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Banking Practice

Micro-, small and medium-sized enterprises in emerging markets:

how banks can grasp a $350 billion opportunity

Mutsa Chironga
Jacob Dahl
Tony Goland
Gary Pinshaw
Marnus Sonnekus

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Executive summary

This paper argues that the time is right for banks to step up their efforts to serve micro-, small and medium-sized enterprises (MSMEs) in emerging markets. There are three reasons for our optimism. First, an estimated 60 per cent of global banking revenue growth over the next decade will lie in emerging markets. Second, more and more banks in emerging markets are finding ways to overcome the difficulties of serving the important MSME segment. Third, innovations in technology, risk assessment and business models are increasingly facilitating their effort.

It is not just banks in emerging markets that should grab the opportunity. Western banks will find innovative practices that they can use to refresh and adapt their traditional banking models back home.

The size of the opportunity

Emerging market MSMEs looks a very attractive segment. We estimate that bank revenues could jump from $150 billion in 2010 to ~$367 billion by 2015 – a growth rate of 20 per cent per annum (**Exhibit 1**).

Exhibit 1

MSME banking revenues are $150 billion today and are expected to more than double over the next 5 years (20% p.a. growth)

MSME bank revenues, $ billions

Regions	2010	Growth 2010–15[1]	2015	CAGR %
East Asia	62	105	167	20
South Asia	20	44	64	21
Latin America	27	33	59	18
Sub-Saharan Africa	5	7	12	19
MENA	6	9	15	18
Eastern Europe	30	19	49	14
Grand Total	150	217	366	20

1 2010–15 nominal GDP growth plus growth in financial inclusion (growth 2005–10 extrapolated to 2015) plus growth based on convergence between developed and emerging markets product penetration (refer to technical annex)

SOURCE: McKinsey Global Banking Pool (GBP); IMF Financial Access Survey; Honohan 2008; McKinsey analysis

Three factors will be responsible for this expansion: high GDP growth in emerging markets, increased penetration of the large number of unserved and under-served MSMEs and an increased take-up of more advanced and higher revenue banking products.

The inherent challenges of serving MSME bank clients – low revenue per client, high risk of credit losses and the need for a physical presence to lend to MSMEs – are no longer the obstacles they used to be. Revenue growth should therefore be profitable. Our research revealed that a few leading emerging market banks are making returns on equity (ROE) of over 30 per cent in the MSME segment, and many others are earning 20–30 per cent.

Five leading practices

We believe winning banks will do one or more of the following five things:

- **Develop a granular understanding of their markets.** With MSME clients typically widely dispersed banks must identify clear geographic concentrations of these businesses. It is equally important to understand the size of the potential banking revenue pool in the sectors in which MSMEs operate and the "nuance" of the financial needs of each sector.
- **Radically lower operating costs.** Given the low level of bank revenue per MSME client, banks have to find a highly efficient way of serving them. This requires bold new thinking in distribution (both remote and physical channels), product design and staff deployment.
- **Manage risk innovatively.** A people- and judgement-intensive approach to risk is likely to be too costly. Banks must develop new and creative ways to assess credit, such as psychometric testing, cash flow estimates, or qualitative credit assessment (QCA)[1]. All associated credit processes (e.g., loan origination, monitoring and collections) must be streamlined.
- **Empower MSME clients.** Financial and business illiteracy in emerging markets leads to poorly presented business cases, the single most important reason why banks decline credit applications. Banks should take the initiative to address this problem, for example, by organising seminars for existing MSMEs or providing start-up packages for new ones.
- **Engage with government.** Governments can be useful allies in overcoming challenging business environments – so banks must work with them by, say, establishing risk-sharing facilities and credit bureaus, or seeking out information that identifies under-served and unserved clients.

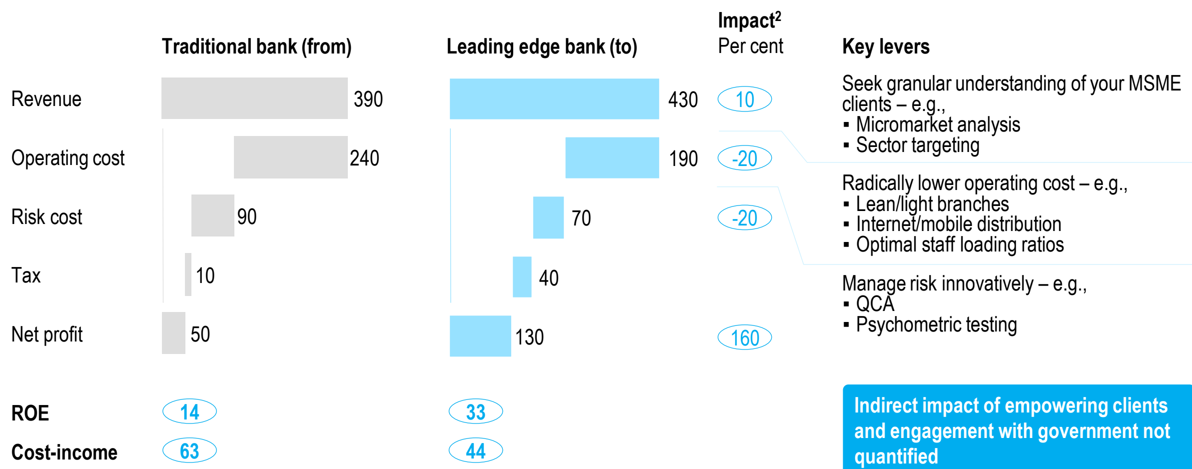
1 A McKinsey & Company proprietary risk-scoring approach where qualitative factors are added to risk models by a process of statistical, regression analysis, to establish whether the qualitative factors increase the predictive power of existing risk scoring models.

We believe these practices are complementary and that those banks adopting one or more of them will more likely be winners in the race to capture the emerging market MSME segment. We calculate that applying these practices could increase a bank's ROE in the MSME segment from ~14 to ~33 per cent and raise profits after tax from ~$50 to ~$130 million per annum (**Exhibit 2**).[2]

Exhibit 2

Applying the 5 leading practices can have a dramatic impact on bank economics, increasing ROE from ~14 to ~33 per cent

Year-5 comparison for start-up bank, $ millions[1]



1 Rounded to nearest $10 million, 2 Rounded to nearest 5%

SOURCE: McKinsey analysis

The strategic choices

Based on the size and growth of the MSME banking opportunity, we see three groups of emerging markets countries:

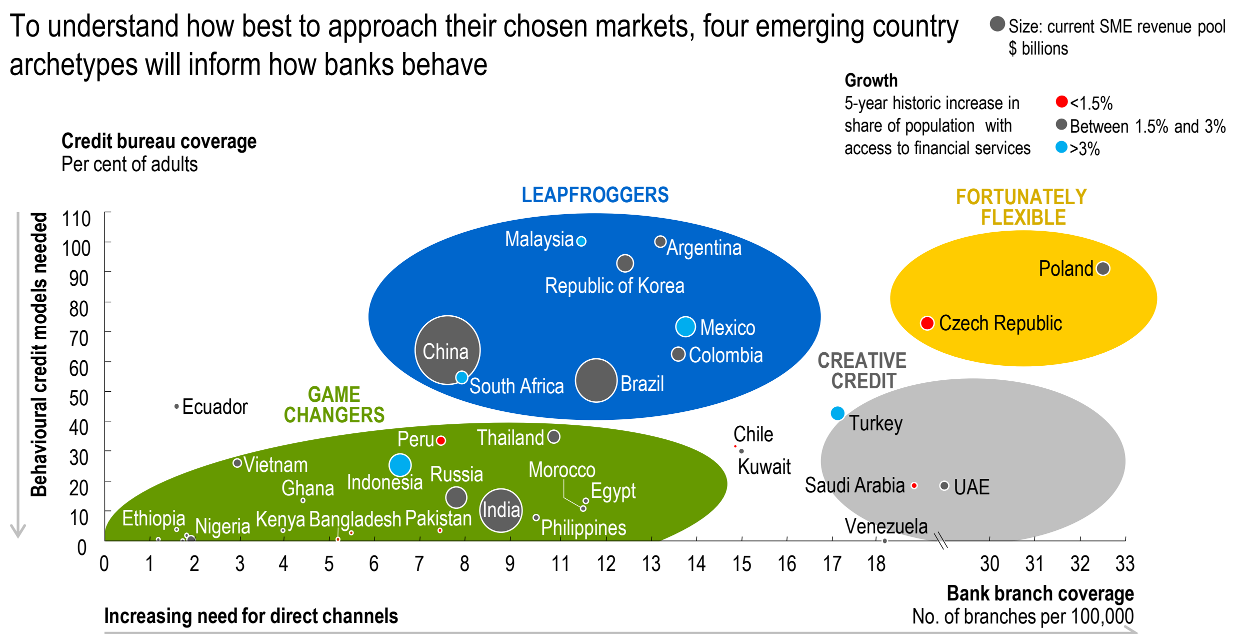
- "**Red hot**" countries have fast-growing, large and partly unserved MSME banking markets, such as China, India, Brazil, Indonesia, Russia and Mexico. Banks should invest disproportionately in these territories.
- "**Warm**" countries should see moderate growth in financial penetration[3] of, say, 1.0–2.0 per cent per annum, yet they still represent an exciting opportunity for banks. These include Thailand, Nigeria, Vietnam, Argentina and Chile.
- In "**cool**" markets, financial penetration is increasing at less than one per cent per annum. Countries in this group are either close to saturation point (e.g., Poland and the Czech Republic) or are yet to create the conditions in which MSMEs will really thrive (say Pakistan or DRC).

2 Refer to Our methodology (page 8) and Technical annexure (page 45).

3 Proxied by per cent of the population with access to financial services.

We have also developed archetypes based on barriers to distribution and the management of credit risk. "*Game changers*" are countries in which both distribution and risk management are challenging. "*Leapfroggers*" have high credit bureau coverage but under-developed physical distribution. "*Creative credit*" countries typically have good distribution and low credit bureau coverage. And "*fortunately flexible*" countries have advanced distribution networks and credit risk methods (**Exhibit 3**).

Exhibit 3



SOURCE: McKinsey Global Banking Pool (GBP); World Bank – Doing Business; IMF Financial Access Survey 2006–10; McKinsey analysis

Getting started

We see two main types of business models, though in some cases they could be combined. One is a *credit-led proposition with low-cost physical distribution*. Face-to-face contact with clients is critical, in addition to a strong end-to-end credit process. The other is a *payment-led proposition with direct channel distribution*. Banks that want to emphasise payment solutions in their MSME proposition will focus more on direct channels such as mobile, ATM and contact centres. In both models, all five leading practices should be applied, though their emphasis will be different.

No single agenda is equally relevant to the diverse range of institutions – incumbent banks, start-up banks and other financial players – that can capture the MSME opportunity. Nevertheless, the CEO of any bank bold enough to embrace the challenge faces the same key choices:

Is the emerging market MSME segment part of your bank's strategy?

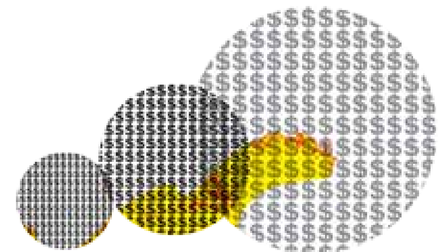
- Is the emerging market MSME segment part of your growth agenda? Does this segment have synergies with your current set-up and other business unit?
- Is your home market attractive enough or do you need to go cross-border to capture the opportunity?
- What is your bank's level of ambition for this segment in terms of earnings or market share? Is it commensurate with the size of the opportunity?
- How quickly can the MSME segment make a meaningful contribution to your bank's financials?

Does your bank have the required capabilities, and which ones will you have to build?

- Does your bank understand the MSME opportunity at a sufficiently granular level to attack it effectively?
- Does your bank have an appropriate, end-to-end risk management process for MSMEs, leveraging the latest innovations?
- Does your bank need to "change its game" in distribution to capture the opportunity profitably?
- Does your bank have a value-maximising coverage model to capture the opportunity fully?
- Does your bank have the innovative mindset required to serve MSMEs profitably and at scale?

Is your bank ready to execute at scale?

- Does your bank have the plan, processes and tools required to execute at scale?
- Does your bank have the talent and leadership to execute against the MSME aspiration? Does your bank attract people with the required skills and have a "factory" for developing relevant talent?



It is not just banks in emerging markets that should grab the opportunity. Western banks will find innovative practices that they can use to refresh and adapt their traditional banking models back home.

Introduction

The question of how to serve micro-, small and medium-sized enterprises (MSMEs[4]) in emerging markets is not new. Many practitioners – including commercial banks, non-profit microfinance organisations and venture capitalists – have searched for a winning formula over the years, with mixed results. Academics and policy makers[5] have written volumes on how to provide financial services to the millions of MSMEs around the world that remain unbanked or under-banked.

Why are we writing about this now?

We believe there is an interesting opportunity for banks and others to achieve a step change in their approach to MSMEs, in light of several factors.

First, we see increasing evidence that MSME financing has gone beyond social objectives and the role of microfinance institutions. In this article, we present evidence that an increasing number of private sector banks across emerging markets is attacking this segment, and that many of them are doing so profitably.

Second, banks around the world are looking to emerging markets for new growth opportunities. For example, in a recent publication, *The State of Global Banking – in search of a sustainable model*[6], McKinsey estimated that 60 per cent of global banking revenue growth from 2010 to 2020 will come from emerging markets. And within emerging markets, MSME is an under-served segment.

Third, innovations in technology, risk assessment and business models are happening at such a pace that we believe a breakthrough model, the "MSME bank of the future", is finally within our grasp.

The time is ripe not only for emerging market banking executives to look anew at the opportunity, but also for those in advanced market banks to view emerging markets as an innovation frontier with many leading practices that can be applied in their own markets.

This article lays out our perspectives as follows. In Chapter 1, we outline the size of the MSME banking opportunity across emerging markets. In the Chapter 2 we discuss five leading-edge practices in MSME banking in emerging markets. In Chapter 3 we present the strategic choices for banks keen to play in this arena. Based on these premises, in Chapter 4 we offer a possible version of the MSME bank of the future and its economics. We close in Chapter 5 with critical questions to address when moving to action.

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4 In this article, MSME refers to micro-, small and medium-sized enterprises earning a turnover of up to $3.5 million – the average upper bound across emerging markets.

5 See for example Murdoch, Jonathan, "The microfinance promise", Journal of Economic Literature, December 1999; IFC, "Scaling-up SME access to financial services in the developing world"; Stein, Peer, Tony Goland and Robert Schiff, "Two trillion and counting – assessing the credit gap for micro, small, and medium-size enterprises in the developing world", IFC: World Bank and McKinsey & Company, October 2010.

6 McKinsey & Company, September 2011.

Our methodology

The article combines several different sources of information and ideas. We conducted exclusive in-depth interviews with 29 leading banks across six emerging market regions – Latin America, Asia, Sub-Saharan Africa, North Africa, the Middle East and Eastern Europe. These interviews provided insights into how banks perceive the MSME opportunity in their markets, how they are set up to attack it, challenges they face in doing so, and innovative practices they are seeing in the MSME segment.

We estimated the size of the MSME banking opportunity across emerging markets using the McKinsey Global Banking Pools, a proprietary dataset developed and tested over several years, and covering 79 of the largest economies across advanced and emerging markets. In addition, we also gained insight from existing literature and by analysing third-party datasets such as the IFC/World Bank enterprise survey, which include MSMEs across the emerging markets, and the FinScope survey of 6,000 MSMEs in South Africa.

The research also draws on the experience of McKinsey's network of MSME banking experts from across the emerging markets.

Finally, we tried to imagine what a large-scale bank serving MSMEs would look like, and built a financial model for that bank linked to operational drivers such as number of clients, products and channel mix.

We estimate that banking revenues from MSMEs in emerging markets will grow 20% per annum from $150 billion in 2010, to over $350 billion in 2015.

01.

The size of the MSME opportunity

A huge opportunity

A large and growing market for banks

The opportunity for banks to serve MSMEs[7] in emerging markets is large. In 2010, banking revenue from MSMEs in emerging markets totalled $150 billion, or one sixth of all emerging market banking revenues. By 2015, we estimate this figure will grow by around 20 per cent per annum to approximately $367 billion (**Exhibit 4**). Our interviews with 29 leading banks in emerging markets were consistent with this: almost two-thirds believe that MSME lending will increase by over 20 per cent per annum or more over the next five years, and another 10 per cent believe it will increase by at least 15 per cent per annum.

