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“SME Growth Opportunities

&

How Policies and Banks Miss Them”

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List of Abbreviations

Abbreviation	Meaning
BDs	Business Developers
BEP	Business Enabling Project
CEVES	Centre for Advanced Economic Studies
EBIT	Earnings Before Interest and Taxes
EMBI	Emerging Markets Bond Index
EU27	27 Member States of the European Union
EURIBOR	Euro Interbank Offered Rate
IFC	International Finance Corporation
IRB	Internal Rating Based Approach
MEs	Medium Enterprises
NBS	National Bank of Serbia
NPLs	Non-performing Loans
OECD	The Organisation for Economic Co-operation and Development
pp	Percentage Points
RM	Relationship manager
SBRA	Serbian Business Registry Agency
SEs	Small Enterprises
SMEs	Small and Medium Enterprises
SMS	Short Messages System
SORS	Statistical Office of the Republic of Serbia
USAID	U.S. Agency for International Development
VAT	Value Added Tax

1. Introduction

This report is the final outcome of CEVES's project "SME Growth Opportunities and How Policies and Banks Miss Them," funded by USAID's Business Enabling Project (BEP). The purpose of our research is to assess the access to finance of Serbian SMEs. It is also a foundation for further research aimed at developing policy recommendations that could help enhance the SME sector's performance, growth and their contribution to the overall value added.

Expansion and development of the SME sector is both the opportunity and necessity for Serbian economy. Serbia's truly large companies are few, and unlikely to provide the growth locomotive needed for the country's development. Also, Serbia cannot expect that large foreign investors will enter in significant numbers and consequently enhance economic growth, as it happened in some transition countries prior to becoming EU member state. Hence, it is of a crucial importance to support the growth of SMEs as to fill in the existing gap. First and necessary condition, which will enable SMEs to become a key part of progressive, globally competitive industries, creating large number of jobs and generating income opportunities for their stakeholders, are supportive government policies and financial institutions with SME friendly practices. Also, the competitiveness of today's economies is largely dependent on creativity and capacity for innovation of SMEs. SMEs tend to be creative and innovative at much lower cost while at the same generating greater impact. Another reason is that the quality of economic growth tends to be higher when based on dynamic and creative SMEs. Such SMEs enable the creation of a stronger middle class and reduce the gap between those who "have" and those who "do not have".

Good and fruitful cooperation between the SME sector and the financial sector, especially banks, is crucially important for achieving and sustaining economic growth. In Serbia's case, increasing SME access to funding is probably the single most important measure that can be offered, other than providing a more stable and entrepreneurship-friendly legal and regulatory environment. Still, it is well known that Serbia's enterprises are highly dependent on self-financing, and this suggests there is a large scope for expanding bank finance in the country (nearly 60% of firms, and probably as many as 75% if sole-proprietorships are included, do not substantially rely on bank funding. 80% of those that do not rely on bank credit considered that they "do not to need it") (USAID BEP, 2013).

This report has two components, first that is focused on demand side and second, that is focused on supply side. The first component aims at shedding the light on the structure, performance and growth potential of Serbia's SMEs, a very large segment of Serbia's economy that is little understood, and has been relatively neglected by both policymakers and the public. The purpose of the second component is to understand and analyse bank SME funding practices in order to identify if there are opportunities to expand funding to the mutual benefit of both banks and SMEs while at the same time contributing to the country's growth.

Hence, in the first component, using comprehensive and in-depth financial analysis, we assess if there exist both healthy and successful SMEs in Serbia with good potential and if they have access to financing. We define healthy and successful SME as a firm that in period of 2005-2012: 1) managed to overcome negative impact of crisis; 2) increased its real revenues and employment; and 3) operated profitably. Our analysis and assessment are based on indicators from financial statements of all enterprises that have both operated in Serbia and reported financial statements to SBRA on regular basis in period of 2005 to 2012. Data from financial statements are used with extreme caution, observing only trends of the most important financial indicators while analysing,

without relying on absolute figures more than it is necessary. SMEs' access to finance has been assessed by using two kinds of indicators: 1) those derived from a similar BEP's survey; and 2) presence of interest payments in financial statements of an SME. Within this component, **our research has identified a significant number, almost 30%, of initially micro, small and medium companies that have been able to grow and show resilience to the global crisis, but this progressive segment of SMEs has generally low access to finance – only 45% of these firms rely on bank financing.**

