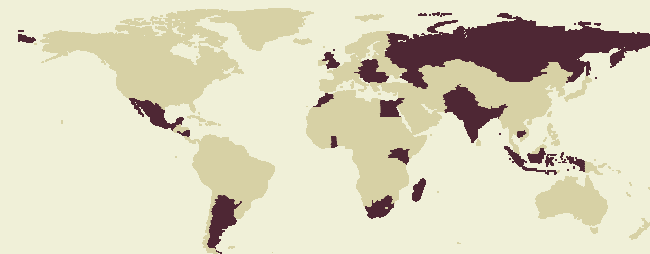


**Small Business Lending:
Overview of Good Practice Basics**

SHOREBANK CORPORATION
SHOREBANK INTERNATIONAL
SHORECAP EXCHANGE



Overview of Small Business Lending

Introduction:

The missing middle

- too small for the banks....too large for micro

Double bottom line – profitability and development impact

Quick facts and statistics

Trends

Who is operating in this space and why

ShoreBank Snapshot

- **Largest development finance institution in the U.S.**
- **Founded in 1973 to maintain banking services and arrest decline in Chicago community**
- **Has grown to \$1.8 billion in assets**
 - Bank achieves returns equal or superior to banks of comparable size that do not have a community banking focus
 - Managed to “triple bottom line” of development impacts, conservation and profitability
- **International companies focusing on microfinance and small business finance:**
 - ShoreBank International – Consulting and Capacity Building
 - ShoreCap Exchange – TA Facilitation, Capacity Building and Knowledge Exchange
 - ShoreCap International - Investing
- **Core competencies in:**
 - Financing residential real estate rehabilitation
 - Small business lending
 - Promoting wealth accumulation for lower-income families

Good Practice Basics (1)

Investment / Lending Approach:

- Role of small businesses
- Products
- Structure

Good Practice Basics (2)

Pricing and Cost:

- Risk and Return

Good Practice Basics (3)

Signs of Trouble:

- Early detection
- Don't put good money after bad

Good Practice Basics (4)

Things Small Business Lenders Like to See:

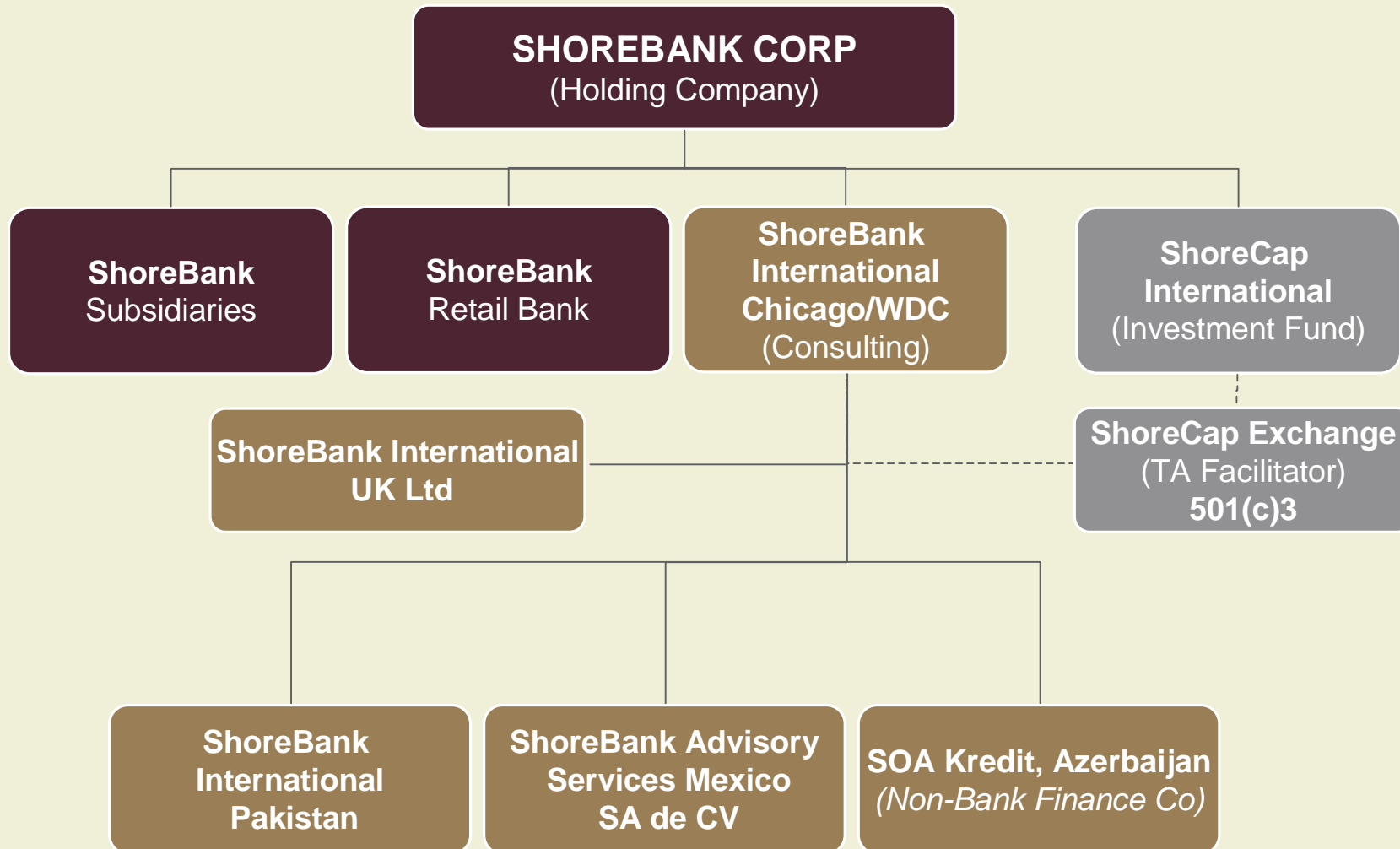
- The entrepreneur is at risk
- Local ownership
- Management experience
- Existing companies
- Positive cash flow
- Real competitive advantage.
- The entrepreneur must understand obligation to repay