Exhibit 4

MSME banking revenues are $150 billion today and are expected to more than double over the next 5 years (20% p.a. growth)

MSME bank revenues, $ billions

Regions	2010	Growth 2010–15[1]	2015	CAGR %
East Asia	62	105	167	20
South Asia	20	44	64	21
Latin America	27	33	59	18
Sub-Saharan Africa	5	7	12	19
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1 2010–15 nominal GDP growth plus growth in financial inclusion (growth 2005–10 extrapolated to 2015) plus growth based on convergence between developed and emerging markets product penetration (refer to technical annex)

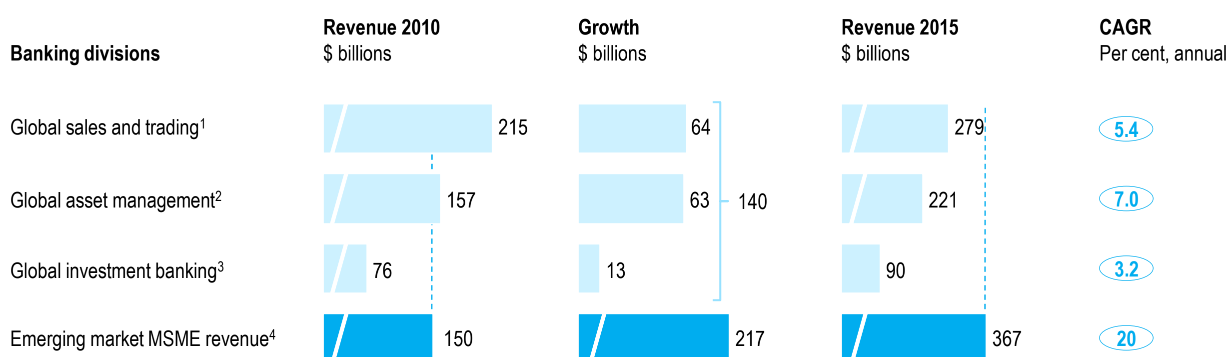
SOURCE: McKinsey Global Banking Pool (GBP); IMF Financial Access Survey; Honohan 2008; McKinsey analysis

7 In this article, MSME refers to micro-, small and medium-sized enterprises earning a turnover of up to $3.5 million – the average upper bound across emerging markets.

Strikingly, this projected $217 billion revenue growth by 2015 is larger than the combined growth of $140 billion in global sales and trading ($64 billion), global asset management ($63 billion) and global investment banking ($13 billion) (**Exhibit 5)**.

Exhibit 5

Projected emerging markets MSME revenue growth is likely to be larger than the combined growth of some other banking service lines



1 Secondary market transactions
2 Includes corporate pension funds, institutional funds, mandates, third-party-managed insurance funds
3 Includes all advisory and discretionary fee-based services such as M&A, ECM, DCM, structuring
4 Projected growth based on nominal GDP growth to 2015, in penetration in financial services and increased share of wallet
SOURCE: McKinsey Global Banking Pool (GBP); IMF Financial Access Survey; Honohan 2008; McKinsey analysis

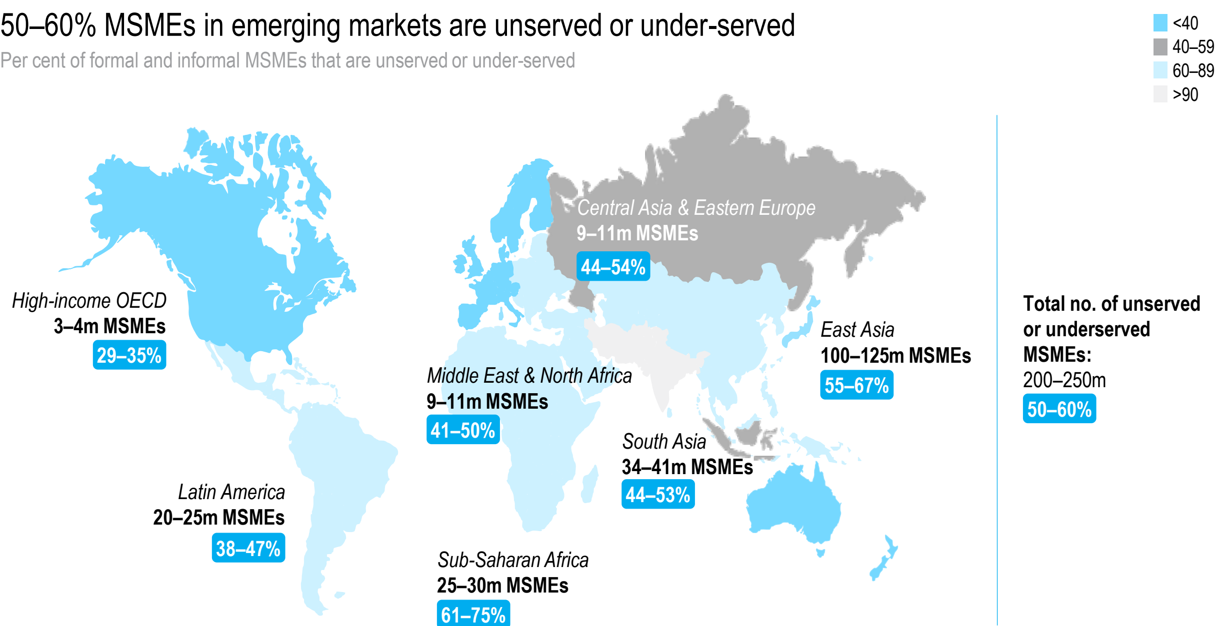
Three important factors are driving the projected growth in MSME banking revenues:

- Big increases in nominal GDP, averaging 14 per cent across emerging markets, account for $153 billion or roughly 70 per cent of the growth. These GDP estimates are based on a consensus base case. The scenario of, say, a disorderly break-up of the euro or a fiscal crisis in the U.S. is not incorporated.

In 2010, banking revenue from MSMEs in emerging markets totalled $150 billion, or one sixth of all emerging market banking revenues.

- Increased penetration of the large number of unserved and under-served MSMEs accounts for $49 billion or about 23 per cent of the growth. Our research[8], undertaken with the International Finance Corporation (IFC) in 2010, revealed that an estimated 50–60 per cent of emerging market MSMEs are either under-served or completely unserved (**Exhibit 6**). Some markets have millions of un-served MSMEs (e.g., China, India and Nigeria); in others unserved MSMEs run into the hundreds of thousands (e.g., Thailand, Brazil and Mexico).

Exhibit 6



SOURCE: IFC/Worldbank MSME database 2011

- A bigger take-up of more advanced and higher revenue-type products, such as trade finance, factoring and cash management, accounts for roughly $14 billion or six per cent of the projected revenue growth. The share of these products in GDP varies significantly between emerging markets and advanced markets – even after taking the bigger penetration of unserved and under-served MSMEs into account. Our estimate assumes that emerging markets will close 15 per cent of the gap in the next five years as MSME product needs become more sophisticated and banks transfer product knowledge from advanced markets.

An innovation laboratory for Western banks

MSME banking in emerging markets is also relevant for Western banks, who can adopt leading practices from emerging markets in their own markets. In the recent publication, *The State of Global Banking – in search of a sustainable model*[9], McKinsey points out that banks simultaneously face stricter regulation, evolving technology, and shifting customer preferences.

8 Stein, Peer, Tony Goland and Robert Schiff, "Two trillion and counting – assessing the credit gap for micro, small, and medium-size enterprises in the developing world", IFC: World Bank and McKinsey & Company, October 2010.

9 McKinsey & Company, September 2011.

If banks in advanced markets are to secure a sustainable future, we argue, many will have to transform their business models in ways more radical than they have contemplated to date. Western banks can draw lessons from the results of innovation in banking in emerging markets.

Banking would not be the first global industry to undergo a metamorphosis in the face of swiftly changing regulatory and technological realities and customer behaviour. In the 1990s, the telecom sector underwent a transformation as deregulation, the introduction of mobile technology and new consumer preferences posed a challenge to existing business models. In response, some incumbent companies embraced the new environment (e.g., a major traditional European telecom company acquired a mobile phone company) and others reduced cost and staff numbers by 30–50 per cent.

In the 1970s, the automotive industry began a transformation in response to the downturn in global demand and the advent of Japanese competition, which emphasised practices such as just-in-time inventory management. Productivity improvements, fierce competition and significant merger and acquisition activity all ensued. We believe banking is at a similar crossroads and that emerging markets could be an incubator for innovative practices yet to sweep the sector.

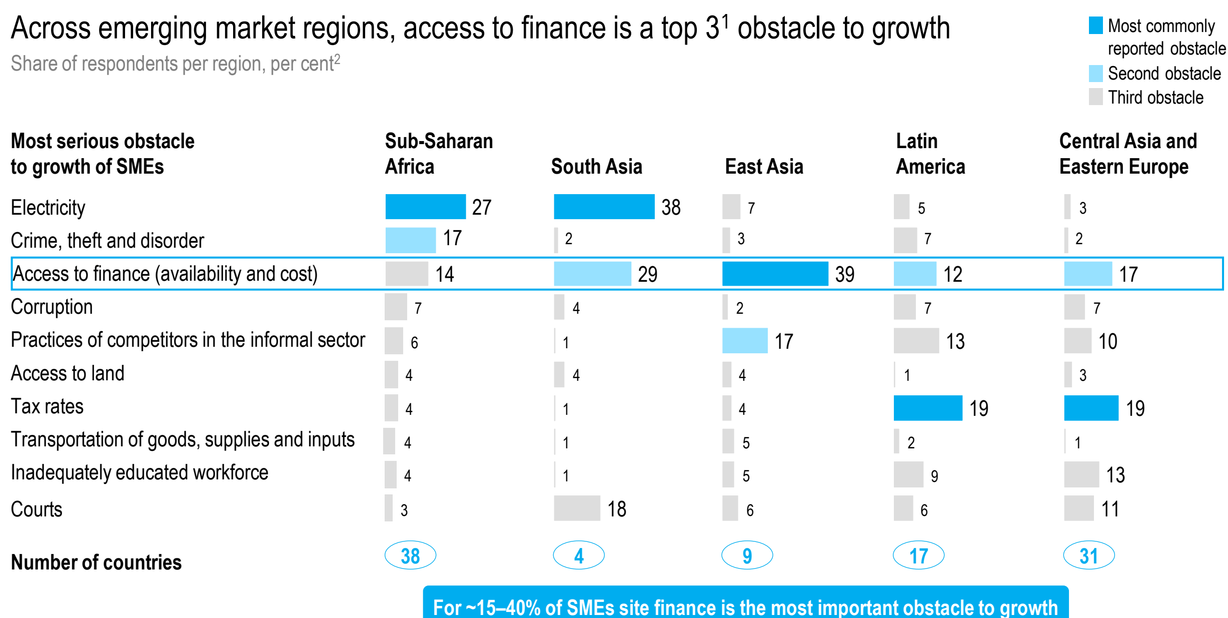
A source of growth and employment for governments

Governments stand to benefit from growth in the MSME segment. MSMEs are a major contributor to GDP and employment. For example, our analysis of nine emerging markets[10] has shown that MSMEs account for approximately 40 per cent of GDP and 65 per cent of employment. Indeed, MSMEs are increasingly attracting government attention as a source of economic growth and employment, especially in the prevailing economic climate.

10 China, Indonesia, Singapore, Brazil, Mexico, Argentina, South Africa, Nigeria and Kenya.

However, in surveys of MSMEs, access to finance is consistently cited as one of the top three obstacles to unlocking the segment's growth and employment potential (**Exhibit 7**). With MSMEs such a priority, banks should be able to count on the support of governments.

Exhibit 7



1 Exception is MENA,
2 Average medians; averages are GDP weighted
SOURCE: IFC/World Bank Enterprise Survey 2006–10; World Bank GDP 2008–10

Indeed, we already see several governments facilitating bank lending to MSMEs. For example, the UK government has created a variety of enhanced incentives for banks to lend to MSMEs: the Enterprise Finance Guarantee fund (£2 billion) which provides a 75% government guarantee on long-term (10-year) SME loans to banks; the Enterprise Capital funds (£200 million) which are government-sponsored venture capital funds supporting the key sectors within the SME segment; and the Financial Literacy Initiative, which is investing £10 million towards building skills and changing the mindset of MSMEs and potential MSME owners.[11] Brazil's government reduced tax bureaucracy for MSMEs by simplifying the tax filing (from eight documents to a single document), and unifying federal, state and municipal taxes under the Simple National tax reduction programme[12]. By July 2011, 3.6 million small enterprises had been granted tax exemption by subscribing to the programme.[13] China's government encourages banks to lend to MSMEs by sharing information on MSME locations, industry and creditworthiness with a major bank. Nigeria's government recently launched a $500 million fund to share risks with banks that lend to agriculture, a sector with many small enterprises. Banks should proactively engage governments on issues they need to resolve to facilitate MSME lending.

11 BBC News report on SMEs, 14 January 2011.

12 "General Micro and Small Enterprise Law" and under the "Complementary Law no. 123 of Dec/2006".

13 Innovating gaining market share and fostering social inclusion – success stories in SME Development; UN, ECLAC, IDB, December 2010.

A potentially profitable segment

Traditionally, many banks in emerging markets have struggled to earn returns in the MSME segment above their 10–15 per cent cost of capital, particularly at the small or micro end of the market. MSME bankers have had to balance several factors to attain profitability:

- Relatively low revenue per client compared to, say, revenue per corporate client
- The risk that credit losses on MSMEs can be high, and the fact that MSMEs can be sensitive to economic downturns, in part due to relatively low business diversification
- The need for "feet on the street", i.e., a distributed physical presence to service and lend to MSMEs.

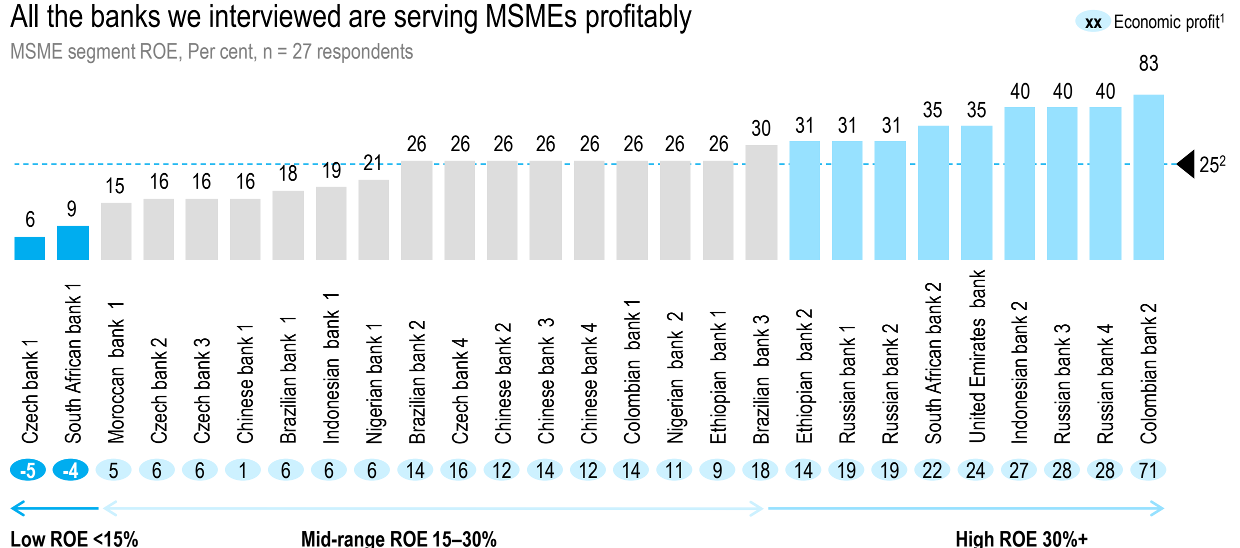
Given these factors, banks have tended to allocate capital to other areas of their business where the economics seemed more favourable, such as corporate and investment banking and the retail segment.

There are signs that things may be changing. In our interviews with 29 leading banks across emerging markets – selected in part because they were recognised as leaders in their respective markets in the MSME segment – almost two-fifths reported ROE in the MSME segment in excess of 30 per cent. About another half of respondents reported ROE in the range of 15–30 per cent, while only two banks told us they earned less than 15 per cent ROE (**Exhibit 8**). At an average ROE of 25 per cent, this sample significantly outperforms the emerging market average ROE for the MSME segment of 14 per cent.

