognition that the advisory and the investment services need to be combined in building capacity of their partners.
- IFC frequently uses partial risk and credit guarantees to address the issue of banking liquidity and credit risk. It creates a de-risking pool of money to allow banks to do more for SMEs.

Cooperative Bank of Kenya Limited

- In 1968, a group of peasant farmers came together with the intention of forming their own bank. The President at the time helped them to raise capital, and they opened their doors in 1968. The bank's majority shareholders were peasant farmers. In 1994, they received a license to operate as a fully-fledged commercial bank, the Cooperative Bank of Kenya, and welcomed other/new sectors, individuals, corporates and diaspora clients.

- The cooperative movement in Kenya is the largest in Africa, with over 22,000 registered cooperatives.
- The Cooperative Bank of Kenya currently have 7.1 million customers. When taking into account all family members, the bank has an impact on over 30 million Kenyans. Of the 22,000 cooperatives in Kenya, around 500-700 are Savings and Credit Cooperative Organization (SACCOs). In fact, some are even larger than Tier 2 and Tier 3 banks in Kenya. Some have bought out banks, with the cooperative running advisory services for them.
- In 2008, the bank was listed on the Nairobi Stock Exchange, and maintains the ownership 65 percent ownership by the cooperative movement in Kenya.
- In terms of "Bridging the Last Mile", the cooperative bank has developed a mobile platform that enables it to service customers, with a cooperative switch that connects SACCO members with the cooperatives. SACCO members can then run their accounts through a cooperative bank or agent.
- With a large number of customers, cooperatives found that most clients were going to the branches for very basic needs. They decided to launch a branch transformation and encourage customers to use alternative banking channels, such as agents and mobile banking. Today, 84 percent of their transactions are conducted through these alternative channels.
- The implementation of new banking channels means that customers spend less time waiting in a bank queue. This is particularly important for SME owners that may need to close their businesses while they are running errands. The cooperative, Kwa Jirani (neighbor in Swahili), are the next-door agents with whom customers can make their transactions.
- The bank's 10,000 agents are also MSME owners that have a second line of revenue. The agents are empowered to sell through a salesforce effectiveness program. The SFE program entails training of the Agents, their employees and the bank agent support team on the expanded banking services offered by the agents. This includes account opening, insurance & loan application further to the normal transactional services of cash in & cash out.
- The bank has been a beneficiary of the IFC credit programs with the latest being US$15.2 million in January 2018 targeting the MSME sector.
- The bank is also a beneficiary of the IFC SME advisory services currently ongoing since October 2016. The program aims at transforming the MSME services offering for co-operative bank.

Gulf African Bank (GAB)

- The Gulf African Bank began operations in Kenya in 2008. At first, the bank struggled to define a structured plan vis-à-vis SMEs because it had people from different backgrounds and cultures. In 2014, the GAB signed a consultancy agreement with IFC that helped in segmenting its customers properly, specifically by analyzing and understanding the different types of risks and dynamics in each region's markets. IFC also maintains an equity share in GAB.
- During the first few years, the GAB doubled its SME portfolio. Today, its lending portfolio is 70 percent corporate and 30 percent SMEs — with plans to turn these numbers around, that is, with the majority of the portfolio going to SMEs. In this context, since every bank's definition of SMEs is different, larger banks might view GAB's clients as largely comprised of SMEs.
- Considering that most SMEs tend to be family businesses or formed by sole proprietorships, they face the challenge of sustainability. With an expected short lifespan,

owners often think that there is no need to keep proper books or records, especially since there is a great amount of fear surrounding the Kenya Revenue Authority (KRA). The lack of records also poses an obstacle to lenders looking to finance this segment of the SME market.

- Kenya's government has made improvements in some areas pertaining to SMEs and financial inclusion. Today, the Constitution states that 30 percent of all government contracts must go to women, youth and persons with disabilities. However, challenges persist, given that only 2 percent of the land in Kenya is owned by women. Moreover, men find ways of circumventing the 30 percent contractual rule.
- The GAB has implemented a program that offers unsecured loans for women, youth and persons with disabilities that are backed by government tenders and Local Purchase Orders (LPOs). The first loan can be made for up to 3 million Kenyan Shillings (US$30,000 equivalent). If it is successful, a second loan can be made up to 20 million Kenyan Shillings (US$200,000 equivalent). These loans have the lowest default rate within the GAB's portfolio.

Business Partners International (BPI)

- BPI began operations in 1981 in South Africa as a risk capital financier, working as a complement to banks. Its mandate was to support the development of the small business sector through customized financial solutions, mentorship, and technical assistance in capacity building. BPI views itself as complementing the banks and other financial service players.
- A pilot project was implemented in Kenya and Madagascar with the expertise of BPI in South Africa, and funding from IFC and two development finance institutions (DFIs). After the Kenyan project's 10-year fund successfully closed, new engagements were made in Namibia, Malawi, Rwanda and Zambia. Moreover, a permanent vehicle has been established in Kenya, Rwanda and Uganda, and the plan is to continue expanding the footprint to become truly pan-African.
- Some SME challenges include capacity constraints, a lack of efficient financial management systems, and the inability to meet collateral requirements. Financiers seeking to work with these businesses must also become advisors, and this comes with a cost. BPI's model operates in this difficult space by providing interest-free capacity-building, technical assistance funding, and financing when there is no collateral.
- BPI provides SMEs with financing at a price that could be higher than the market, but it structures its funding using mechanisms to include a mix of debt and equity. These self-liquidating instruments enable BPI to fund SMEs and still receive a return. The model has been successful, with 2,000 active clients and yearly disbursements of over US$100 million.

How to "Bridge the Last Mile"

- The "Last Mile" revolves around how to develop the next set of products that can better serve SMEs. For instance, many SMEs have great ideas and capacity, but no collateral. It is also important to keep in mind that different segments of the population may have different needs. For instance, IFC is a partner and shareholder to one of the first Sharia (Islamic) banks in Kenya. Indeed, Islamic banking is becoming a significant segment in many countries.
- The topic "Bridging the Last Mile" can be looked at from a variety of perspectives. From a physical distance perspective, it concerns how to go from cities to villages. From a technology perspective, it concerns how to do banking in new ways. From a product

perspective, it may concern the design of new products to go beyond the old ways, perhaps encompassing a broader policy or environmental perspective.

- Financial institutions have the challenge of working with some of the riskiest, important sectors of the economy. Indeed, education, health and agriculture are some of the most challenging sectors. For instance, if a school is taken as a security itself, a bank cannot shut it down in the event of a default. The same applies for medical equipment or seeds that did not germinate in a crop. In this regard, insurance companies may not cover some of the risks in these sectors.
- Collateral issues need to be addressed. Even when there is collateral, it can be difficult to obtain compensation in case of default. Financiers need to provide financing to help SMEs deal with this issue.
- Another challenge is how to build SME capacity and skills. For example, many banks shy away from Greenfield projects because they do not know how to assume such a risk.
- NPL levels are higher in the SME sector. However, only a half or a third of the NPL levels actually translates into losses.
- There is no simple answer as to how to segment SMEs. It is necessary to look at the economic structure and the nature of their economic activities. The new approach is not to segment based on annual sales turnovers. BPI defines SMEs as those who need funding from between US$50,000 and US$1 million.
- International Financial Reporting Standard (IFRS) 9 presents a challenge because it requires banks to provide funding from the very start. In this context, the biggest problem for Kenya is the interest rate cap that came into effect in 2016.