Good Practice Basics (5)

Useful Tools:

- Loan risk rating systems
- Independent loan reviews
- Clearly written policies and procedures
- Regular loan monitoring
- Timely portfolio reporting including watch and problem asset reports

ShoreBank's International Organization





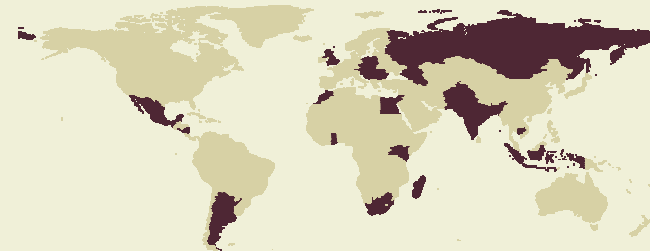
SHOREBANK INTERNATIONAL

formerly ShoreBank Advisory Services

Small Business Lending:

Lessons from the Field

SHOREBANK INTERNATIONAL LTD



Small Business Banking: Lessons from the Field

- Background on ShoreBank / ShoreBank International
- **Overview of SBI Small Business Finance Consulting Experience**
- Principles and Approach
- Lessons and Examples from the Field
- Where to next?

Overview of SBI Small Business Finance Consulting Experience

- **Extensive experience in bank “downscaling” projects**
- **Long-term, full-time, on-site consultant ensures implementation of best practices, sustainability of MSME lending activity**
- **Particular focus in last 10-15 years in CEE/FSU (EBRD); Increasing focus on Asia and Africa (IFC)**
- **No consultancy is exactly the same as another; tailored solutions to meet each partners needs and strategic objectives**
- **Evolving models**

SBI Experience Managing Long-term Small Business Finance Programs

Service Elements

- **MSME Lending Methodology**
- **Specialized Staff Training**
- **New product development**
- **Process improvements, including Credit Scoring**
- **MSME Loan Portfolio Oversight and Promotion**
- **Credit Risk Management**

Recent Projects Include

EBRD SME Finance Facility

- Establishing MSME Units in Commercial Banks
- Czech Republic, Romania, Slovak Republic, Slovenia