Exhibit 8

All the banks we interviewed are serving MSMEs profitably

MSME segment ROE, Per cent, n = 27 respondents



1 ROE less country-specific cost of equity (cost of equity used for the countries: Angola 15.4%; Brazil 11.8%; Colombia 12.4%; Czech Republic 10.5%; Ethiopia 17.4%; India 13.2%; Indonesia 12.9%; Kenya 13.9; Malaysia 10.7%; Mexico 11.6%; Morocco 10.2%; Nigeria 15.3%; Russia 12.3%; Saudi Arabia 10.9%; Singapore 9.9%; South Africa 13.0%; United Arab Emirates 11.1%; China (used bank specific – average 14.1%)

2 Average of all banks excluding the 83% outlier

SOURCE: Emerging bank interviews; McKinsey analysis

With the exception of just two banks, all those we interviewed were making an economic return (ROE adjusted for cost of capital) in the MSME segment. Such returns ranged from 5–28 per cent, with one outlier reporting an economic profit of 71 per cent.

Contrary to popular belief, the MSME segment can therefore deliver high levels of profitability. Those banks that have recognised this and are tackling the challenges of doing business in emerging markets are making a healthy economic profit. How have they done it?

Based on the successful banks we interviewed and worked with, we have identified five leading practices in the MSME space. We turn to these leading practices in Chapter 2.

What the banks and MSMEs say

We interviewed 29 leading banks serving MSME from across emerging markets, conducted desk research on publicly available MSME surveys[14], and collated results from our interviews with MSMEs in Asia and several African countries. Our insights gleaned are as follows:

What MSME clients want

- **Simple products and services.** Products need to be simple and easy to use (application forms no longer than one or two pages), and quick turnaround times of one to four days.[15]
- **Unsecured loans – even at a high price.** Frequently without collateral, MSMEs often require access to unsecured credit and are willing to pay a higher interest rate to obtain it. Several banks are already piloting unsecured credit offerings and the high take-up rates confirm MSMEs do indeed value this.
- **Trustworthy, convenient channels.** "Trustworthy" typically means "face to face", especially at the beginning of a relationship. Many banks interpret "face to face" to mean a branch, but it could also be an agent who visits the MSME owner at his or her premises.

What banks say about the opportunity

- **MSMEs are strategically important.** This segment's share of bank profits is typically five percentage points higher than its share of bank revenue, assets and liabilities.
- **MSME loan books forecast to grow strongly.** While the typical MSME loan book is currently less than $5 billion, two-thirds of banks agree it is likely to grow by more than 20 per cent a year over the next five years. In addition, more than 90 per cent of banks expect losses on loans to be less than five per cent per annum.
- **Poor data and poor business cases constrain lending growth most.** Around three-quarters of the banks we interviewed listed poor business cases as a critical reason for credit declines, and more than two-thirds cited poor information availability as a critical constraint to lending.

14 FinScope survey of 6,000 MSMEs in South Africa; IFC/World Bank enterprise survey of MSMEs across emerging markets.

15 More complex or high turnover MSMEs may demand more complex products, e.g., cash management and trade finance.

In all the emerging market regions, banks see MSMEs as strategically important to their business, cite poor business cases and poor information as the major constraints to lending, and estimate expected losses in the MSME segment to be less than five percent.

- **Channel innovation will be a defining feature of the future.** New technology means banks are likely to pursue significant channel innovations to reach MSMEs. Of the banks we interviewed, 60 per cent believe the Internet is most likely to reduce operating costs by 10 per cent or more over the next five years, and a third cited mobile.
- **Use of tools is uneven.** More than 70 per cent of banks interviewed have an influential credit scoring tool combining qualitative and quantitative information; nearly two-thirds, however, have no meaningful sales tool.

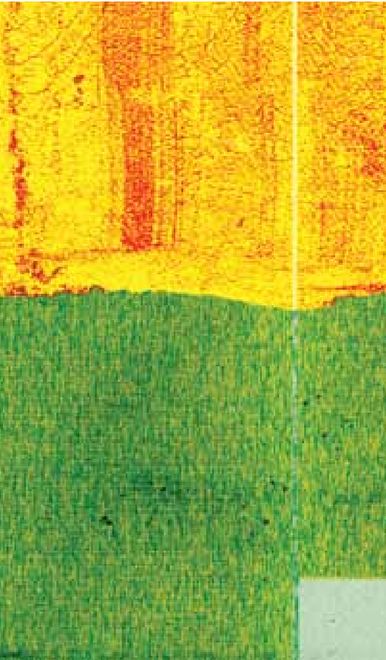
Regional differences and similarities

In our interviews, some themes were consistent across regions, and others varied. In all the emerging market regions, banks see MSMEs as strategically important to their business, cite poor business cases and poor information as the major constraints to lending, and estimate expected losses in the MSME segment to be less than five per cent.

However, banks' outlook for growth in the MSME segment differed. While more than seven in 10 respondents from Africa, Asia and Eastern Europe expect growth in MSME lending in the next five years to be more than 20 per cent, only four in 10 respondents from Latin America, North Africa and the Middle East agreed. There were also regional variations in perceptions of the big technological influences to come in the next five years. More than 60 per cent of respondents from Sub-Saharan Africa cited mobile, compared to 20 per cent in other regions. Meanwhile more than 60 per cent from Eastern Europe and Asia cited automation of credit scoring as a large cost reduction lever, against approximately 20 per cent in other regions.

02.

Five leading practices



We believe banks will improve their chances of capturing the emerging market MSME opportunity on a significant scale if they do five things (**Exhibit 9**):

1. Seek a granular understanding of target MSME clients
2. Radically lower operating costs
3. Manage risk innovatively
4. Empower their MSME clients
5. Engage with governments.

These five leading practices each address challenges that make MSMEs difficult to serve profitably on a significant scale. They are not mutually exclusive and they complement each other. For example, a granular understanding of target MSME clients will help define the most optimal approach to distribution and help reduce risk cost. Distribution and risk are particularly interlinked. All things equal, the deeper a bank reaches into the business community and the more it develops close personal interactions, the better will be its performance on risk.

Exhibit 9

We see 5 leading practices that will make the difference in the race to capture the emerging market MSME banking opportunity

Challenges		Leading practices
1 Dispersed clients	Urbanisation lower than in advanced markets – e.g., 30% in India, 40% in Africa, 45% in China versus ~80% in Europe	Seek granular understanding of target MSME clients
2 Low bank revenue per client	Bank revenue per client averages $2,100, so traditional distribution is unprofitable	Radically lower operating cost
3 Poor data availability	Only 5–30% of emerging market SME borrowers are covered by credit bureaus	Manage risk innovatively
4 Business/financially illiterate clients	Financial literacy in BRICS countries (most developed emerging markets) of ~50 to 60% compared to G7 countries of above 60%	Empower your MSME clients
5 Poor business environment	Emerging market nations rank in lower half of World Bank Doing Business indicators	Engage with government

SOURCE: United Nations; IFC; Financial Inclusion Expert Group; World Bank – Doing Business; McKinsey analysis

Distribution is arguably secondary to risk processes and the bank's approach to risk management should therefore drive the design of the distribution model.

The five practices are relevant across a wide spectrum of MSME banking markets and strategies, and banks serving MSMEs successfully display one or more of these leading practices.

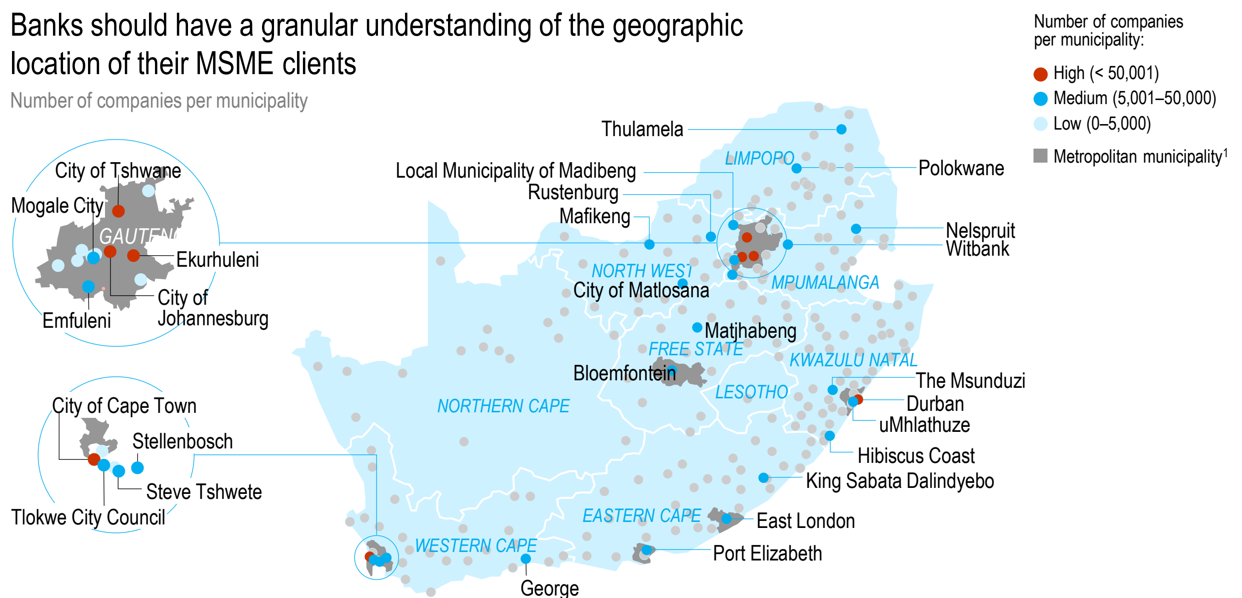
We explore each in turn over the next pages.

1. Seek a granular understanding of target MSME clients

In emerging markets, MSME clients are typically more dispersed than they are in advanced markets. For example, the share of people living in cities and towns is approximately 30 per cent in India, 40 per cent in Africa and 45 per cent in China, compared to 80 per cent in Europe. In addition, the MSME sector mix in emerging markets is disproportionately weighted towards agriculture and informal retail and wholesale. This has two implications for banks.

First, banks need to be able to identify geographic locations with high MSME concentrations, for example, using micromarket sizing techniques. The municipality is a good level at which to perform this analysis as in the case example from South Africa set out in **Exhibit 10**.

Exhibit 10



1 A metropolitan municipality represents large densely urbanised regions that encompass multiple cities, hence it represents a metropolis

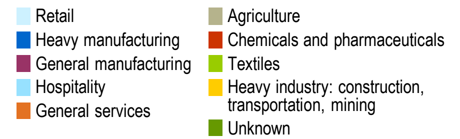
SOURCE: Lightstone

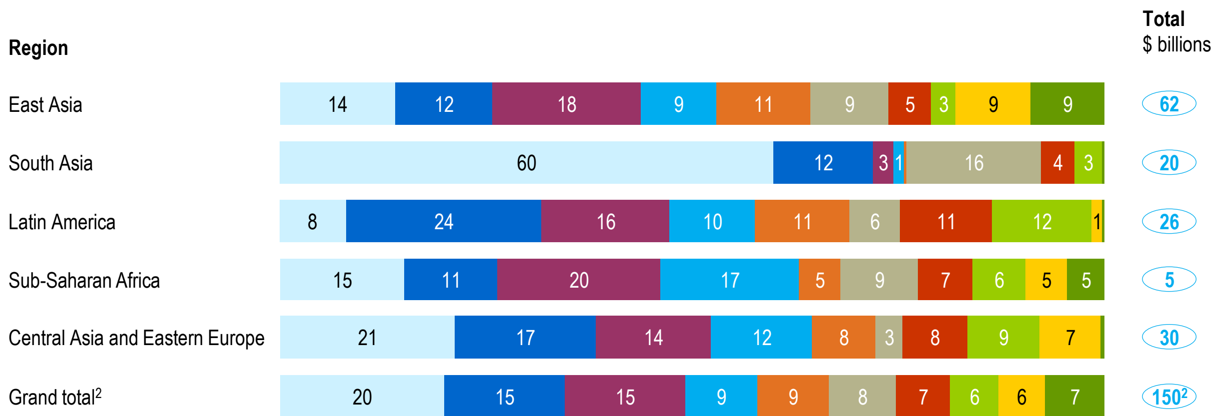
It is equally important to understand the size of the banking revenue pool in the sectors in which MSMEs operate. In emerging markets, five sectors comprise around 75 per cent of the MSME banking revenue pool: retail (approximately 20 per cent), manufacturing (30 per cent), hospitality (nine per cent), general services (nine per cent) and agriculture (eight per cent). The size of these sectors differs by region and by country (**Exhibit 11**).

Exhibit 11

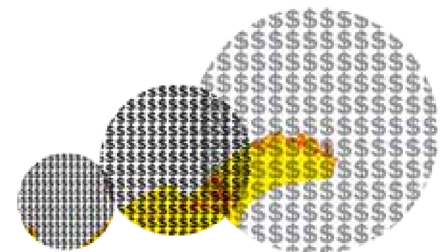
Equally important is to understand the size of banking revenue pools in the sectors in which MSMEs operate

Emerging market MSME banking revenue by sector[1], Per cent





1 Middle East and Northern Africa (MENA) region not shown separately due to unavailability of sector breakdown
2 Middle East and Northern Africa (MENA) account for $7 billion of grand total
SOURCE: IFC/World Bank Enterprise Survey 2006–10; McKinsey Global Banking Pool (GBP); McKinsey analysis



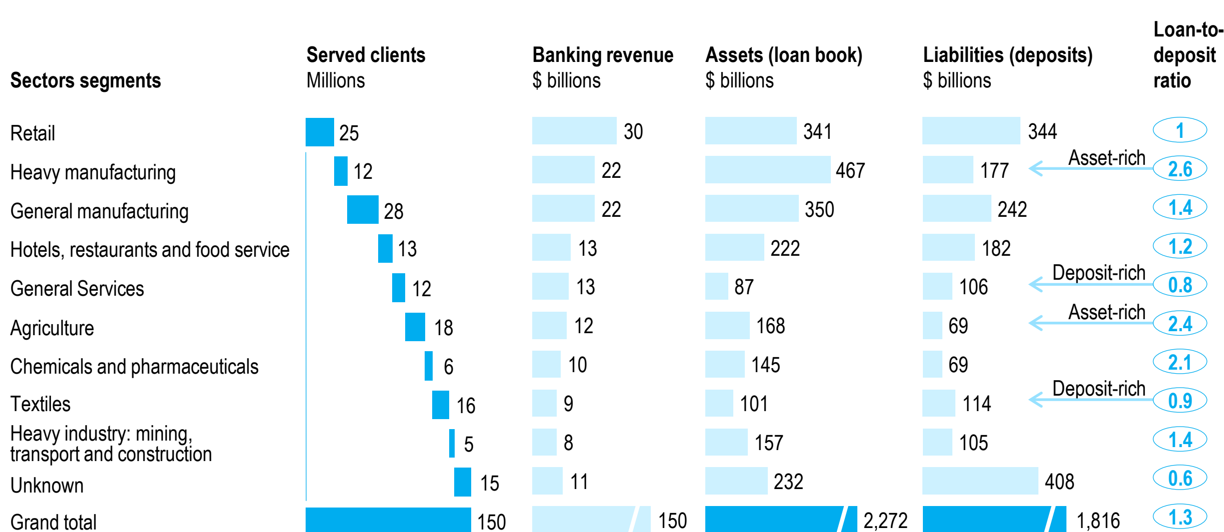
In emerging markets, five sectors comprise around 75 per cent of the MSME banking revenue pool: retail (approximately 20 per cent), manufacturing (30 per cent), hospitality (nine per cent), general services (nine per cent) and agriculture (eight per cent).

An understanding of the "nuance" of the financial needs of each sector can provide a basis for sector targeting. Some sectors are asset-rich, such as agriculture and manufacturing, while others are liability-rich, such as services and textiles (**Exhibit 12**). Armed with this knowledge, banks are able to develop tailored propositions specific to particular sectors.

Exhibit 12

It is critical for banks to understand the size of the sectors in which MSMEs operate

Emerging market MSME clients



SOURCE: IFC/World Bank Enterprise Survey 2006–10; McKinsey Global Banking Pool (GBP); McKinsey analysis

For example, in India, one bank in the agriculture sector provides secured lending to acquire farm equipment and machinery (for example tractors and ploughs), while another provides tailored input finance to help farmers manage the seasonality of cash flows. Two examples from the retail sector include a South African bank that launched an automated cash acceptance terminal on client property allowing small cash deposits to accumulate into bulk deposits – similarly a Mexican bank provides unsecured loans to a group of retail microentrepreneurs to be paid back bi-weekly. The success of this method lies in the bundling of loans and the promise of larger loans, which exerts peer pressure on the group for repayment.