In the second part of our research we investigate organization and lending practices of Serbian banks to identify any possible opportunities for improvements of client selection methods to help banks identify and support the most promising/successful SMEs. To this end, we interviewed heads of sales and risk in 11 banks (that present approximately 70% of the banking market) in Serbia asking them to evaluate financing opportunities that they offer to SMEs. CEVES created two tailor-made questionnaires – one consisting of 77 questions for Head of SME (sales function) and another consisting of 53 questions for Head of Risk (risk function) in the bank. **Through our research, we identified considerable room for improvements that would further reduce the costs and risks of SME funding to banks and therefore facilitate the access to finance for a greater number of SMEs**. Banking regulation and the operating environment are out of scope of this report. Instead we focus on things that banks alone can improve in short-term to improve SME access to finance and their own bottom line.

2. Structure of the Serbian Economy and SMEs Access to Bank Loans

2.1. Serbia is an economy of SMEs

SMEs are one of the most powerful economic forces in both developed and emerging countries since their contribution to both employment and GDP is rather high. If we use the number of employees as only criterion to segment companies in Serbia, it can be clearly seen from table 1 that nearly 99% of the total number of companies in Serbia is classified as SMEs, 96.2% of which are classified as micro companies. Serbian SMEs also employ 70.8% of the total workforce. Contribution of Serbian SMEs to the total value-added is 55.6%.

The share of SMEs in the total number of companies in Serbia is identical as that of the EU27 (see table 1). Serbian SMEs when compared to SMEs from EU27 employ 3.3 percentage points more of the total workforce. Contribution to a total value added of Serbian SMEs is by 2.8 pp lower than that of SMEs in the EU27.

Although the share of SMEs in the total number of companies in Serbia is high and at the same level as in EU27, there is an obvious difference in the structure within the Serbian SME segment. Serbia has a relatively higher number of micro firms, while small and medium firms are not as large in share as they are in the EU27. Only 3.7% of Serbian firms employ between 10 and 250 employees, while that share in EU is twice as high - 7.6%.

If we look at employment generation and contribution to value added, the difference in the structure of SMEs is also evident. Micro firms employ 42% of total workforce in Serbia, while the contribution of small firms to total employment stands at only 12.9%. In the EU, share of those two groups in the

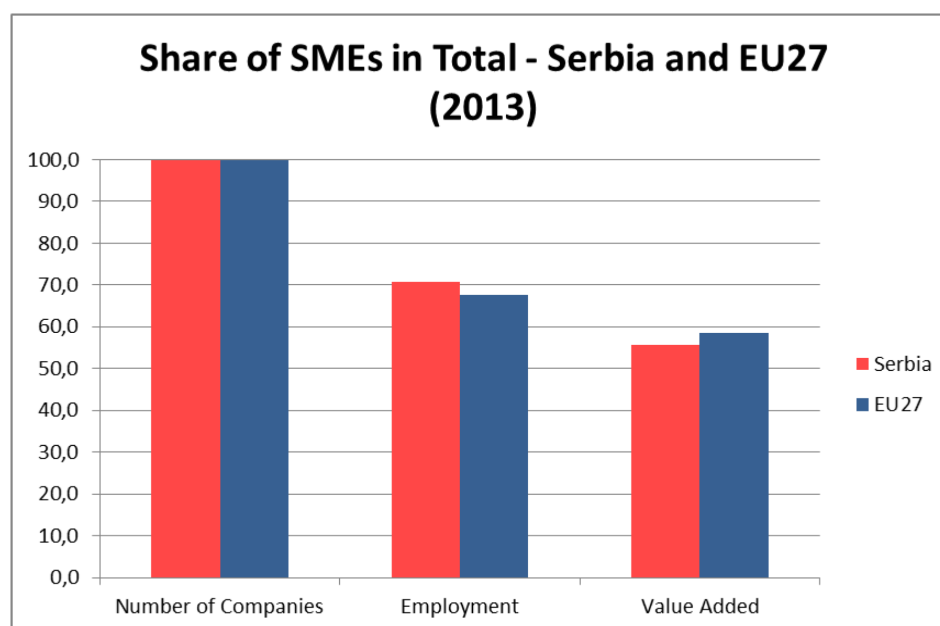
total workforce is more balanced – micro companies employ 29.7%, while small firms employ 20.6% of EU total workforce.