K-REP Bank, Kenya

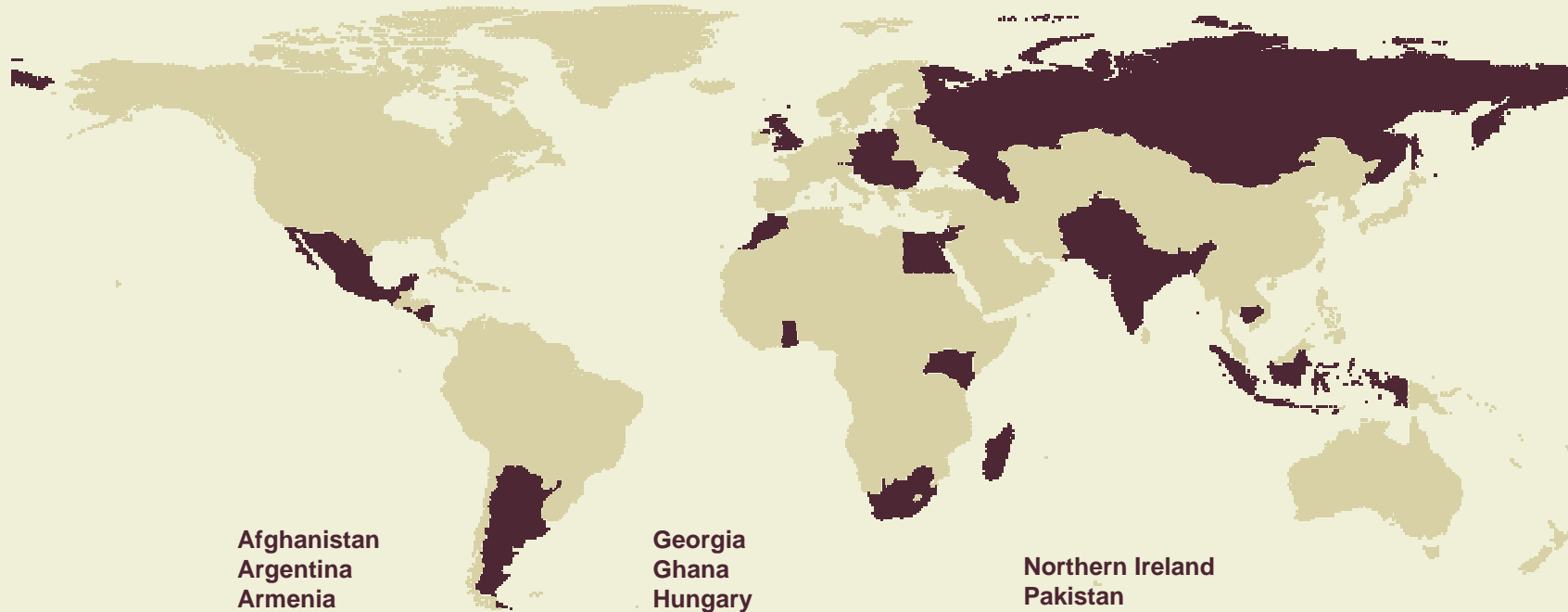
- Growth from Microfinance into SME sector

Societe Generale, Madagascar

- Downscaling corporate bank to SME sector

In 16 years SBI has worked with more than 53 private banks to support the SME sector and disbursed over 10,200 MSME targeted loans totaling more than \$315 million with average charge-off ratio of less than 1.0%.

Service Reach of ShoreBank International



Afghanistan
Argentina
Armenia
Azerbaijan
Austria
Bangladesh
Bosnia
Bulgaria
Cambodia
Croatia
Czech Republic
Egypt
El Salvador

Georgia
Ghana
Hungary
India
Indonesia
Israel: West Bank/Gaza
Jordan
Kenya
Madagascar
Mexico
Mongolia
Morocco
Nicaragua

Northern Ireland
Pakistan
Poland
Romania
Russia
Serbia & Montenegro
Slovakia
Slovenia
South Africa
Tajikistan
Uganda
United Kingdom

Small Business Banking: Lessons from the Field

- Background on ShoreBank / ShoreBank International
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- **Principles and Approach**
- Lessons and Examples from the Field
- Where to next?