Some banks combine sector-specialised offers with micromarket strategies. For example, a bank in Indonesia set up a subsidiary initially targeting self-employed retailers such as "mom and pop" stores and within 10 years it had set up 1,300 outlets in micromarkets where many of these clients were located. The bank used a "community model" in which it recruited relationship managers (RMs) from the local area to serve clients within a three-kilometre radius. The RMs often had personal knowledge of their retail clients' character and were familiar with their business' cash flow and sources of borrowing, thereby enhancing their understanding of the risks and opportunities. This approach has underpinned strong, targeted client growth and helped keep risk costs impressively low.

In another example, a bank in Brazil recognised the importance of acquiring a detailed understanding of its clients. The bank's model targets specific sectors like retail and manufacturing, and focuses on getting to know the client at close quarters, paying close attention to the business in the first few months of the relationship. For its Head of SME, "the most important thing in SME lending is going to where the client is and seeing the business with your own eyes". Over time, clients are migrated to lower cost, remote channels, but the understanding built early on is invaluable when loans are subsequently extended.

2. Radically lower operating costs

Banks must strike a balance between creating value for shareholders and adding value to MSME clients at an affordable price. In emerging markets, MSME bank revenue per client is typically low, estimated at an average of $2,100 per annum[16] (compared to an average $21,000 per client in advanced markets). Assuming a 50 per cent cost to income ratio, this only allows for an average cost per client of up to $1,050 per annum across emerging markets. At the lower end of the MSME spectrum, where revenue per client can be as low as $100 per annum, the Western RM model is simply inappropriate.

Banks must therefore meet their client needs at the lowest possible operating cost, leaving no room for excessive credit losses and engaging in some bold thinking about distribution, products and people.

Distribution

Fundamental innovation in both physical and virtual distribution channels can radically reduce costs for banks and clients alike.

Low-cost branches and correspondent banking should be at the heart of any traditional bricks-and-mortar infrastructure:

- **Low-cost branches.** One Indonesian bank relies on 1,300 very low-cost branches for serving MSMEs. The bank's outlets are small (less than 100 square metres) and have two to four permanent staff, compared to an average of eight to 10 staff in a standard branch.
- **Correspondent banking.** This model is popular in Latin America, where banks use retailers to extend their distribution reach. For example, a bank in Colombia has 700 branches and 900 correspondent outlets. In Brazil, correspondent outlets outnumber bank branches by seven to one; in Colombia by two to one. This approach is feasible even in countries where large networks of formal retail outlets do not exist – in Nigeria, for instance, one bank is planning to roll out 20,000 agents.

Technology is a major battleground and innovation is rife. Almost 60 per cent of the banks we interviewed believe that the Internet will have the greatest impact on lowering MSME operating costs over the next 10 years. For example, a bank in Nigeria is introducing a process that enables MSME clients to apply for rolling credit, be assessed and obtain approval – all online.

16 These estimates are derived from dividing the total emerging market MSME bank revenue pool by the total number of banked MSMEs in emerging markets.

Technology-led innovations are already transforming emerging markets in a number of ways:

- **Contact centre model.** One of the banks we interviewed uses a full contact centre model for its smallest MSME clients in Brazil. One of the large African banks is building a section in a contact centre dedicated to MSMEs staffed by bankers rather than call centre agents. This model has proved to be very successful in advanced markets. In the U.S., for example, a major credit card company has advanced unsecured credit to up to four million small business clients in 10 years without any branches or checking accounts.
- **Mobile.** In Kenya, 60 per cent of MSMEs use M-Pesa, a mobile phone-based product, offering clients payments and deposits/savings functionality. M-Pesa is a runaway success and has so far captured over 16 million individual and MSME users.
- **Laptop and POS-enabled agents.** A large African bank deploys MSME relationship officers armed with POS machines to collect cash in person from retail sector MSMEs in their marketplace. The officers collect cash up to a maximum limit (for security reasons) and deposit it at the nearest bank where it is credited to clients' bank balances in real time. Not only does this maximise cash balances for the bank, it enables the local branch to recycle cash into the local micromarket rather than requesting top-ups from distant bank depots. MSME clients access their cash via cards and mobile phones, which is both convenient and secure. A bank in Colombia and a microfinance organisation in Kenya are lending to MSMEs using agents with laptops; in the Kenyan case, M-Pesa is used to transfer the loan and repayments.

Product processes

Banks can reap enormous benefits by creating products anchored in lean, automated processes. Even simple things can make a difference. For example, an African bank made savings of around $15 million by reducing its application form to two pages. An Indonesian bank signs up clients through a credit process that asks a few, simple questions, sends the answers to a centralised credit scoring centre, then returns an answer so that credit can be disbursed within three to four days.

The most innovative MSME banks have long abandoned product processes with complex 20-page application forms borrowed from the corporate department and asking for financial statements, a credit score, and collateral before being run through a multivariate credit-scoring model. Complicated product processes in this segment are neither necessary nor economical.

People

Banks should match the number and tenure of bankers assigned to MSMEs according to the revenue potential of their three or four targeted segments, always striving for a similar cost-income ratio. For example:

- For the highest revenue sub-segment, say turnover of between $1.5 and 3.5 million, a bank might employ an experienced, well-qualified RM with a loading of 100 to 120 clients. The RM knows the clients well and visits them several times a year. Such an enhanced service should be combined with sound performance management and key performance indicators (KPIs). For example, with roughly 250 working days per year, and on the assumption that the RM can reasonably make three outbound

client meetings or calls per day, total outbound client contacts should total 750 per year. Assuming 120 clients, the RM's KPI could be built around an average six outbound contacts or visits per client each year and the associated sales and risk cost targets for that size portfolio.

- For the middle revenue sub-segment (turnover of between $0.5 and 1.5 million) the bank may have a lesser skilled banker with a loading of up to 200 to 250 clients. The banker will only know some of his or her clients on a first-name basis – perhaps focusing on those with credit exposure. In this model, much of the client service will be reactive, but the banker still has some scope for outbound contact focused on high revenue or high risk clients, at a rate of, say, one or two clients per day.
- For the lowest revenue sub-segment (turnover of below $0.5 million), bankers serve their clients almost entirely on a reactive basis, with a staff/client ratio of anything up to one staff member per 1,000 clients. Only the very largest clients, or ones with large loans, would receive outbound attention, but they would form a small percentage of the banker's portfolio. Ideally, the remaining clients should be empowered to use the self-service channels.

On the face of it, banks serve small business clients in advanced markets in a similar way. However, two differences should be noted. Literacy levels are lower in emerging markets than in advanced markets, requiring face-to-face contact with clients, especially in the

When business gets personal: reconciling dual MSME client needs

In emerging markets, MSME owners are often affluent and there can be a significant overlap between the two segments. For example, MSMEs account for 50–70 per cent of affluent clients in the Chinese business of one prominent, multinational bank. Recognising these links offers financial upside for the bank. Results from a 2008 Asia-Pacific SME banking survey found that the share of wallet for personal banking in China, India, Indonesia and Thailand is significantly higher when SME owners use their primary business bank for personal banking. How can banks marry the needs of the individual and his or her business?

As discussed above, an RM who knows all his small business clients individually can only be justified in the highest segment. One option is to assign a "super RM" to these clients who is empowered to deal with both business and personal financial needs. Benefits to the client include a single point of contact, less duplication and access to the most appropriate packages. From the bank's perspective, the credit process is more insightful as banks are able to monitor both business and personal accounts for anomalies. In addition, client loyalty can be heightened, allowing flexibility around pricing and leading to greater client openness to cross-sell.

Another option is to deploy dual RMs who coordinate and refer the two sides of the client's needs. In this case it is the quality of these interactions that makes the difference: failure to refer can lead to missed sales opportunities. In one successful variant of this model, a bank we studied offers a dedicated business RM to MSMEs above a revenue threshold of $1 million. This RM is the "relationship owner" as far as the MSME client is concerned. The MSME division then deploys personal bankers to service the same client's personal needs. These personal bankers are called on only occasionally by the business RM as specialists to service a client's individual needs; they do not "own" the client relationship.

early stages of the relationship. Also, emerging markets have lower staff costs and this approach can therefore be economical.

3. Manage risk innovatively

In high-revenue-per-client segments, such as corporate banking, banks take a people- and judgement-intensive approach to risk. This simply does not work in emerging markets where costs must be kept low. Furthermore, MSMEs rarely possess the information required for a traditional credit scoring model – a credit rating, financial statements or collateral. For example, on average, only 30 per cent of MSME borrowers in BRIC countries are covered by a credit bureau, compared to 95–100 per cent in advanced markets.[17]

New approaches to credit scoring

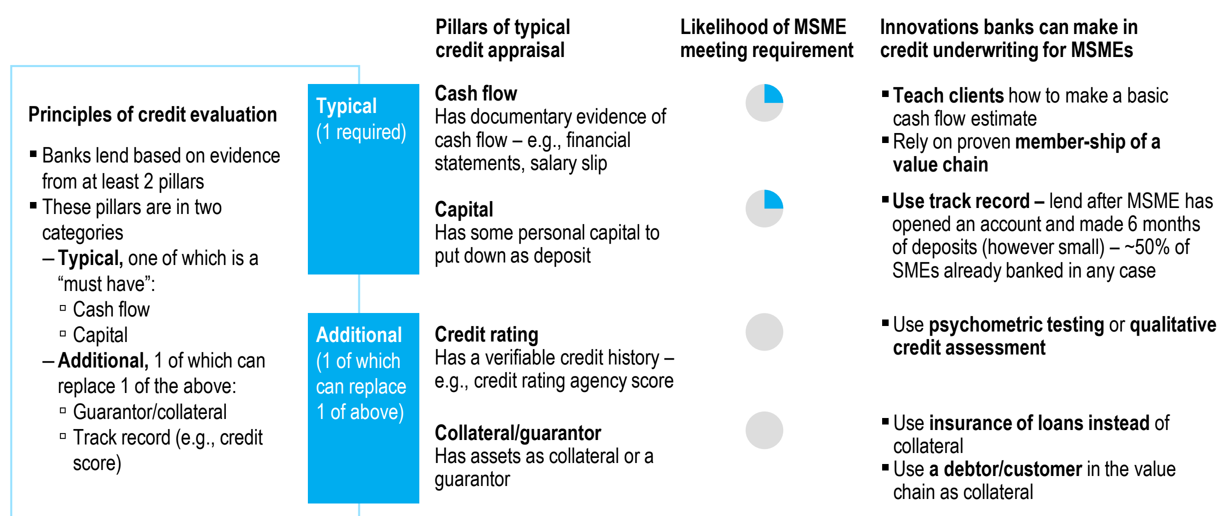
In the words of one Latin American bank we interviewed: "The biggest challenge with MSMEs by far is lack of information – that and better risk models would do most to help us increase our MSME lending." Banks must think beyond standard risk models to design simple, data- and IT-enabled approaches.

So far, few have done this. The bank interviews show that 72 per cent of banks actively use a credit scoring model though the tools are based primarily on traditional information sources such as documented evidence of cash flows, collateral, and a credit bureau score. Some 69 per cent of respondents indicated that these were quite poor or even unavailable.

However, a few banks are beginning to break the mould in credit scoring, introducing new and creative ways to assess a client's credit (**Exhibit 13**).

Exhibit 13

Banks are beginning to break the mould in credit scoring, introducing new and creative ways to assess a client's credit



SOURCE: McKinsey analysis

17 IFC "Doing Business" indicators, 2010.

- Some are using psychometric testing, which uses the test score to separate good risks from bad and can lower default rates by 25–40 per cent. The psychometric test measures attributes such as the entrepreneur's psychological profile, ethics and integrity, intelligence and business skills. The test is self-administered in 30–40 minutes on a touch screen computer for ease of client use – without any banker supervision, the cost of the assessment is 45 per cent of traditional assessment measures. The test has been piloted in seven countries in nine languages, and a few of the banks we interviewed were already using it. Being computerised, simple and low cost, it is ideal for use by small-scale entrepreneurs lacking the traditional credit scoring inputs.
- Other banks are using approaches which combine quantitative and qualitative assessment, such as Qualitative Credit Assessment (QCA), a McKinsey tool. QCA is a 15–25 question assessment that banks' MSME clients can navigate through in 30–60 minutes. Each of the 15–25 questions is then aggregated to provide a score, with the weight of each question in the score determined by the question's predictive power. QCA has been used by over 20 banks across all the emerging market continents, and has achieved risk cost reductions averaging 35 per cent. QCA typically covers non-conventional variables in four areas: MSME management (identifying the strength and integrity of the entrepreneur); MSME features (such as ownership structure or relationship with the bank); MSME competitiveness; and MSME company operation (including relationships with suppliers and customers). To assess the entrepreneur's integrity, for example, a question could provoke four possible responses: the entrepreneur only volunteers positive information; the entrepreneur also provides negative information but only with probing; the entrepreneur volunteers negative information without probing; or the entrepreneur also provides negative information with curiosity about how the bank can assist him or her in addressing it. QCA questionnaires can be tailored to reflect factors relevant to a bank's country and target client segments.
- Another approach is to dispense with collateral altogether and to advance unsecured credit instead. Priced correctly, this can deliver exciting returns from loans and some banks are seeing a high take-up. Others no longer ask for financial statements and rely on the banker's estimate of cash flow either through observation of the business or analysis of payments into a transactional account.

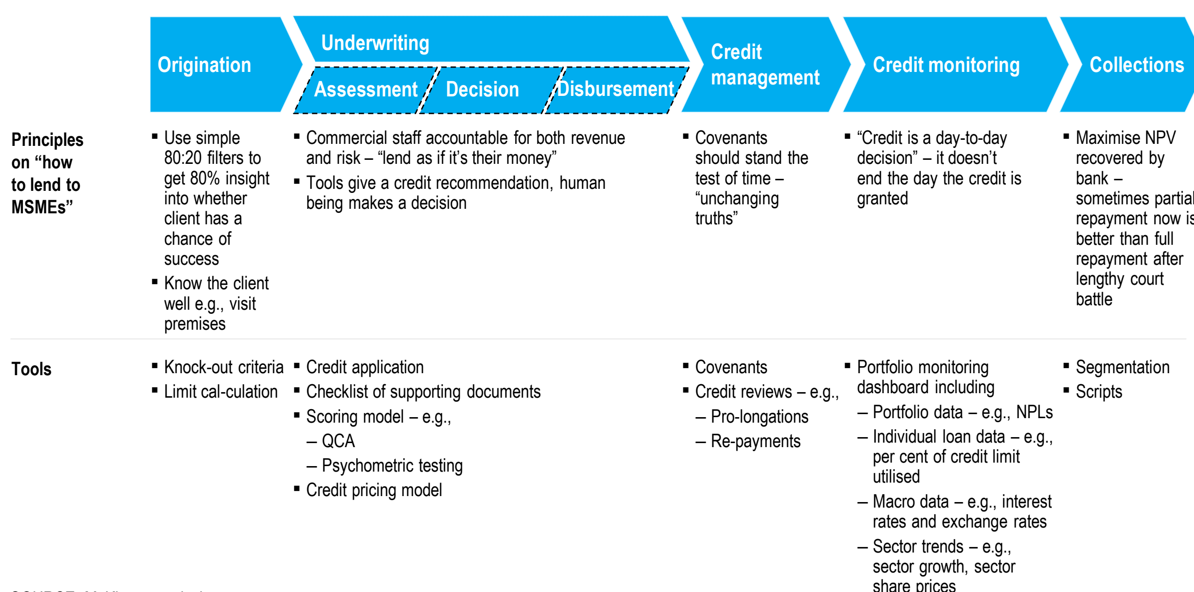
Banks should match the number and tenure of bankers assigned to MSMEs according to the revenue potential of their three or four targeted segments, always striving for a similar cost-income ratio.

Other elements of the credit process

Credit scoring is only one element, and to succeed in the MSME segment, banks must review all parts of their credit process (**Exhibit 14**). Indeed, many banks we interviewed acknowledge that there is scope for improvement in credit origination, underwriting, monitoring and collections.

Exhibit 14

Banks should review their entire credit processes end-to-end if they wish to succeed in the MSME segment



SOURCE: McKinsey analysis

Take collections, for example, where a 10 percentage point improvement can translate into a 10–20 per cent reduction in losses. Banks can also set up their game by prioritising continuous credit monitoring, ensuring that the relationship manager does an early pre-workout, segmenting workout cases and allocating them to the right collection/workout officer.

In origination, an important challenge is to limit or even eliminate client fraud. Cross-selling to existing, non-credit clients, sourcing new clients with the help of current clients, using pre-defined fraud knockout criteria, or looking out for fraud in financial statements using Benford's Law[18] can all help. Residual fraud risk can then be priced in, ideally using the probability of fraud for a particular client.

4. Empower MSME clients

Emerging markets suffer disproportionately from financial and business illiteracy. In Nigeria, for example, just six per cent of the banked population is financially literate, compared to 60–70 per cent in advanced markets.