***Table 1*: SMEs in Serbia and EU27 – Basic Figures**[1]

	Number of Companies			Employment			Value Added		
	SRB		EU	SRB		EU	SRB		EU
	Number	Share	Share	Number	Share	Share	Number	Share	Share
Micro[2]	289.551	96,2	92,2	591.101	42,0	29,7	3.549	22,1	21,5
Small	8.984	3,0	6,5	181.033	12,9	20,6	2.576	16,0	18,6
Medium-sized	2.103	0,7	1,1	223.367	15,9	17,2	2.808	17,5	18,3
SMEs	300.638	99,8	99,8	995.501	70,8	67,5	8.933	55,6	58,4
Large	488	0,2	0,2	410.403	29,2	32,5	7.144	44,4	41,6
Total	301.126	100,0	100,0	1.405.904	100,0	100,0	16.077	100,0	100,0

Source: European Commission (2012)

Graph 1: Share of SMEs in Total – Serbia and EU27 (2013)



Source: European Commission (2012)

[1] Number of employees was used as a size criteria (less than 10 employees - Micro, less than 50 - Small, less than 250 - Medium, more than 250 - Large). By using employment as a size criteria, we have obtained data that is comparable to EU27

[2] Category of Micro enterprises is consisted of Micro companies and Sole proprietors (unincorporated enterprises). While official data about number, employment and value added of Micro companies exist, there is no such reliable official data about Sole proprietors. SBRA has been used as a source for number of Sole proprietors, while SORS has been used as a source for their employment data. Value added of Sole proprietors has been roughly assessed by CEVES team

Even though SME segments in Serbia and EU exhibit almost equal productivity, different structures within segments imply different productivity of sub-segments. Micro sub-segment in Serbia employs a notably greater share of employees when compared to small and medium size sub-segments, while the relation between sub-segments in EU in this regard is more balanced. Furthermore, the percentage of value added produced by SME sub-segments in Serbia remains almost the same as in EU. Based on this information we can conclude that Serbian micro sector has demonstrated a lower level of productivity, since higher number of employees when compared to EU generates almost equal level of value added. Possible explanations stemming behind can be related to low level of innovative activities and cooperation, as well as insufficient internationalization in comparison to EU SMEs. Notwithstanding, we believe that with supportive government policies and increased access to finance Serbian SMEs have a chance to internationalize its business, export its products and raise its value added.

Nevertheless, whenever we talk about SMEs and especially when we try to build relations and comparisons with the SME segment and its performance in other countries, we have to take into account the fact that, in the time of project implementation, legal definition of SMEs in Serbia was different from the one within the EU countries. Such a difference implied the lower level of criteria defining the size of the companies.[3] Therefore, more companies (in nominal as well as relative terms) fell into category of small, medium and large companies, while share of micro companies in total number of companies dropped. Besides that inconsistency and incomparability to EU data, there was a general opinion that Serbian economy consisted of a bit larger companies (933 large companies in comparison to 488 of them before applying legal criterion, and similar difference in small and mid-size companies). After this change in legal definition, it became apparent that Serbia is economy of SMEs since great number of large companies by Serbian definition falls into SME segment by EU definition. We can even go a step further stating that Serbian economy is economy of micro companies that have considerably less earning power/productivity relative to micro companies in EU27.

2.2. Growth Potential of Serbian SMEs

Expansion and development of the SME sector is both an opportunity and a necessity for the Serbian economy. With supportive policies of governments and SME designed product, SMEs can become a key part of progressive, globally competitive industries. They can create large number of jobs needed both to reduce poverty and generate income opportunities for their workers and to create tax revenues for government services (IFC, 2011). In order to modernize and develop, Serbian SMEs should aim to internationalize their business activities and become a part of dynamic and growing EU value chains. Yet, the question to be answered is: what model of development of the SME sector is the most appropriate and feasible for Serbia?