Overall Principles Guide Our Work

- **Create sustainable capacity – to assure continuing impact after we depart**
- **Undertake assignments that tap into ShoreBank's core competencies**
- **Employ project managers who have finance backgrounds and experience in transitional markets**
- **Use local staff wherever possible; building networks of local experts**
- **Apply a collaborative approach – Adapting our methods to existing structures and strategic development plans of partner institutions**

Principles and Approach: Cash Flow based Lending

Core Principles of SBI Small Business Credit Methodology:

- **Cash flow-based – Attempt to measure the client’s real capacity to generate future cash flow for servicing debt (not always evident in “official” historical accounting)**
 - **Develop lender skills in the construction of well-founded and defensible cash flow projections**
 - **Cash flow model – Sensitivity and breakeven analysis**

- **Character based – Quality and experience of management**
 - **Interviewing and due diligence skills**

Principles and Approach: Human Resources; Sales & Marketing

Transforming function-oriented analysts into client-oriented relationship managers

- **Training in selling skills and customer service**
- **Marketing Strategy and Sales Tactics**
- **Performance Incentive Schemes**

Example: - Performance Incentive Schemes

Sample Loan Officer Incentive Scheme (bonuses and penalties on a monthly basis):

- Bonus for one loan disbursed (irrespective of the loan amount): 10 USD
- Bonus for every 5,000 USD disbursed as loan amount: 10 USD
- Penalty for one loan in arrears (irrespective of the loan amount): 10 USD
- Penalty for every 5,000 USD in arrears (outstanding principal): 10 USD
- Penalties for loans in arrears are deducted from disbursement bonuses.

Example:

- ***A loan officer disburses in a month 5 loans, overall amount 100,000 USD. He/she has 2 loans in arrears, outstanding capital 8,000 USD. His/her monthly bonus will be calculated as follows:***

$$\text{Net bonus} = 10 \text{ USD} \times 5 \text{ loans} + 10 \text{ USD} \times 20 - 10 \text{ USD} \times 2 - 10 \text{ USD} \times 1.6 = 214 \text{ USD}$$

Principles and Approach: Constant Process Improvement

Product Matrix

Loan Product:	Developing Enterprise Loan
Range:	\$3,000 - \$30,000
Use of Funds:	Mostly working capital though shorter term investment credits are also considered
Analytical Approach:	Judgmental scoring; construction and analysis of “family P&L”; site visit intensive
<hr/>	
Loan Product:	Small and Medium Enterprise Loan
Range:	\$30,000 - \$150,000
Use of Funds:	Purchase of inventory or fixed assets, renovations
Analytical Approach:	Detailed cash flow projections; some reliance on official accounting; fixed asset security typically taken

Principles and Approach: Constant Process Improvement

Evolution of Consultancy Approach *(as partner bank increases in sophistication)*

- 1. Implement best practices in small business lending (credit policies and procedures)***
- 2. Transfer credit and selling skills (classroom training)***
- 3. Reinforce skills (on the job training)***
- 4. Streamline procedures for smaller loans***
- 5. Automate procedures***
- 6. Judgmental credit scoring***
- 7. Statistical credit scoring***

Small Business Banking: Lessons from the Field

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- Principles and Approach
- **Lessons and Examples from the Field**
- Where to next?

Small Business Banking: Lessons from the Field

Romania I (1996-1998)

- small, closely held, private, regional bank
- joined loan program (risk and profit share) due to attractive economics and as entrée to equity from lender/donor
- less competitive banking market, low MSME client expectations
- poorly skilled lending staff
- risk averse, mistrustful credit culture
- underdeveloped MSME borrower finance skills, reporting standards and legal framework for lending, widespread corruption

Approach

- negotiated risk sharing agreement on behalf of lender/donor
- “negotiated” new policies and procedures with credit management
- “negotiated” staff allocation and new hires with branch management
- trained lending staff in the classroom and on the job
- “piloted” program through small number of branches (4)
- all loans reviewed by joint credit committee

Small Business Banking: Lessons from the Field

Romania I (1996-1998)

What went wrong?