18 Benford's Law states that any genuine (i.e., non-fabricated) set of figures has the first digit of each number distributed in a particular, non-uniform way. For example, the digit 1 is the first digit of a number in 30 per cent of cases, and larger numbers appear with lower and lower frequency to the point where the digit 9 is the first digit of a number in only approximately five per cent of cases.

Poor financial literacy increases transaction costs, notably the investment in time required to explain products, services, interest rates and other issues to bank clients.

About three-quarters of the banks interviewed told us that poorly presented business cases, a consequence of poor financial literacy, is the number one reason why banks decline credit applications for MSMEs. Such businesses, they added, often have limited knowledge of supply chain management, sourcing, marketing, pricing and other quite fundamental practices.

It is therefore as much in their own as in their clients' interest for banks to help develop MSME financial literacy and business skills. This will help existing MSME clients survive where they might not otherwise have done so and new clients prosper, so fueling the bank's revenue growth.

Most banks have a start-up package to help new MSMEs and give these clients added support. For example, one African bank runs business seminars for their MSME clients to introduce them to business skills, such as inventory management, supply chain management, and financial reporting.

5. Engage with government

Banks need to start engaging much more with governments in emerging markets in an effort to improve the business environment.

For example, ranked by "ease" of doing business, BRIC countries, on average come 101 compared to 24 for their G7 counterparts, according to IFC Doing Business Indicators. Legal processes can be costly and difficult to enforce. For example, it takes on average 630 days to enforce a loan contract in emerging markets in the case of a default, compared to 530 days in advanced markets. Poor infrastructure can be another obstacle. Internet penetration averages 18 per cent in emerging markets, compared to 72 per cent in advanced markets. Similarly, limited access to transport and electricity raises the cost of bank operations.

We see three ways in which banks could engage much more actively with government to improve the business environment:

- **Participate in risk-sharing facilities.** All 24 of Nigeria's banks participated in a central-bank-led $500 million fund to share around 50 per cent of the risk of unpaid agricultural loans. Launched in 2011, it is expected that the fund will create additional loans to agricultural producers of $3 billion over 10 years, including four million farmers and agricultural MSMEs.
- **Set up credit bureaus.** The presence of a credit bureau roughly halves the likelihood of MSMEs reporting financing constraints (from 49 to 27 per cent), significantly increases the chance of loans being granted (from 28 to 40 per cent), and radically cuts default rates (from 2.2 to 1.3 per cent for large banks; from 2.4 to 0.5 per cent for small banks). There is still significant scope for banks to work with government to create credit bureaus in emerging markets – only 5–30 per cent of MSME borrowers are covered at the moment.
- **Leverage government information.** Banks can identify under-served and unserved clients by harnessing government support to understand where MSMEs are located and whether they have credible and viable businesses. A bank in China has reached

four million MSME clients, leveraging information on credible and viable businesses held by Chinese municipal governments.

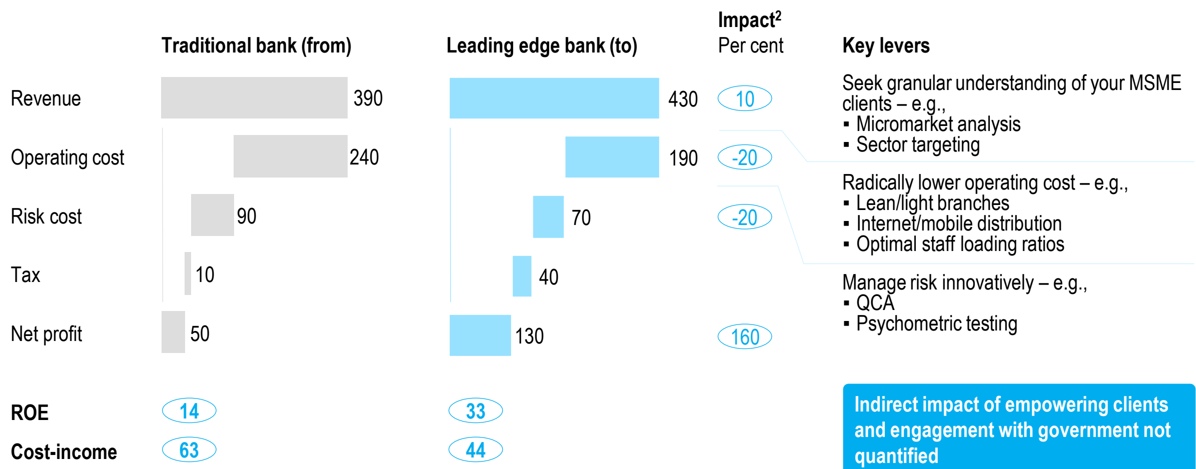
Using a detailed financial model of a typical MSME division, we believe that applying the five leading practices can have a dramatic impact on bank economics. Relative to the base case ROE of ~14 per cent and net profit after tax of ~$50 million per annum, our analysis suggests the five leading practices could increase a bank's ROE from the MSME segment to ~33 per cent, and raise profits after tax to ~$130 million per annum (**Exhibit 15**). Under conservative assumptions, we estimate that having a granular understanding of clients and targeting them more precisely and effectively (with sector-specific products, for instance) can raise revenues by around 10 per cent; radically lowering distribution, people and products costs can reduce operating costs by around 20 per cent; and significantly improving risk practices can reduce risk costs by about a fifth.

According to McKinsey's Global Banking Pools model, such an ROE compares favourably with the returns offered by, for example, developed market corporate loans (around 15 per cent) and developed markets retail lending (around 13 per cent)[19].

Exhibit 15

Applying the 5 leading practices can have a dramatic impact on bank economics, increasing ROE from ~14 to ~33 per cent

Year-5 comparison for start-up bank, $ millions[1]



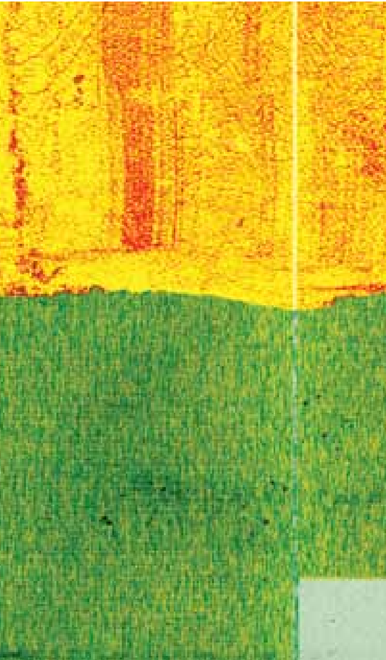
1 Rounded to nearest $10 million, 2 Rounded to nearest 5%

SOURCE: McKinsey analysis

19 ROE calculated using McKinsey Global Banking Pool data: net profit after tax (which is calculated using the effective tax rate for banks in the country, cost to income determined by research into listed banks and central bank data; and risk costs which are typically determined from central bank information), divided by cost of regulatory capital, assuming tier 1 and tier 2 (equity and subordinated debt) capital required by Basel I and II.

03.

Strategic choices



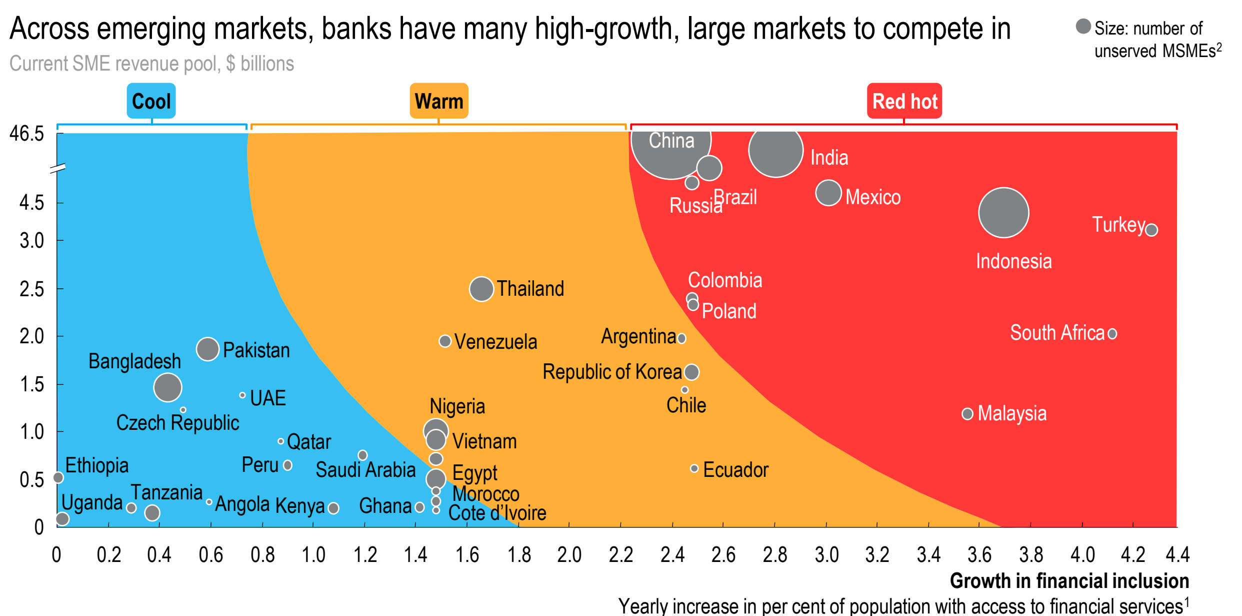
As well as understanding and adopting the leading practices, banks must make strategic choices about entering the MSME segment. In particular, they have to decide where to play and how to play. These two strategic choices will determine the mix of leading practices and the extent to which each is applied.

Where to play

Emerging markets are extremely varied, and banks must understand the relative size of the opportunity across each market. Doing so will help large, multinational banks define where they pursue the MSME opportunity. It will help banks based largely in one market understand if the country they are in offers an exciting opportunity or not.

Emerging markets can be split into three country groups according to their size and growth (**Exhibit 16**):

Exhibit 16



1 Based on 5-year growth of deposits per capita according IMF Financial Access Survey 2006–10

2 Number of MSMEs who are under-served and unserved with regard to credit as per IFC/World Bank Enterprise Survey 2010

SOURCE: IFC/World Bank Enterprise Survey 2006–10; McKinsey Global Banking Pool (GBP); IMF Financial Access Survey; Honohan 2008; McKinsey

- "**Red hot**" countries have both fast-growing and large MSME markets. Growth in financial penetration (defined as the percentage of the population with access to financial services) has been 2.0 per cent per annum or more over the last five years; for many countries in this group, the MSME revenue pool exceeds $5 billion. Many red hot countries, including China, India, Brazil, Indonesia, Russia and Mexico, still have large numbers of unserved MSMEs. Turkey, Malaysia, Poland and South Africa also fall into this group by virtue of the growth of their unbanked populations. Banks should take full advantage of red hot countries and be willing to invest on a significant scale.
- Countries that are "**warm**" are achieving a moderate growth in financial penetration of 1.0–2.0 per cent per annum but still represent an exciting opportunity. The larger markets in this group include Thailand, Nigeria, Vietnam, Argentina and Chile. Banks that call these markets "home" should take full advantage; multinational banks should consider them a second-tier priority after red hot countries.
- Markets in the "**cool**" zone – for example, Pakistan, the Czech Republic, Morocco, the UAE, Kenya, Ethiopia and Saudi Arabia – are increasing financial penetration at less than 1.0 per cent per annum. Some markets are cool because they are close to saturation point (e.g., the Czech Republic), while others have yet to establish the conditions that will allow banks to fully capture the MSME opportunity (e.g., Ethiopia, Pakistan). Domestic banks can pursue profitable MSME niches within "cool" countries, and multinational banks can approach these markets opportunistically as part of a broader portfolio of markets weighted towards red hot and warm countries.

How to play

To understand how best and most profitably to approach their chosen markets, banks must consider the country's characteristics in two key respects:

- How easy is it to reach MSME clients? Branch density, measured as bank branches per 100,000 inhabitants, is a useful proxy.
- How easy is it to manage credit risk? Here, credit bureau coverage is a useful proxy, measured by percentage of adults covered. This measure correlates well with other dimensions of credit management, such as the ease with which collections can be made and contracts enforced.

Emerging markets are extremely varied, and banks must understand the relative size of the opportunity across each market.

The advantages of the cross-border model in the MSME segment

Banks should consider the pursuit of the emerging market MSME opportunity across borders. Many banking markets are too small to tackle individually, and many banks choose to serve several countries at once, for example Standard Bank in Africa and Raiffeisen in Eastern Europe. Perhaps more importantly, the cross-border model offers scale, skill and scope advantages that banks can use to create a more competitive model than medium-sized, domestic players. The degree of centralisation will vary, and a pragmatic approach is required to deal with different infrastructures and legal regimes. In addition, banks' governance models typically reward country performance rather than regional performance, leading to localised products, IT systems and operating models. However, under the lens of our five leading practices, the cross-border model does offer some opportunities:

- Sector-specific knowledge and micromarket analytical capabilities can be deployed across borders. The same sectors, notably agriculture, tend to be dominant across a region, and segment-specific customer approaches and packages will therefore be similar (one pan-emerging market bank is approaching multiple markets in this way).
- Know-how on rolling out a low-cost branch network also travels well. Despite differences in infrastructure, common IT platforms can be established as a basis for offering the "same" products at low cost. A good example of this is an African bank that operates a shared IT system across its African markets.
- Some behavioural risk model parameters are common across markets, and there are significant benefits in terms of skill development to be derived from entering a new country armed with the knowledge of what has worked in other emerging markets.
- Client education and empowerment can be based on the same curriculum and formats, but tailored and delivered locally.

Finally, a cross-border presence can be beneficial if your MSME clients trade extensively with, or have operations in, a neighbouring country. It will, for example, help capture more trade finance opportunities.

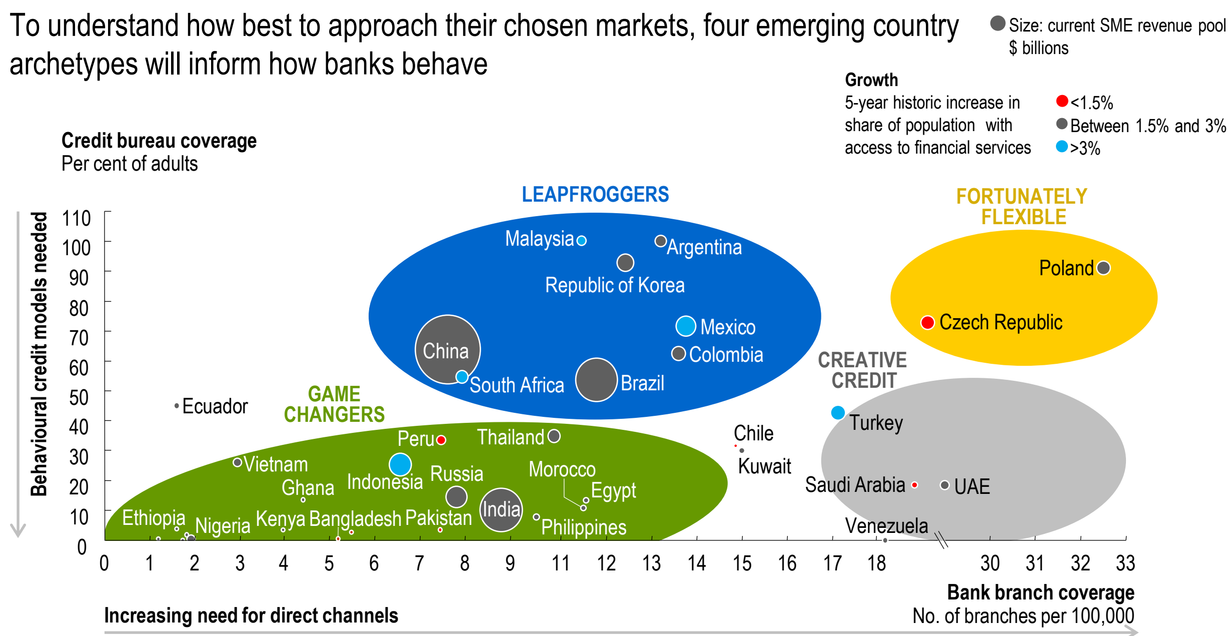
We expect cross-border bank MSME activity to become more important, especially in regions with smaller markets, such as Africa, the Middle East, Eastern Europe and much of Latin America. In larger markets, such as India and China, purely domestic players will continue to have sufficient scale.

In both "game changer" and "leapfrog" countries, innovation in distribution is critical. One option is to partner with retailers and telcos, which reach a larger share of the population in many emerging markets than banks.