In Serbia, SMEs had to and are likely to continue to develop in the near absence of successful large businesses. Serbia’s truly large companies are few, and unlikely to provide the growth needed for both the SME growth and the country’s development. Large companies in Serbia tend to be inactive, inefficient, ineffective and low value added. Overall level of success of large companies in past 8 years is remarkably low and stands below 20%[4]. These companies are mostly comprised of state-owned enterprises, monopolies and trading firms. It is hence of critical importance to put in place

[3] Serbian parliament adopted new Law on Accounting in September 2013, which have brought closer EU and Serbian criteria for defining the size of companies.
[4] More detailed information regarding successfulness of large companies is provided in table 3.

effective policies so that medium-sized companies grow and become large and so that small companies grow and fill in the existing gap.

Moreover, Serbia cannot expect that foreign direct investments will enhance economic growth to a great extent, as it was case in transition countries (countries which joined the EU in 2004 and 2007), where large foreign investors entered in much more significant numbers than in Serbia. FDI in those countries, in three consecutive years that preceded joining the EU, were on average 8% of GDP, while average yearly GDP growth in the same period was also 8% also (IMF, 2014). In those counties, some of the SMEs were also able to steadily grow by servicing these large systems (OECD, 2004).

All in all, the reality is that Serbia does lack large investors and companies, but this gap can and should be filled through continuous growth and development of domestic SMEs. The process starts with supportive government policies that create predictable business environment. In the right business environment, SMEs can grow into large companies, changing the structure and potential of an economy. But even if they remain small or mid-size, they can mutually cooperate, enhance productivity, find appropriate niches and internationalize their business activities and products.

It is significant to show that within the structure of large enterprises in Serbia in 2012, a notable share were small businesses or were created as small businesses in the previous 8-year period. More precisely, 45% of large companies in 2012 developed from small and medium businesses (8% of large companies were small, while 37% were medium companies) in a period of 8 years. These small and medium businesses comprise up to 80% of all large companies which after 2005 acquired the status of large. Similar developments can be observed in the structure of medium-sized companies, of which as much as 47% (about 1,400 of them), were classified as small in the previous 8 years (CEVES calculations based on SBRA data for period 2005-2012).

Taking everything into account, in the period of eight years, it is apparent that small companies have brought great progress and changes in the structure of large (and medium) companies. Hence, we can expect that in future a number of successful small businesses which manage to continually develop will evolve and become medium or perhaps large companies.

But, how large is the base of healthy and perspective SMEs? Are there ways to accelerate this growing process in order to accelerate development of SME sector and Serbian economy in general? In order to answer these questions and to understand more deeply the performance of SME sector, first we have to define the term “healthy and perspective” company. Hence, observing the period of 2005-2012, we define such companies as a resilient and resistant company that has managed to overcome the negative impacts of a global economic crisis. To be labelled in this way the company needs to show the potential to operate profitably in a long-term, even in the post crisis period, while having its sales, customer base and employment increased. If a company fulfils all of these criteria, we can consider that company as healthy and perspective one. The table below illustrates the level of success of companies, based on above specified criteria, with highlight on micro and small companies.

Table 2. **Number and share (as a % of total in given size group) of companies by size and accomplished criteria of success**

Size	1) Companies with continuously positive operating profit (EBIT)		2) Profitably growing companies		3) Profitably growing companies that generated employment		Total
	Number of companies	Percentage	Number of companies	Percentage	Number of companies	Percentage	Number of companies
Micro	31.904	58,0	18.703	34,0	14.690	26,7	54.991
Small	11.181	64,2	6.661	38,3	5.580	32,0	17.411
Medium	1.358	49,9	932	34,3	688	25,3	2.720
Large	351	45,1	251	32,2	141	18,1	779
Total	44.794	59,0	26.547	35,0	21.099	27,8	75.901