- Bank was in the project for the wrong reasons; wasn't convinced that expansion into the MSME sector was a potential profitable proposition.
- Market/economic environment that enabled complacency
- Hard negotiation of burdensome risk sharing agreement established lack of trust between consultant and bank from the start
- Proposed incentive programs rejected as misaligned, potentially disruptive
- Credit and branch management had no motivation to support program
 - Newly trained staff was strong but viewed by middle managers as alien to the HR regime, was gradually pulled back into the system
 - High percentage of loans (supported by consultants) were rejected in Committee
- Donor-imposed application and sub-loan agreement were burdensome
- Donor did make best use of carrot and stick

Results

- No loans made in first six months
- Donor responded by sweetening risk sharing arrangement
- 17 loans disbursed in one year; several experienced delinquency issues due to lack of monitoring, improper use of funds
- Program terminated after one year

Small Business Banking: Lessons from the Field

Romania II (2000-2003)

- Same small, closely held, private, regional bank
- joined loan program because it wished to carve out a market niche (and, secondarily, as entrée to equity from lender/donor)
- top donor priority to rapidly develop a solid portfolio of MSME loans
- attractive financing and TA agreement
- increasingly competitive banking market, low MSME client expectations
- cautious credit culture balanced with corporate growth culture

Approach

- goals of top management, donor and consultant aligned and agreed in the first week of the project
- policies and procedures (improved upon from first program) adopted within first month of project
- training and program implementation rolled out in phases
- very effective incentive program adopted
- centralized loan review
- streamlined procedures for “micro loans”

Small Business Banking: Lessons from the Field

Romania II (2000-2003)

Keys to success

- Alignment of goals; top management support
- Excellent PM relationship management, collaborative approach:
 - Senior management buy-in and support
 - Steering committee
- Measured profitability from the outset; demonstrated project “breakeven” within nine months of operations
- Development and empowerment of talented local staff
- Effective incentive system
- Rapidly developing economy and banking market
- Time: Three years allowed us to maximize penetration

Results

- 149 lenders trained
- 388 loans disbursed for €16.6 million (average loan size: €43,000)
- Bank adopted micro and SME lending methodology for all of its lending operations
- Top performing lenders moved to senior branch and credit management positions
- Bank now a strong national presence in the retail sector
- Lender/donor purchased 15% equity stake

Small Business Banking: Lessons from the Field

Czech Republic 2001-2004

- former state S&L, second largest bank, national network 160 branches
- newly privatized and in midst of restructuring
- history of portfolio problems (fearful credit culture)
- rapidly evolving market / competition

Approach

- steering committee formed to bring together marketing and risk managers
- rapid training of 160 lenders
- program loans designated as “key product” for incentive purposes
- centralized loan review
- streamlined procedures for “micro loans”
- delegation of lending authority
- data collection tool for development of credit scoring
- credit scoring model development – use to rate loans
- support for “SME centers”

Small Business Banking: Lessons from the Field

Czech Republic 2001-2004

Keys to success

- Alignment of goals (shareholder an experienced CEE retail bank)
- Excellent PM relationship management, collaborative approach:
 - Senior management buy-in and support
 - Steering committee of Marketing, Risk and Consultant Team
 - Invited onto Experian scoring project
- Well aligned and effective incentive system
- Development and empowerment of talented local staff (bank and consultant)
- Time: Three years allowed us to offer a complete spectrum of services

Results

- MSME loan products offered through national network within six months
- 160 lenders trained
- 1,243 loans disbursed for €41.4 million (average loan size: €34,000)

Small Business Banking: Lessons from the Field

Kenya (2005-2006)

- Small private bank, historically focused on larger, especially Asian-owned, businesses
- New shareholder attempting to reposition bank to address the broader MSME sector
- Strong and supportive senior management
- Donor “testing” the approach (TA only; no loan funds)
- increasingly competitive banking market, low MSME client expectations
- poorly skilled lending staff
- underdeveloped MSME borrower finance skills, reporting standards and legal framework for lending, widespread corruption

Approach

- Donor support in steps:
 - Began with one month feasibility study
 - Followed (after pause) with six month “pilot”
 - Followed by three month extension
- Policies and procedures needed to be completely redeveloped
- All new staff, including departmental management, needed to be hired and trained
- No lending took place during “pilot”; only began during extension phase
- Loan closing process proved to be very lengthy
- Official product “launch”, bank re-imaging took place at end of consultancy

Small Business Banking: Lessons from the Field

Kenya (2005-2006)

Strengths

- Alignment of goals; top management support
- Ability to hire and train new staff
- Rapidly developing economy and banking market
- Repositioning of bank and launch of MSME products has been well received
- Donor now prepared to provide long term commitment

Weaknesses

- Initial donor hesitancy, lack of commitment
 - Limited consultant resources
 - Disrupted implementation effort
- Lack of talented human resources
- Cultural resistance to sales approach
- Weak bank image in the marketplace
- Difficult loan closing process