Based on these two measures, we have identified four emerging country archetypes that will inform how banks play (**Exhibit 17**):

Exhibit 17

To understand how best to approach their chosen markets, four emerging country archetypes will inform how banks behave

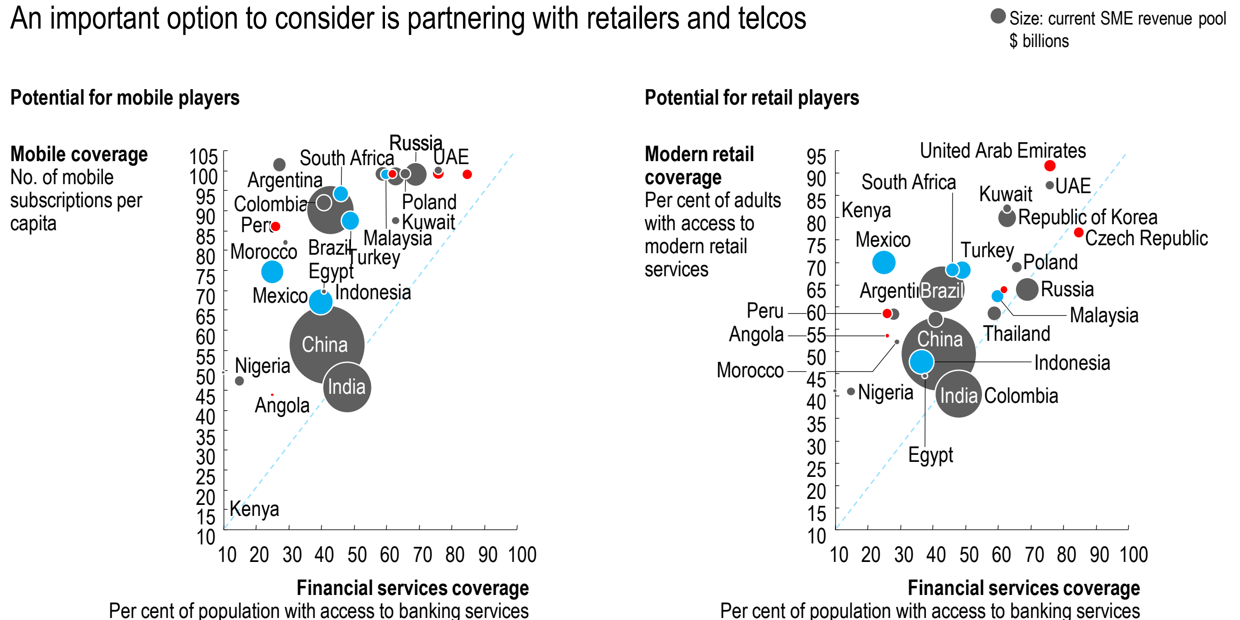


SOURCE: McKinsey Global Banking Pool (GBP); World Bank – Doing Business; IMF Financial Access Survey 2006–10; McKinsey analysis

- “**Game changers**” are countries where it is relatively difficult both to reach clients and manage risk: “game-changing” approaches to both distribution and risk are therefore required. Examples of countries in this group are India, Thailand, Nigeria, Peru, Russia and Egypt.
- “**Leapfroggers**” have relatively good credit bureau coverage, but poor physical distribution relative to the population size. Some major emerging market countries are in this group, including Brazil, China, Mexico and South Africa. Here, banks should leapfrog traditional branches using direct channels or innovations in low-cost physical distribution.
- “**Creative credit**” countries typically have good distribution but sparse credit bureau coverage. This group has relatively few countries and includes Turkey, the UAE, Chile and Saudi Arabia. Banks operating in these countries must pay extra attention to risk management because of the lack of information.
- “**Fortunately flexible**” markets such as the Czech Republic and Poland score well on distribution and credit risk. Banks here will find it relatively easy, if never straightforward, both to reach clients and assess the risks of lending to them. Successful players are using remote channels to control distribution costs and advanced risk management approaches to lower risk costs.

In both “game changer” and “leapfrog” countries, innovation in distribution is critical. One option is to partner with retailers and telcos, which reach a larger share of the population in many emerging markets than banks (**Exhibit 18**). Many forward-thinking players are forging such partnerships to:

Exhibit 18



SOURCE: McKinsey Global Banking Pool (GBP); World Bank – Doing Business; IMF Financial Access Survey 2006–10; Honohan 2008; McKinsey analysis

- Share physical infrastructure, for example retail outlets for correspondent banking, as in Latin America
- Use mobile as a distribution channel for financial services – e.g., M-Pesa in Kenya
- Use account data from telecom companies to assist with credit scoring.

To get started, banks must also make a choice about which business model to adopt. We believe the various business models we have seen can be synthesised into two main types:

- **Credit-led propositions with low-cost physical distribution**. Credit is a key MSME need. Well-priced and managed, it can be profitable and a compelling part of a bank’s proposition. A strong but simple end-to-end credit process is important. For credit-led propositions, some form of face-to-face interaction is required, typically implying some level of low-cost physical distribution. The elements of this model could include:
  - Low-cost outlets with locally hired RMs who know the MSME client intimately and visit him or her regularly
  - Roving RMs/bankers who provide unsecured credit at the MSME location
  - Contact centres used to lower costs after the initial face-to-face stage of a banking relationship.

- **Payment-led propositions with direct channel distribution**. Convenient, secure payments are also a key MSME need. Banks wishing to emphasise payment solutions for MSMEs can put much greater emphasis on direct channels, as done by M-Pesa with mobile across Africa.

Over time, these business models may merge as banks offer both credit-led and payment-led propositions. In practice, banks may pursue a dual approach, using low-cost physical channels primarily for credit while trying to offer most of their transactional services through remote channels. In both models, all five leading practices can be applied, with different emphases.

The business model choice should be made in relation to the banking opportunity. With healthy projected growth rates for a number of products, there is scope to pursue either model, or indeed a dual model (**Exhibit 19**).

Exhibit 19

The projected growth is well distributed across products

Products	Current banking revenue $ billions	Growth in market $ billions	Total $ billions	CAGR Per cent
Simple lending products[1]	80	108	188	19
Specialised lending[2]	8	24	31	31
Cash management[3]	44	61	106	19
Long-term deposits[4]	18	24	42	18
Total	150	217	367	20

1 Simple lending – medium- and long-term financing (12–36 months), overdrafts, guarantees
2 Specialised lending – equipment leasing, factoring, trade finance, project finance, LBO financing, loan syndication
3 Cash management – short-term minimal interest bearing, check payments, payment systems, i.e., B2B
4 Long-term deposits – interest-bearing deposits with restriction liquidity
SOURCE: McKinsey Global Banking Pools (GBP); IMF Financial Access Survey; McKinsey analysis

Having explored these strategic choices and understood the five leading-edge behaviours, we are ready to envision the emerging market "MSME bank of the future" – this is the focus of the next chapter.

04.

The emerging market MSME bank of the future

The MSME bank of the future

To make the MSME bank of the future come to life, we characterised and modelled a hypothetical bank to help readers understand what it could look and feel like.

The successful emerging market MSME bank of the future will offer simple, tailored products; flexible, convenient channels; fast, easy credit; and support for the MSME owner to build his or her business – and all at a very low cost.

A typical client might be a start-up commercial farmer in Africa or Asia with a simple, single-account product that offers fast and easy access to his money and helpful information about his business and agriculture through his mobile phone (**Exhibit 20**)[20]. Clients will be able to enquire about loans and insurance online. Unsecured loans will be offered up to a certain level, say $10,000, and free business seminars will be available on topics relevant to MSMEs, such as pricing, marketing, supplier management and financial record keeping.

Exhibit 20

The MSME bank of the future will offer simple, tailored products; flexible, convenient channels; fast, easy credit

Example advertisement

SOURCE: McKinsey analysis

20 One African company, Mi-Fone, has launched a smartphone costing $50, showing that this technology will be increasingly affordable to a broad range of MSMEs and can become a more widespread channel in emerging markets.

From the bank's perspective, the MSME bank of the future could have the following attributes (**Exhibit 21**):

Exhibit 21

The MSME bank of the future may look like this

	Area	Metric	Value	Implication
	Bank life-cycle		☑ Start-up ☐ Mature	Start-up attacking bank
	Business model		☐ Transaction-led ☑ Dual ☐ Credit-led	Dual credit and payment focus
Revenue	Client profile	Segment split, per cent	Micro 70; Small 20; Medium 10; 100	Focus on medium and small clients
		No. of clients year 5, 000s	Micro 130; Small 50; Medium 20; 200	200,000 clients; 5 years to capture
		Target market share	10%	
Cost	Channel	No. of branches	200; ☑ Core banking system	Initial infrastructure required
		No. of ATMs	1,000; ☑ Online/mobile system	
		Transaction by channel, per cent		Focus on direct channels (payments)
		Withdrawal/deposit	Branch 50; ATM 50; Direct 0; 100	
		Payments	Branch 20; ATM 20; Direct 60; 100	
		No. of transactions per client per year	Deposits 262; Withdrawals 104; Payments 180; 546	~550 transactions per client per year (if holding product)
	Service model	Clients per front office staff	Micro 1,000; Small 200; Medium 100; 1,300	Better service for medium segment
	Staff profile	Front-to-back office ratio, per cent	Front 67; Back 33; 100	
	Risk	Expected loss, per cent	2%	Use of innovative risk tools

SOURCE: McKinsey analysis

- Around 40,000 clients at start-up, growing to 200,000 within five years. In a typical emerging market, 200,000 MSME clients roughly equal a 10 per cent market share[21]. Clients might be segmented as follows: 10 per cent highest revenue sub-segment (annual turnover of between $1.5 and 3.5 million); 20 per cent middle revenue sub-segment (annual turnover of between $0.5 and 1.5 million); 70 per cent lowest revenue sub-segment (annual turnover of below $0.5 million). This client mix is representative of the distribution of MSMEs according to IFC data[22] and in line with our experience of banks already active in emerging markets.
- Average loan balances ranging from $31,000 for the lowest revenue sub-segment to $210,000 for the highest revenue sub-segment, with average deposit sizes between $7,000 for the lowest and $45,000 for the highest[23]. Interest margins are assumed to be around four per cent on loans, and around three per cent on deposits[24].

21 The median emerging markets by number of MSMEs include Morocco (~2.0 million MSMEs), Argentina (~2.1 million MSMEs), Saudi Arabia (~1.8 million MSMEs) and Poland (~2.1 million MSMEs).

22 IFC/World Bank enterprise survey, 2008–10.

23 Total loan and deposit size based on McKinsey Global Banking Pool data, and a number of MSMEs based on IFC/World Bank enterprise survey.

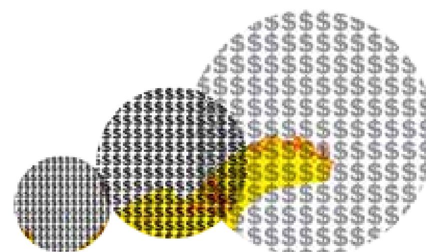
24 Based on estimates for emerging markets from McKinsey Global Banking Pool data.

- The lowest possible distribution, people and product costs:
  - **Distribution**. We assume the bank has 200 low-cost branches and 1,000 ATMs concentrated in micromarkets with a large number of MSMEs in the bank's priority sectors. Around 60 per cent of payments will be transacted via direct channels and the remaining 40 per cent via physical channels. Physical channels will be used mostly for sales and to educate clients on how the bank can help them grow their businesses and empower them to take better advantage of remote channels.
  - **People**. The bank has around 200 employees in year one, growing to roughly 1,000 in year five. The minimum requirement for staff experience is one to five years depending on the segment. RMs serve the highest revenue sub-segment and look after 100–120 clients each. Bankers in branches serve the middle revenue sub-segment and are each responsible for about 200–250 clients. The bankers that serve the lowest revenue sub-segment are largely reactive and operate through both branches and contact centres.
  - **Products**. All application forms are a maximum of two pages. All clients have transactional products, but only about a quarter have loans. Asked in our interviews what percentage of their clients use/have access to credit facilities, two-fifths of banks said "less than 20 per cent"; the remaining responses were evenly split among the options "20–40 per cent", "40–60 per cent" and "more than 60 per cent".
- The bank uses innovative credit assessment tools like QCA and psychometric testing, which help keep risk costs at a minimum (say a two per cent loss rather than the more common three per cent).

Economics of the MSME bank of the future

In all probability, most banks will have other divisions to complement MSMEs (such as affluent retail banking). This will typically offer even greater benefit to the bank due to cross-selling opportunities or more holistic credit assessment, for example. We nevertheless chose to show the economics of a stand-alone MSME bank in isolation to clarify the independent business case.

The economics of this bank are attractive. For example, a start-up/attacker bank in a "game changer" market that opts for a dual credit and payment-led product focus and emphasises digital channels could achieve a pre-tax net profit of around $167 million ($128 million after tax) and an ROE

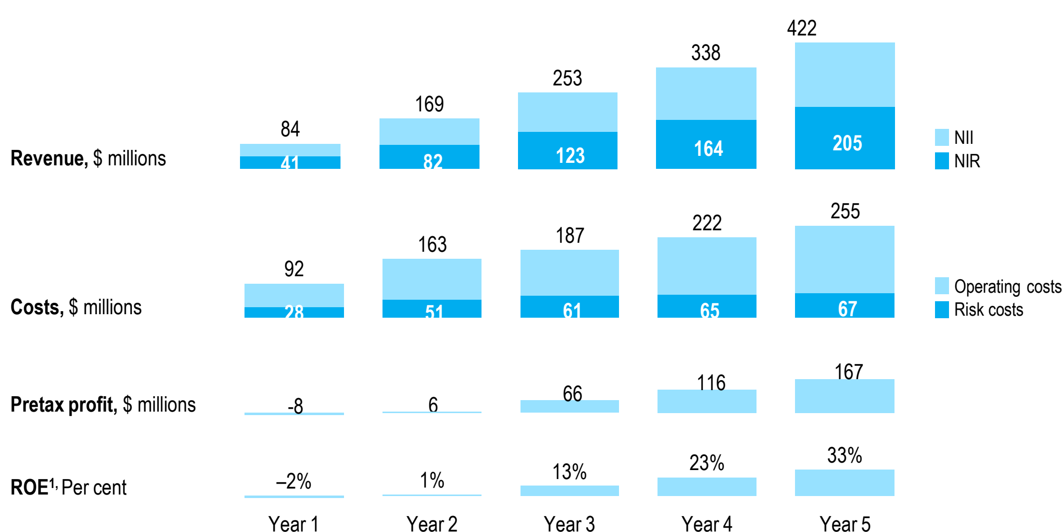


The successful emerging market MSME bank of the future will offer simple, tailored products; flexible, convenient channels; fast, easy credit; and support for the MSME owner to build his or her business – and all at a very low cost.

of 33 per cent (**Exhibit 22**). This includes accounting for and depreciating start-up costs such as core banking system, banking license, branches and ATMs. Approximately 60 per cent of interest income comes from loans. Operating costs are split approximately between staff (40 per cent), IT and distribution (42 per cent), and depreciation and other costs (18 per cent). By year five, the cost-income ratio of this bank is 44 per cent.

Exhibit 22

The economics of an ideal bank operating in the MSME space shows ROE of 33% after 5 years



1 ROE = After-tax profit/equity
SOURCE: McKinsey analysis

The economic case may be attractive, but MSMEs are highly sensitive to economic cycles thanks to typically limited business diversification and their low capital reserves. The adverse effect of a recession on risk costs is severe (increasing expected losses from about two to four per cent). Together with the impact on margins and volumes, this could cut the bank's pre-tax profits in year five to just $38 million (compared to $167 million), while ROE would be only 12 per cent (compared to 33 per cent).

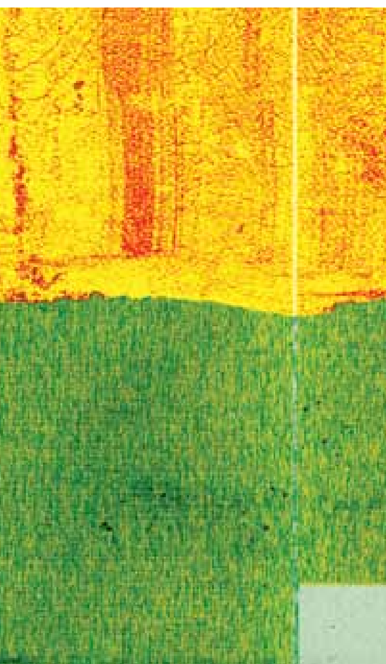
Irrespective of which strategic options banks choose to pursue, we believe the successful MSME bank of the future will combine several of the practices discussed earlier. Many leading MSME banks are good at some of them, but no bank combines them all. In our model of the economics of the MSME bank of the future, we find high profitability, with ROE of approximately 33 per cent by year five.

