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Banking Practice

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

how banks can grasp a $350 billion opportunity

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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.

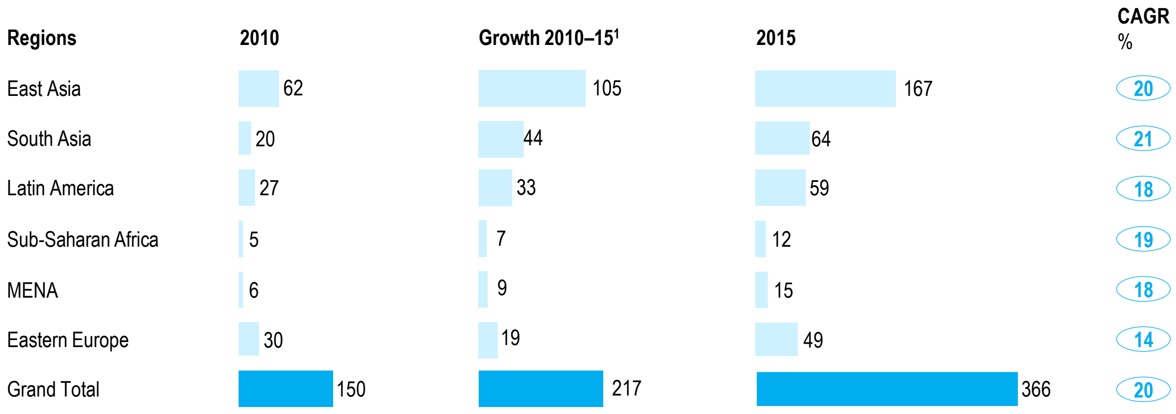
The size of the opportunity

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



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.

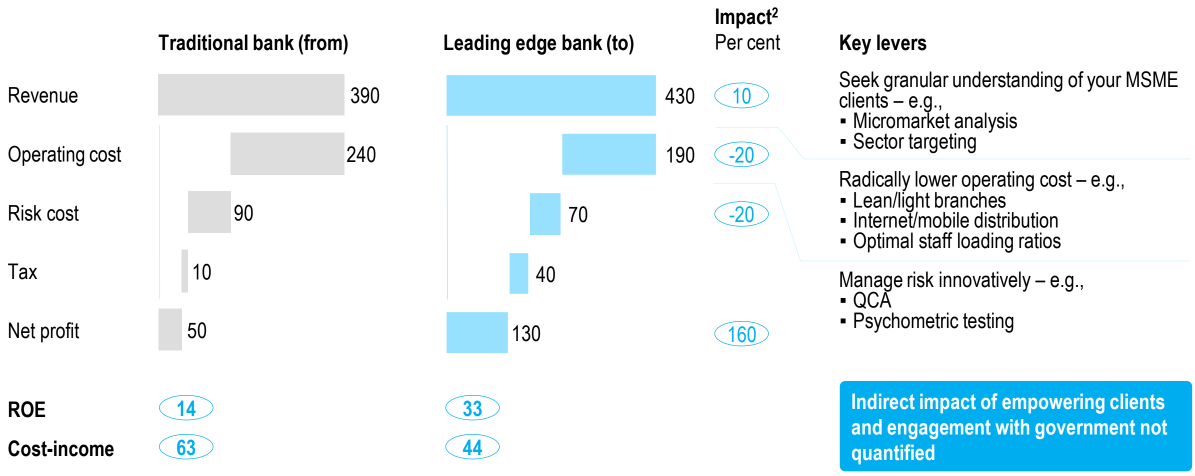
1 A McKinsey & Company proprietary risk-scoring approach where qualitative factors are added to risk models by a process of statistical, regression analysis, to establish whether the qualitative factors increase the predictive power of existing risk scoring models.

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).

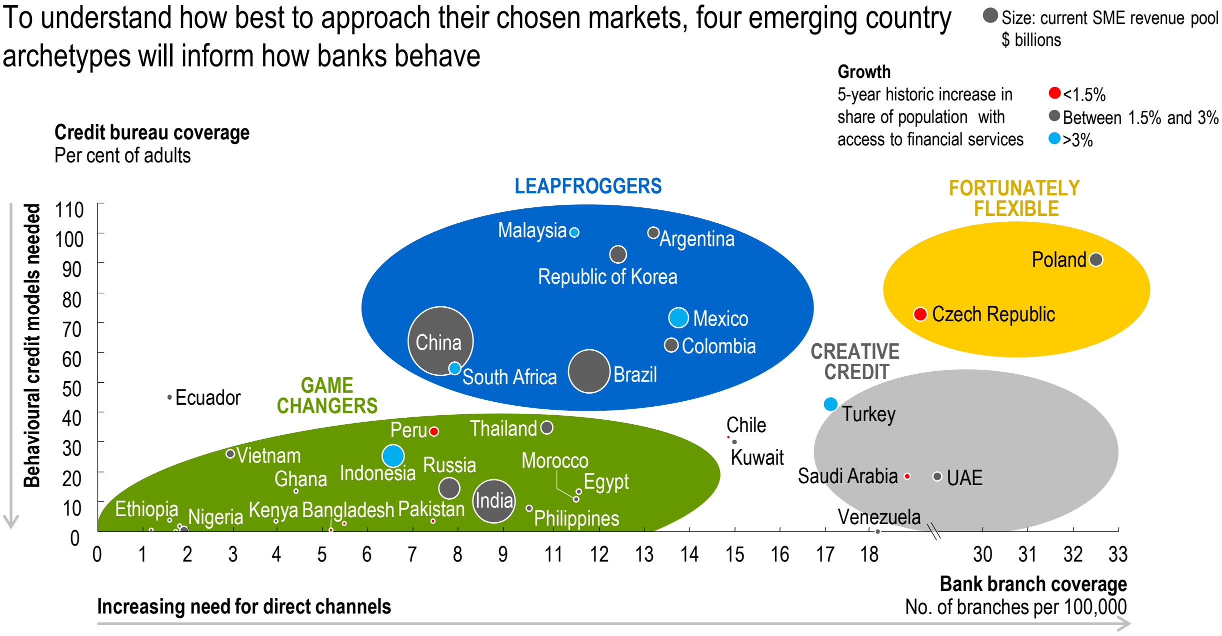
2 Refer to Our methodology (page 8) and Technical annexure (page 45).

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

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

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.