Summary: Lessons for Success

- Long-term, “embedded” approach
- Alignment of goals (bank, donor and consultant)
 - Engage senior management and get buy in
 - Apply a collaborative approach
 - Adapt methods to existing structures and strategic development plans of partner institutions
- Design program for long term sustainability and profitability from outset
- Aligned incentive systems
- Design and Deliver Technical Assistance in line with:
 - Local market conditions; Maturity of financial institution; Receptiveness of senior management
- Local staff development as an aspect of sustainability

Small Business Banking: Lessons from the Field

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- **Where to next?**

Credit Scoring - Scorecard Development Approaches

Available, Reliable and Applicable Data?

Yes

No

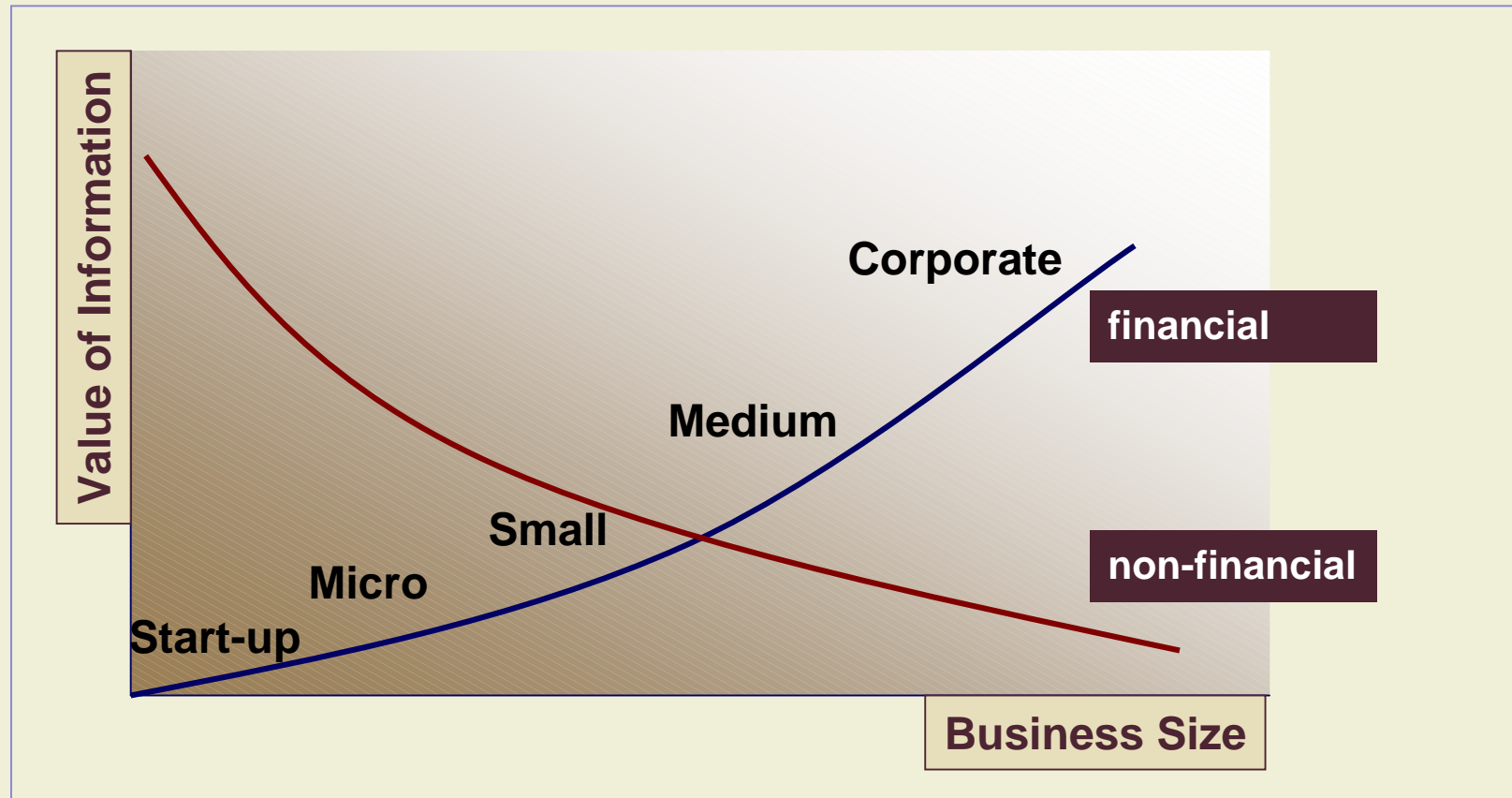
Statistical Model Development

Leveraging data representative of the bank's target clients. SBI identifies variables relevant for micro/sme assessment by using advanced analytical and statistical techniques. The resulting scorecard can classify loans into risk categories and/or provide predictions regarding repayment performance.