We call it the bank of the future, but we see increasing evidence from leading emerging market banks that the future is now, and we expect banks to more fully capture the opportunity within the next five years.

We turn next to critical questions to address when moving to action.

05.

Moving to action



No single agenda can be equally relevant to such a diverse collection of institutions as domestic incumbent, start-up, and multinational banks and other financial players. However, there are some common questions to address. We articulate below some relevant questions that the CEO of an ambitious bank should consider before embarking on this course:

Is the emerging market MSME segment part of your bank's strategy?

- **Is the emerging market MSME segment part of your growth agenda?** Banks continually look for new sources of growth. The book T*he granularity of growth*[25] found that 80 per cent of the growth differences between companies have to do with choices about where to compete. Banks should decide if the MSME segment really is a key part of the bank's sources of growth. They should not evaluate the MSME segment in isolation, but explore synergies with other segments.
- **Is your home market attractive enough, or do you need to go cross-border to capture the opportunity?** Incumbent MSME-serving banks should consider if their "home" country offers enough exciting opportunities given the size of the MSME market, its projected growth and the number of unserved MSMEs. If not, banks should consider entering new cross-border markets or acquiring other banks.
- **What is your level of ambition for this segment in terms of earnings or market share, and is it commensurate with the size of the opportunity?** To make the aspiration tangible, banks should consider how much earnings or market share growth they expect to capture from the MSME segment in a defined time frame.
- **How quickly can the MSME segment make a meaningful contribution to your bank's financials?** Does your bank have sufficient capital to deploy to the MSME opportunity, and how does the MSME business case compare to others? How quickly can the MSME segment make a telling contribution to overall bank financials? The banks we interviewed reported that the MSME segment makes a larger contribution to banks' profits than to assets and liabilities. Can this be the case at your bank, and how quickly can this contribution be scaled? Banks should diligently assess the viability of their MSME business case. The business case should be robust and based on realistic assumptions about number and mix of clients, product mix, average product balances, product margins and fees and channel mix.

25 Baghai, Mehrdad, Sven Smit and S. Patrick Viguerie, "The granularity of growth", May 2007.

Does your bank have the required capabilities, and which ones will you have to build?

- **Does your bank have the innovative mindset required to serve MSMEs profitably and on a significant scale?** Banks need to recognise that serving MSMEs requires a special mindset and that importing corporate banking approaches will not work. As bank revenue per MSME client is low, banks need to understand clients' needs and meet them at the lowest possible operating and investment cost. A low-cost business model is not the sole objective in itself; rather, the objective should be to find the model that lowers costs as far as possible while still allowing the bank to capture the required share of customer wallet.
- **Does your bank understand the MSME opportunity at a sufficiently granular level to attack it successfully?** Banks should analyse the concentrations of MSMEs and ask themselves if they are present in these micromarkets. This requires an in-depth understanding of the large pockets of MSMEs in a country. Similarly, banks need to prioritise sectors of the economy where they are able to compete for MSME business, based on an estimate of the available MSME banking revenues.
- **Does your bank have an appropriate, end-to-end risk management process for MSMEs, leveraging the latest innovations?** To compete in this segment, banks have to have lean and low-cost risk assessment methods with high predictive power. The people- and judgement-intensive approach to risk applied in high-revenue-per-client segments is not economical for MSMEs in emerging markets.
- **Does your bank need to "change its game" in distribution to capture the opportunity profitably?** Banks should consider how well positioned they are to reach clients in their target markets. Does the situation warrant "game-changing" approaches in these important areas? It could be a question of introducing or innovating around a particular technology (mobile, contact centres, laptop or POS-enabled agents), or adapting physical structures (e.g., with low-cost branches or correspondent banking).
- **Does your bank have a value-maximising coverage model that fully captures the opportunity?** Are the bank's MSME client segments each served by a model whose cost is justified by the revenue generated by those clients? Does the bank have sufficient sector-specialist bankers and sector-specific client offers to add value to MSME clients in priority sectors?

Banks should diligently assess the viability of their MSME business case. The business case should be robust and based on realistic assumptions about number and mix of clients, product mix, average product balances, product margins and fees and channel mix.

Is your bank ready to execute at scale?

- **Does your bank have the plan, processes and tools required to execute at scale?** Banks should be confident of their execution skills, their previous track record when it comes to tackling new segments and the soundness of their governance structures for large-scale project implementation.
- **Does your bank have the talent and leadership to execute against the MSME aspiration?** A broad set of skills will be required, from RMs and bankers who understand the segment, to sector specialists to support growth in particular MSME sectors (e.g., agriculture, retail and wholesale), to credit specialists who can institute and operate the innovative risk practices that will be required. Banks will need to ensure they attract people with the required skills and have a “factory” for developing relevant talent.

Banks will need to answer these questions diligently, with an open mind and based on a sound fact base. If the answers suggest they should pursue the MSME opportunity with renewed vigour, they should not do so with a business-as-usual approach. They should adopt the five leading-edge practices and build an “MSME bank of the future” to serve MSMEs profitably and on a significant scale.

We believe this “future” is within the grasp of many banks – if captured responsibly, the benefits to banks, MSMEs and emerging market societies will be immense.

Acknowledgements

Any venture such as this is by its nature a very collaborative effort, which could not have been possible without the insights, energy and perseverance of many people across the emerging markets.

First, we owe a deep debt of gratitude to the 29 leading banks from across the emerging markets that allowed us to interview them and to learn from their experiences with the MSME segment. We cannot name you here, but you know who you are, and you are pioneers in this exciting arena. Long may your MSME financing journeys continue to be both exciting and rewarding.

McKinsey & Company directors, Jacob Dahl, Tony Goland and Paal Weberg, godfathered, catalysed and steered this effort. Together with McKinsey directors from across our emerging market regions, Irene Shvakman, Hans-Martin Stockmeier, Emmanuel Pitsilis and Joydeep Sengupta, and partner Jan Bellens, they comprised the steering committee. The steering committee members were most generous in sharing their plentiful experiences from many years serving banks in emerging markets and helped the team tease out the key insights during the months of this endeavour. We also thank Paul Jenkins and Pedro Rodeia, members of the firm's broader financial services leadership, who provided helpful comments. Susan Lund, partner at McKinsey Global Institute, was insightful and extremely helpful as always with her contributions. Miklos Dietz and Adam Homonnay from the Global Banking Pool team were invaluable in helping the team navigate through the global banking pool data and testing the resulting analyses.

Mutsa Chironga led and coordinated the development of the material from beginning to end. But it would not have been possible without the time, energy and commitment of numerous partner and associate principal colleagues from across the emerging markets who invested time and energy, and contributed greatly with ideas, material, experiences and examples that enriched the paper. These colleagues include Gary Pinshaw (Sub-Saharan Africa), Yran Dias (Latin America), Petr Slechta (Eastern Europe), Edoardo Ginevra (North Africa), Renny Thomas (South Asia), Akash Lal (South Asia), Jun Xu (China), Amy Jin (China), Maya Horii (North America), Michael Fei (China), Robert Schiff (North America), Tobias Baer (East Asia), Nawal Roy (South-East Asia), Farid Sedjelmaci (North Africa), Francisco Goncalves Pereira (Sub-Saharan Africa) and Mark Walker (Europe). Senthil Durairaj (South-East Asia) helped us understand the needs of MSMEs.

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Finally, heartfelt thanks to our able editors, Helen Donald and Tim Dickson, for their diligence. In many instances, they replaced clumsiness with clarity and colour.

While this article would not have been possible without the people listed above, the authors take full responsibility for any remaining errors or inaccuracies. The research is the independent perspective of McKinsey's Financial Services Practice and has not been commissioned or sponsored in any way by any third party.

Technical annexure

1. MSME definitions

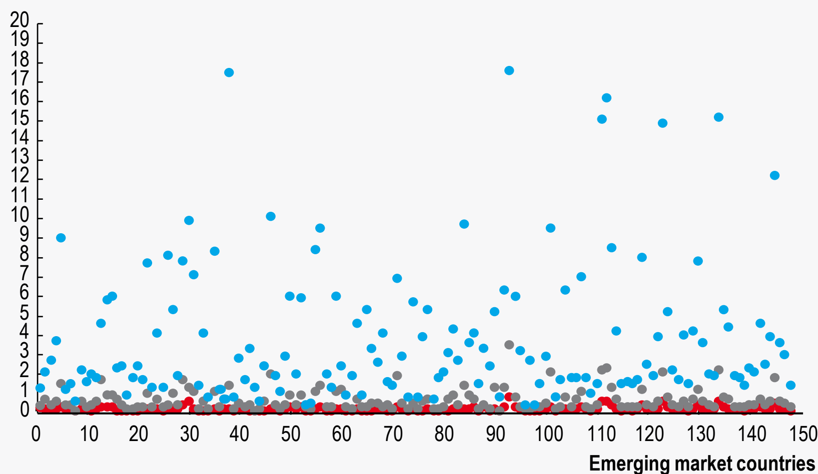
In this article, we define MSMEs as companies with turnover of $3.5 million and below. This is a global average based on the IFC's surveys[26] of 62,000 SMEs (small to medium-sized enterprises) across 110 countries, and varies by region and country (**Exhibit 23**).

Exhibit 23

SME revenue upper bounds have significant variation across regions, and across countries within each region[1]

- Microbusinesses
- Small businesses
- Medium businesses

SME turnover per country
$ millions



	Micro	Small	Medium
Minimum	$6,444	$30,000	$273,050
Maximum	$683,969	$3,383,070	$17,571,802
Average	$104,648	$552,795	$3,787,955
Median	$101,307	$507,249	$3,487,526

1 Extreme outliers were removed in calculation of the per country figures and for unobserved data extrapolations based on GDP were conducted
SOURCE: IFC/World Bank Enterprise Survey; McKinsey analysis

Within the MSME sector, medium-sized enterprises have a median turnover of $3.5 million, small enterprises $0.5 million and microenterprises $0.1 million.

2. MSME banking revenue pools

MSME banking revenue, asset and liability pools per country were estimated based on data from McKinsey's proprietary Global Banking Pools (GBP). These data are collected by regional research teams from the following sources:

- Financial statements of major banks
- Central bank and government data
- Industry analysis of major banks within countries
- Experts both internal and external to McKinsey.

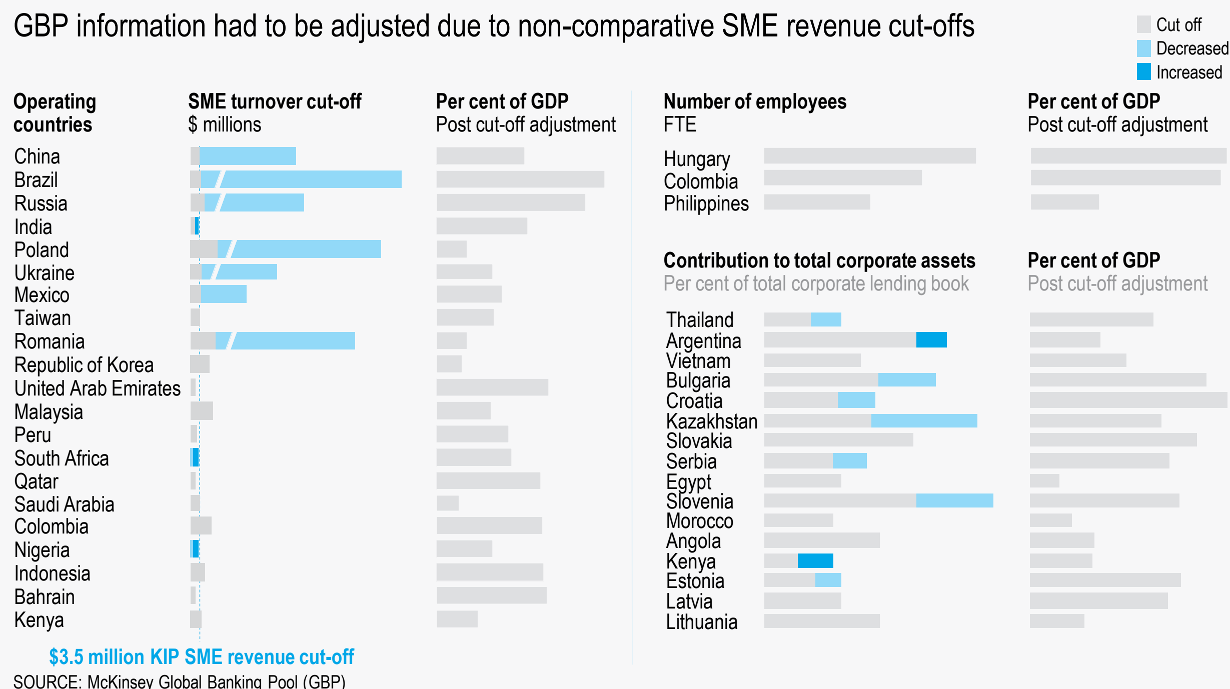
26 IFC/World Bank enterprise survey, 2008–10.

The data are then fed into proprietary regression models which compute missing data points.

The data cover 79 countries from Albania to Vietnam and approximate values for other countries with the use of seven regional models that cover about 99 per cent of global banking assets.

Across emerging markets, there was no consistent revenue threshold defining MSME. Local definitions were therefore applied, and MSME bank revenue estimates then adjusted to be in line with global averages to ensure our estimates were comparative (**Exhibit 24**).

Exhibit 24



- **Revenue**. Typically up to ~$3.5 million, varying slightly depending on the country (based on IFC/World Bank enterprises survey results for the average SME)
- **Number of employees**. Up to 200, depending on the country (based on IFC/World Bank enterprises survey results for the average SME)
- **Percentage contribution to corporate assets**. Based on SME turnover contribution vs. corporate turnover contribution to GDP
- **Less than one per cent of GDP**. Based on the examination of the other cut-offs, greater than one per cent was more than two standard deviations from the mean and therefore determined to be an outlier.

GBP data did not cover the complete set of countries considered in this article. It provided a regional view of the pools. After removing the countries discussed here from the regional pool, the remainder was split proportionally along the uncovered countries according to GDP contribution to the region.

3. Banking revenue growth

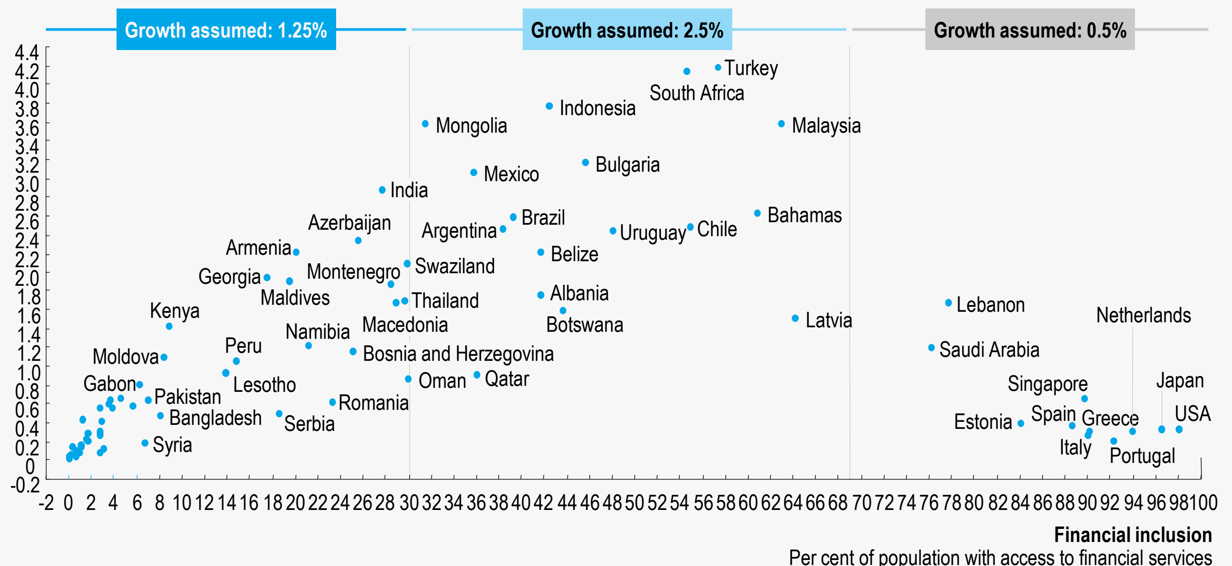
The potential growth in the market indicates whether the MSME sector is attractive and which countries have substantial opportunity within the market. To assess this, we looked at three factors: normal market growth, current and expected growth of financial inclusion, and wallet growth.

