MicroSave – Briefing Note #172

Key Strategies for Banks Expanding Reach to MSME Segment in Kenya

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Key Points:

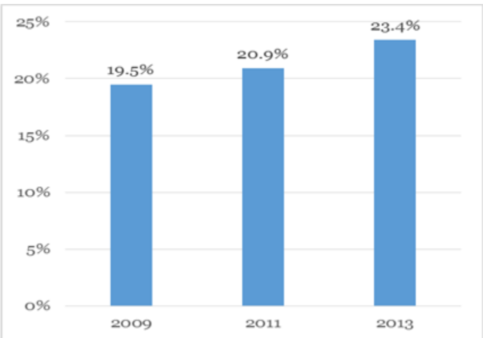
1. *To increase volume and value of MSME lending, financial institutions need a clear MSME strategy.*

2. *Scalability of MSME financing requires incorporation of digital financial services to delivery channels.*

3. *Financial institutions branding should resonate with MSMEs. Product design should capture the financial behaviour of MSMEs.*

Formal financial inclusion in Kenya has increased by 50% in the last 10 years with 75.3% of Kenyans now formally financially included, according to the FinAccess 2016 report. Kenyan banks have contributed to the increase in financial inclusion as more and more banks are providing retail finance to the MSME segment. For the period ended 31st December, 2015, Kenya has 7 large banks with a market share of 58.21%, 12 medium banks with a market share of 32.42% and 21 small banks with a market share of 9.24% as described in Central Bank of Kenya, Bank Supervision Annual Report 2015. Our experience shows that banks expanding to serve the MSME segment in Kenya face competition from the existing banks and as a new entrant, they attract MSME customers who are not only multi-banked but are also actively using informal financial services such as *ROSCAs* and *ASCAs* where members accumulate and invest their savings.

The Kenyan banks' total SME lending portfolio in December 2013 was estimated to be KES 332 billion (US$3.32 billion) or 23.4% of their total lending portfolio as illustrated in the graph below sourced from FSD research on bank financing to SMEs in Kenya.



Graph 1: Proportion of SME Finance to Total Lending in the Banking Industry in Kenya

Considering that the largest percentage of businesses in Kenya are from the MSME sector, the SME lending portfolio should increase significantly. However, a closer sectoral analysis reveals that lending to agricultural SMEs is inadequate despite agriculture being the backbone of the Kenyan economy contributing to 24% of its GDP.

Constraints to SME finance from banks in Kenya include high cost of credit, lack of proper business records, insufficient collateral, and owners' inadequate business experience among others.

With this background, two key questions arise:

1. How can the banks serve the MSME segment in the face of competition from formal and informal financial service providers?
2. How can the banks address the barriers to access highlighted above?

Our working experience with banks venturing into MSME financing in Kenya points to several strategies that can be employed to increase SME finance.

Strategy #1: To Increase Volume and Value of Lending to MSMEs, Develop a Strategy.

Having a deliberate strategy for lending to MSMEs helps the bank to define its MSME customer base and understand the niche segments within the MSME sector. The strategy provides clarity to customers and staff on the niche segments the bank is willing and able to serve. For instance, does the bank understand how to lend to an agricultural SME and how different this is from lending to another segment like hospitality industry or retail? Conducting research is a critical step in the design of an MSME lending strategy. The research should primarily focus on how MSME are meeting their existing financial and non-financial needs. The strategy provides an opportunity for the bank to define objectives and targets to set itself apart from the competition such as defining the portion of its lending portfolio to dedicate to the segment and how to reduce the cost of lending to this segment. This approach can inspire the bank to adopt innovative interventions in areas such as collection and use of information from MSMEs in the lending process despite this segment not always having readily available and accurate records.

Strategy #2: To Gain Loyalty, Your Brand Should Uniquely Reflect the Bank's New Positioning of Serving the MSMEs

A bank wanting to position itself as an MSME finance bank needs to establish the brand perceptions, both positive and negative, from potential clients. Establishing brand perceptions and expectations will help the bank to develop a structured approach in aligning its brand with the MSME market. A brand and image analysis can be conducted which can assist in designing and delivering products and services appropriately to the MSME market, highlighting the direct benefits to the target customers.

Strategy #3: To Attract Deposits, Design Your Financial Services Integrating the Financial Behaviour of the MSME Customers

According to FinAccess 2016 report, 22.3% of bank accounts were closed or dormant as compared to 3.1% in SACCOS and 1.2% of mobile bank accounts. This indicates that despite significant improvement in financial inclusion in Kenya, a gap in terms of usage of bank accounts exists with more customers choosing to close their bank accounts or leaving their accounts dormant as opposed to SACCOS and mobile bank accounts. To reduce the number of dormant and inactive accounts, the bank should avoid developing products using the "copy and paste" approach. Product development incorporating behavioural research techniques and biases such as mental accounting will allow the bank to have a competitive product that the MSME customer will prefer, choose and use.

Strategy #4: To Achieve Scale, Incorporate Digital Financial Services to Delivery Channels

The future of banking in Kenya is "mobile". The potential of providing banking services using the mobile phone as a channel is huge in Kenya as evidenced by the performance of recent deployments like Equitel (officially launched in July, 2015) and KCB M-Pesa (launched in March, 2015). Equitel has processed loans worth KES 20.8 billion as at the end of June, 2016 and KCB M-Pesa had disbursed loans of KES 10.3 billion in loans since its launch. The Central Bank of Kenya, the regulator of commercial banks and microfinance banks in Kenya, reports the value and volume of banking transactions undertaken at agent outlets is increasing since the roll out of agency banking model in 2010. This indicates that bank customers are gaining more trust in agents and are increasingly opting to do their transactions at agent outlets. Digital financial services provide convenient and easy access to financial services for the MSMEs. A comprehensive digital finance strategy is critical as it ensures the bank's digital financial channels are well suited to the MSME segment and are in line with overall business objectives such as expansion.

Strategy #5: To Reduce Credit Risk in Lending, Empower Staff Members Beyond Performing Cash Flow Analysis and Towards Real Customer Relationship Building and Management

There is no "one-size-fits-all" kind of product that can work for MSMEs. MSMEs operate in different sectors of the economy and have diverse needs and challenges at different stages of business growth. Loan officers need to not only understand how to perform cash flow analysis and use financial ratios in appraising the business, but also to have an in-depth understanding of the intricacies of business. In addition, they should know the aspirations and competencies of the business owner. The staff should be able to answer questions such as: How does the business operate and in what environment is it operating? What are the long-term and short-term financial needs of the business? What are the non-financial needs that the bank can address? What other sources of funding do SMEs have and why do they prefer them? What is the relationship between the owners' family and the business? How do they cope in times of financial crisis? This in-depth knowledge of customers will enable the bank to meet each segment at its points of need.

The bank must create long-term relationship with its customers - the customer relationship management process should ensure that the bank relationship is not hinged on one staff member to avoid the risk of breaking the relationship when the employee is transferred or exits the bank.

Conclusion

In conclusion, a bank seeking to expand reach to the MSME segments should take into account the following: Do MSMEs trust the bank's brand? Do they have convenient access to the financial service? Can they get a desired return/benefit (including non-financial benefits)? Does the financial services match the liquidity/illiquidity preference of the MSME customers? Do staff members look beyond the obvious and focus on building long lasting relationships with customers? The answers to these questions are critical as MSMEs broadly base their financial decisions on these parameters.