Expert Model Development

A mathematically rigorous and academically proven process for prioritization using pair-wise comparisons and decision-making justified by graphical reports and sensitivity analyses. (a.k.a. Judgmental Approach).

Credit Scoring - Financial v. Non Financial Data

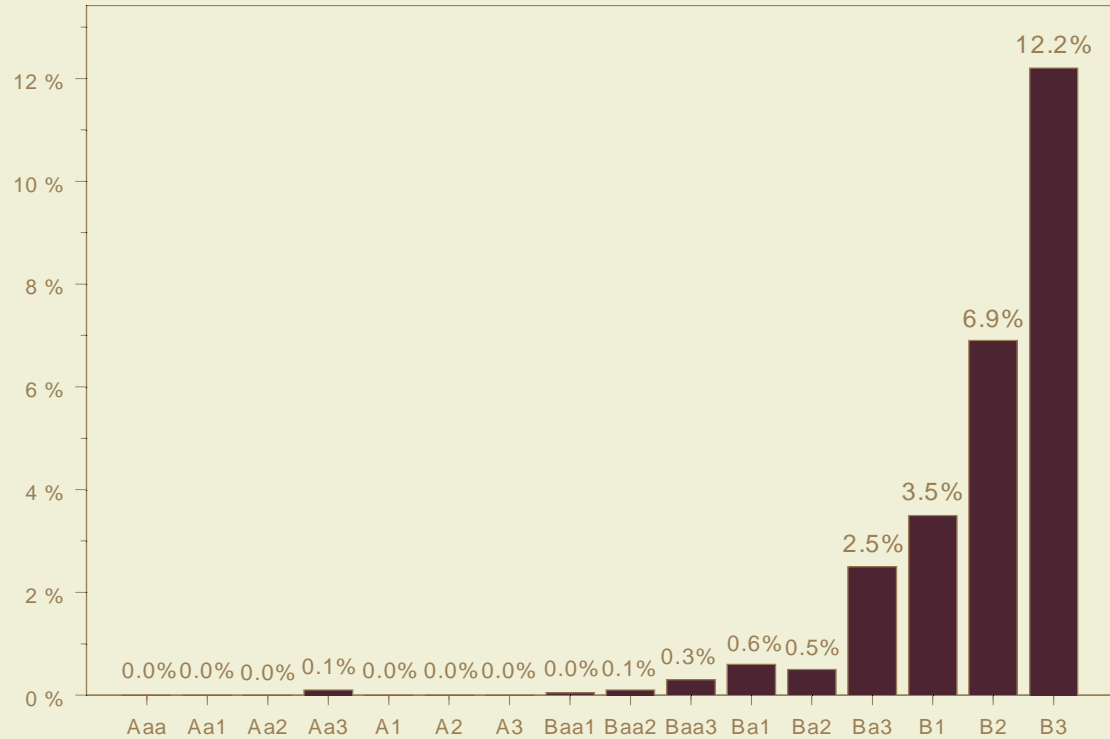


- Financial Variables include activity, leverage, liquidity, profitability and other ratios.
- Non-Financial Variables include owner/management, business, and facility characteristics.