- **Normal market growth** (normal market development). Nominal GDP growth based on forecasts from McKinsey Global Institute was used as a proxy for normal market development, as banking revenue grows nominally.
- **Current and expected growth of financial inclusion**:
  - Financial penetration was measured as a composite index based on the percentage of the population with access to financial services such as a current account, loan or other transactional capabilities as described in a study conducted by Honohan (2008).
  - Projected growth is based on the annual per capita increase in deposit accounts across 81 countries for the last five years as measured by the IMF Financial Access Survey, and is constrained by the level of financial penetration. This ensures inclusion does not go above 100 per cent (**Exhibit 25**).

Exhibit 25

Growth due to financial inclusion development

Growth in financial inclusion
Yearly per capita increase deposits per capita



SOURCE: IMF Financial Access Survey 2006–10; Honohan 2008

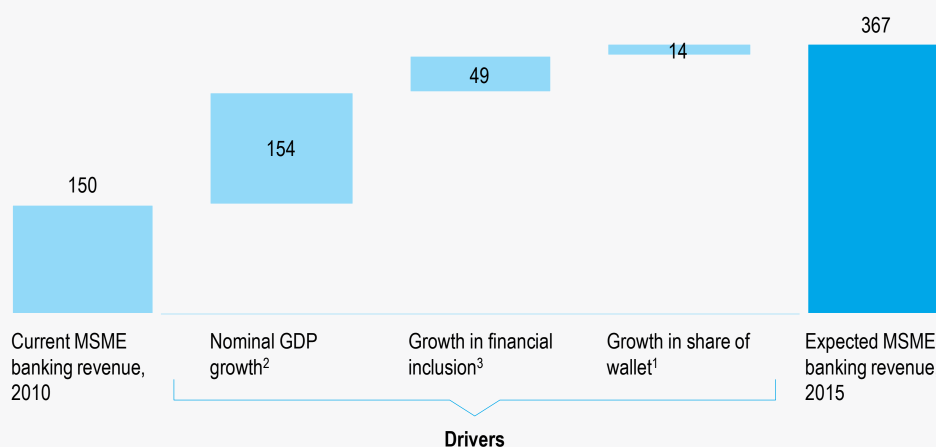
- For countries where data were unavailable, approximations for financial penetration were based on countries with similar GDP per capita, and growth was likewise based on countries with similar financial penetration.

- **Wallet growth** (increase in product penetration):
  - GBP country revenue figures were split into their respective product categories. The percentage contribution to GDP per product was calculated for all countries (extrapolated for countries not covered by GBP).
  - Percentage growth in GDP contribution of each product, due to increased financial inclusion based on the step above, was taken into account.
  - The average percentage contribution of the product revenue to GDP for a developed market was set as the cap for how far emerging markets would grow.
  - The gap between developed and emerging market wallet penetration was predicted to narrow at the rate of financial inclusion growth (about 15 per cent over the next five years) (**Exhibit 26**).
  - The gap closed over the period was then multiplied by the potential banking revenue figure in 2015 (taking into account both GDP and financial inclusion growth).

Exhibit 26

The estimated MSME banking revenue pool is likely to more than double over the next 5 years

$ billions



1 Growth based on increased product penetration (simple credit, specialised credit, long-term deposits and current accounts and payments) as a per cent of GDP per emerging market country towards an average of developed markets, adjusted for the 5-year timeline based on previous 5-year financial service penetration growth
2 Growth based on nominal GDP growth predictions from Global Insights
3 Growth measure as a yearly increase in per cent of population with access to financial services according to IMF Financial Access survey 2010

SOURCE: McKinsey Global Banking Pools (GBP); IMF Financial Access Survey; Honohan 2008; McKinsey analysis

4. Sectors

Liabilities and assets were estimated at MSME sector level.

The sector banking pools were determined in the following manner:

- Sectors were consolidated into comparable categories, for example agriculture, retail, general services and heavy industry. Certain sectors, such as mining, professional services and transportation, could not be extracted independently of the present categories, due to the form of the raw survey data.
- Based on the sample from the IFC/World Bank enterprise survey results, turnover and lending splits were created. We made two assumptions: country results were representative of the urban MSME population; banking revenue and SME turnover split were proportional.
- Due to the lack of information in the survey data, an analysis was conducted across six regions to estimate deposits (liabilities) for each sector. The analysis covered the loan-to-deposit ratios and deposit-to-turnover ratios of up to 10 listed companies per sector. The deposit split was then calculated based on the SME turnover pool, multiplied by the deposit-to-turnover ratio for the sector within the region (500 emerging market companies were used in the sample).
- Due to a lack of rural data in the survey, agriculture (usually comprising a large proportion of MSMEs) was understated. An adjustment was made in proportion to the agriculture's contribution to GDP to calculate revised sector splits.

5. Client bank interviews

Bank interviews were held in emerging markets to gain a closer understanding of the MSME banking landscape and to obtain additional "real world" insights.

The client bank interview survey was designed to understand how banks are approaching the problem of increasing their MSME lending and the ways in which they could close the $2.3 trillion lending gap referenced in the IFC article.[27]

- Each interview was administered to senior bankers in the SME divisions across banks in the major emerging market regions.
- Banks were selected for being leading banks in the MSME segment in their countries.
- The interview covered five main topics on how banks can more profitably serve MSMEs:
  - **Relevance and strategy**. MSMEs' share/contribution of total bank assets, revenue, liabilities, profits and ROE, as well as segment definitions
  - **Operating costs**. Costs that banks could most likely reduce, and what could specifically be done to reduce cost
  - **Risk cost**. Levers that would most help banks reduce risk

27 Stein, Peer, Tony Goland and Robert Schiff, "Two trillion and counting – assessing the credit gap for micro, small, and medium-size enterprises in the developing world", IFC: World Bank and McKinsey & Company, October 2010.

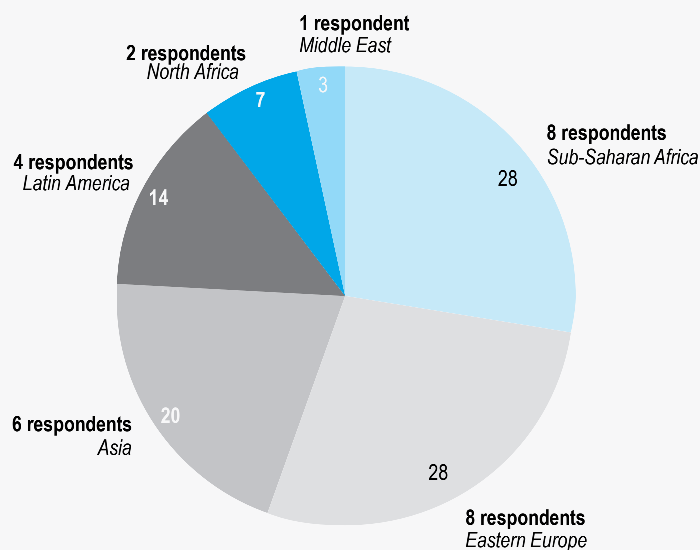
- **Tools**. Credit and sales tools utilised for granting credit and sourcing clients respectively
- **Innovation**. The most important present and future innovations by banks to help increase lending to MSMEs.

The results were compiled and will be shared with all participating banks. To date, a total of 29 banks have been interviewed (**Exhibit 27**).

Exhibit 27

29 bank interviews conducted

Per cent of respondents from each region



SOURCE: Bank interviews

6. Bank economics model

The purpose of the economic model is to forecast a bank's ROE based on its chosen MSME strategy, to show whether MSMEs can be served profitably in various emerging markets.

We modelled lines of the income statement and balance sheet, using operational drivers of these lines wherever possible. The structure and logic of the calculations in the model are articulated in the exhibit below (**Exhibit 28**).

Exhibit 28

Structure for bank economics model

i = client segment
j = channel

Revenue	Net interest income	Liabilities income = Σ_i (# clients$_i$ x average liability balance$_i$ x avg. liability spread) Asset income = Σ_i (# clients$_i$ x average asset size$_i$ x average asset spread)
–	Non-interest income	$\frac{\Sigma_i[(\text{\# clients}_i \times \text{\# products}_i \times \text{fee per product})}{\text{clients}} + \frac{(\text{\# clients}_i \times \text{\# transactions}_i \times \text{fee per transaction})]}{\text{clients}}$
Operating expense	Fixed	Staff expense = # staff x average salary IT expense = cost of banking system Distribution expense = headquarters
–	Variable	Staff expense = Σ_i (staff/ client$_i$ x # clients$_i$ x cost/ staff$_i$) IT expense = Σ_j (# transactions$_j$ x cost/ transaction$_j$) Distribution expense = Σ_j (# transactions$_j$ x cost/ transaction$_j$) + (# channels$_j$ x fixed cost per channel$_j$)
Risk expense		Loans x expected loss
= Pretax profit		Tax rate = x% ROE % = Net profit/equity

SOURCE: McKinsey analysis

- The assumptions made in the model on the "base case" definition of the bank are:
  - The bank's initial and target market share and growth rate
  - The percentage of clients in each segment (micro-, small and medium-sized enterprise)
  - Number of clients holding each type of product (loans and deposits)
  - Number of transactions per client per year for deposits, withdrawals and payments per channel
  - The cost of online/mobile infrastructure, existing and target number of branches and ATMs, and the cost of capital expenditure
  - Staff costs and loading ratios.

- The country-level assumptions cover fixed ratios both for loans and deposits, split by the product focus and the three MSME segments.
- The data for the model were compiled from various sources which include:
  - **IFC**. Per country, the number of SMEs and the number of SMEs served as clients of a bank.
  - **McKinsey Global Banking Pools (GBP)**. Volumes (loans and deposits); interest margins (deposits and loans); fee margins (deposits and loans); risk cost margin.
  - **Interviews, press clippings and McKinsey team analysis.** Cost per transaction for the three channels (ATM, branch and online) and three transaction types (deposits, loans and withdrawals).

Case studies

This section offers additional detail about innovative distribution models we have come across in emerging markets.

"Lite" branches/ community model

A bank in Indonesia established a microbusiness banking subsidiary to focus on the servicing of microsized businesses and self-employed individuals. Small and lite branches are located within two to three kilometres of the target market and staffed with low-cost relationship officers (ROs) recruited from within the community. The ROs know the community well and interact informally and very frequently with clients. The bank offers two loan products – up to IDR50 million and 200 million. Interest rates, although relatively high, are lower than those offered by microfinancers.

By 2010, the bank had built a network of 1,320 outlets, had a loan book of IDR15 trillion accounting for 19 per cent of the group's total lending activity and was operating with an ROE of 40 per cent (more than double the group average).

Key learnings:

- Focus on niche client group – e.g., this bank serves small market traders in a compact geographical location.
- Community model can be used instead of complex modelling/credit scoring to understand and manage risk – e.g., locally recruited ROs know clients and their businesses well, and physical presence in markets allows for close monitoring and facilitates easier "cash pick-up" collections.
- Simplify administrative processes – e.g., short, simple application forms, and quick, centralised credit decisions based on a simple checklist with a few basic criteria.

Correspondent banking

A bank in Brazil entered into a partnership with SME suppliers and service providers located in areas where there is no bank presence or areas of strategic importance, to provide banking services on behalf of the bank. Correspondents have an established track record, hold cash on hand of approximately $15,000 per day, and operate on non-banking days and for longer hours than bank branches. Correspondents provide 10 basic financial services – e.g., cash withdrawal, cheque encashment, remittances and payments. The service fee attached to all transactions is shared between the bank and the correspondent.

This model allows the bank to offer services in low-demand areas and extend operating hours with little additional cost. By 2010, the bank was processing 18 million transactions through 4,750 active correspondents.

Key learnings:

- Direct involvement of correspondent owner/management in customer service is critical for success.
- Service-level agreements with correspondents need to be established and closely monitored, as the correspondent becomes the face of the bank when dealing with clients.
- To ensure smooth operations, correspondents must have sufficient knowledge of technical systems and hold sufficient cash to meet daily requirements.

Specialist MSME bank

A bank in Indonesia launched a fully independent bank to fulfil the needs of the MSME segment and sectors.

With a focus on growth and empowerment of MSME customers, a programme driving financial and business literacy was launched and, in 2010, 6,600 training classes were organised for more than 100,000 participants. Employees are hired, trained and equipped to deal specifically with MSME clients. The bank emphasises the delivery of excellent customer service, and employees are measured on client retention and service levels.

The bank serves 200,000 MSME customers through a network of 560 branches. High-margin MSME loans are growing quickly and the bank's ROE exceeded 36 per cent in 2010.

Key learnings:

- Loan quality can be maintained by proactively educating MSMEs.
- Building long-standing relationships with MSMEs helps ensure that the bank remains the sole financial provider.

POS-enabled agents

A bank in Africa developed a technology-driven transaction and savings model targeted at the informal sector. A roving agent network takes banking to the MSME's place of business, allowing for convenient and low-cost transactions, whilst also building trust in the bank and improving financial literacy. Agents (usually community leaders) walk around with POS devices collecting deposits and using the bank card as proof of identity. Customers can open an account and be issued a chip and pin card within one day.

More than 40,000 accounts were opened within the first six months of operation. After two years of operation, the initiative had 80,000 active clients and close to 300 active agents collecting an average of approximately $800,000 per month.

Key learnings:

- Innovative use of technology can overcome the challenges of limited means of client identification and lack of credit bureaus, extending the potential client base.
- The agent model is useful in areas where financial literacy is low:
  - Personal service is essential for clients with low levels of formal education.
  - Presence in the marketplace aids bank visibility and is necessary to build trust with previously unbanked clients who may fear losing their money.
- Security concerns can be mitigated with cash collection limits on the POS devices, appointing agents who are well known and respected in the community, and providing safety personnel for the agents.

Contact centre model

A major cross-border bank that operates in Latin America leverages contact centres to serve MSME clients more cost-effectively. During initial stages of the banking relationship, there is face-to-face contact with a focus on getting to know the client well and gaining a thorough understanding of the business. Over time, clients are migrated to lower-cost, remote channels. The detailed understanding obtained in the first few months is invaluable as the relationship evolves and credit decisions are made.

In addition to reducing costs, customer satisfaction has also increased through the use of the new innovations, including immediate Web call-back technology, in which new customers can request an immediate call-back to receive further information about any product or service.

Mobile: M-Pesa and NURU

M-Pesa is a mobile money service offering simple, convenient and affordable basic banking. The physical infrastructure is minimal, with account opening, cash transactions and customer support facilitated by more than 28,000 merchants acting as agents.

NURU created a lending platform on M-Pesa, providing rural farmers with access to crop financing and other loan products. The combination allows farmers to conduct all banking and transactions via mobile phone.

60 per cent of MSMEs use M-Pesa in Kenya and 25 per cent in Tanzania. A significant number of MSMEs with traditional bank accounts prefer M-Pesa for flexible, acceptable, safe and reliable transactions.

Key learnings:

- Simple, convenient and affordable solutions attract and retain customers – e.g., tools that would enhance business as usual.
- A sizeable, well-trained agent network allows for superior and cost-effective distribution and service.
- Liquidity constraints (especially in rural areas) favour smaller transaction values.

Microfinance model

A Brazilian bank created a microcredit business unit that, since 2003, has offered financing to low-income formal and informal entrepreneurs.

Lending agents go into the community, meet potential clients, assess businesses and offer credit based on their needs.

Clients sign up via a call centre with both inbound (receptive) and outbound (active) sales.

- **Receptive channel.** Clients phone in to register applications.
- **Active channel.** Telemarketing operators proactively contact the bank's clients with the appropriate profile.

Microinvest also provides entrepreneurs with basic training in accounting, business management and the conscientious use of credit.

By the end of 2010, Microinvest had 70 lending agents and had concluded more than 28,900 financing transactions worth BRL88.5 million.

Key learnings:

- Direct contact is important in the microcredit segment: Microinvest uses both agents and (smart)phone interactions.
- Technology can be leveraged to meet client needs more effectively and keep credit affordable. For example, smartphones can significantly speed up the credit application process and eliminate paper.

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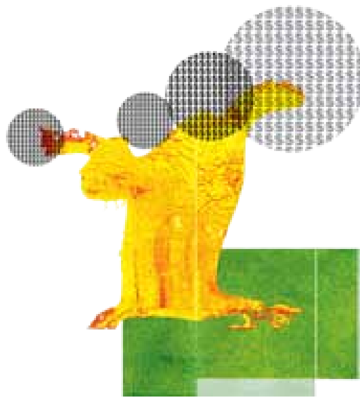

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