Credit Scoring - Statistical Model Development

1. Data Preparation
2. Variable Selection
3. Model Estimation
4. Mapping the Score and Setting Cutoffs

Moody's 1 Yr Default Rates by Alpha-Numerical Ratings



Internal Risk Rating		1	2	3	4	5					
Rating		1	2	3	4	5	6	7	8	9	10
		Approve			Further Review		Decline				

Credit Scoring - The Score Card

Client Data

Business Info

Management Info

Financial Info

Facility Info

Recommendation

SHOREBANK
ADVISORY SERVICES

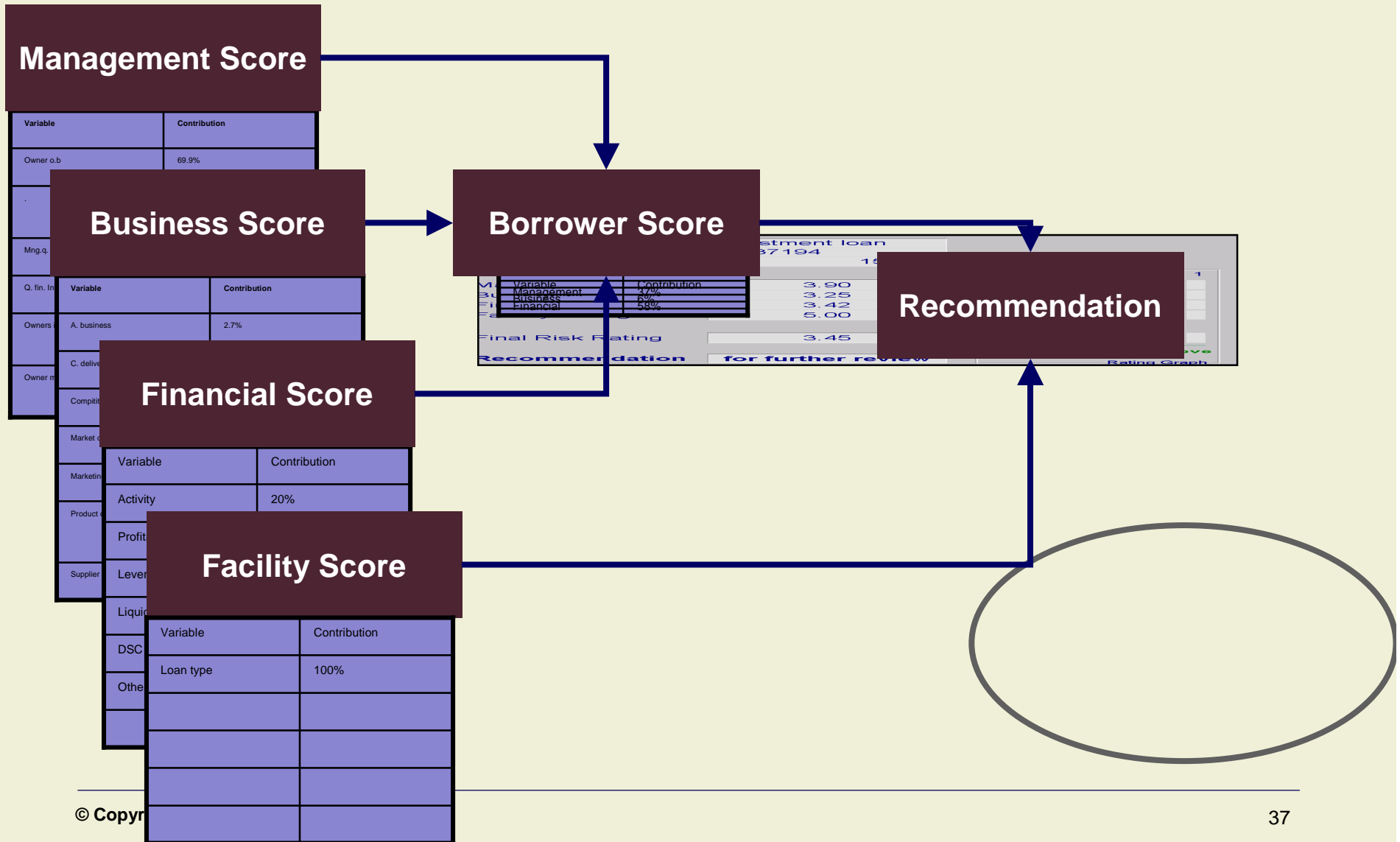
SCORING DECISION

Client Name	JOE SMITH
Loan Type	Other
Customer ID	10237194
Loan Amnt	3,677 US\$
Rating	
Management Grade	3.90
Business Rating	3.25
Financial Rating	3.42
Facility Rating	3.00
Final Risk Rating	3.45

5 4 3 2 1

Review

Credit Scoring - The Score Card



Questions & Feedback