Source: CEVES calculations based on SBRA data for period 2005-2012

The first criterion that we use to assess the performance of a company is EBIT (Earnings Before Interest and Tax) - profit earned from a company's normal core business operations. The core operations are part of a company's mission statement and EBIT is the best indicator to what level are companies effective, productive and successful in their core business activities. In the long term, the productivity and profitability in core business activities are necessary conditions if a company wants to be truly successful. Since we have used financial statements only as indicators of success and for creating a typology of successful companies, we are solely interested in identifying companies with continuous positive EBIT, regardless of annual growth and absolute figures. We believe that companies that continuously create positive EBIT have high potential for further growth – especially bearing in mind that post-crisis years were very difficult for doing business. In table 2, it is obvious that micro and small companies consist of significantly larger portion of companies that have been continuously creating positive EBIT. The share of profitable companies among the group of micro and small companies was almost 60%, while that percentage was remarkably lower for large companies – only 45%.

The second criterion was related to expansion of company's market share and customer base. We consider real revenue growth as a good approximation of a company expansion during the time. With this criterion, we excluded companies that have recorded positive EBIT followed by business downscaling, because our focus is on growing companies with high possibility of becoming growth engine. By introducing the new criterion of profitable growth, we can see that share of profitably growing companies among small ones is still higher than among large ones. Micro and small companies comprise 34% and 38.3% of profitably growing companies, respectively. However, difference between different sizes of companies has now been reduced. That fact indicates that profitable small companies consist of a relatively higher portion of companies that failed to increase their real revenues. Only 58% of profitable micro and small companies managed to increase their revenues, while 71% of profitable large companies raised their real revenues. The strike of the crisis followed by both the illiquidity and need for temporary slowdown of business activities is a very likely reason, but we assume that relatively (compared to large companies) more difficult access to

finance is also very important reason that has had an impact on the slower development of micro and small profitable companies.[5]

Considering employment as a major issue in Serbian economy, our next and final step in the analysis of successful firms was to identify profitable, growing companies that also generated increased employment. We consider companies that accomplish these three conditions are truly successful ones. Table 2 shows us that micro and small companies have the highest share of truly successful companies, 26.7% and 32%, respectively. Small and micro companies are followed by medium companies, whose success rate stands at 25.3%. The least successful companies, classified by size, were large companies. Only 18% of large companies were considered successful using our three criteria.

2.3. SMEs Access to Finance

Access to finance is the key determinant for further development and growth of SMEs since they have very different needs and face different challenges when compared to large businesses (European Commission and Ipsos, 2012). Without an adequate access to finance, SMEs cannot: increase their market share and customer base, conquer new markets, innovate and develop new or modified products, introduce better technology, train their employees etc. The lack of equity capital invested in small companies makes these businesses more reliant on other sources such as bank lending and other types of financial products. But, this evolving segment of SMEs in Serbia, especially its sub segment of SEs, has low access to finance[6].

Table 3 shows overall access to finance for each company size, based on two indicators. First indicator is based on the percentage of companies that revealed having some access to bank credit in BEP's survey. Second indicator is based on the presence of "interest indicator" in financial statements of companies. We emphasize that "no-access to bank credit" does not necessarily mean a business is never able to, and has never, obtained a bank loan. It rather measures a somewhat more unclear concept, of "reliance on bank funding". The column under the USAID BEP heading, with a sub-heading "sought credit from bank" shows the percentage of respondents that include banks as institutions they have turned to for borrowing.[7]

[5] As it will be shown in table 2, approximately 30% of micro companies had access to bank credit, while that share among medium and large companies is significantly higher, standing between 60% and 70%. Also, it is well recognized that SMEs are more dependent on debt financing than are larger companies, since large companies can turn to other types of finance, such as launching public offerings of debt and equity. Foreign owned companies may be financed by mother companies or foreign financial institutions.

[6] In CEVES's background report *(SME's in Serbia: Growth Opportunities & Access to Bank Funding" / REPORT for CEVES's project "SME Growth Opportunities and How Policies and Banks Miss Them", funded by USAID Business Enabling Project (BEP))*, we tried to show how high is SMEs' access to bank credit by comparing data on access to credit in BEP's survey with information contained in financial reports submitted by businesses to the Serbian Business Registry Agency (SBRA), so called "interest indicator".

[7] BEP survey has other questions on access to bank credit, and if positive responses to all of them are added, it shows fewer companies have never had it.

***Table 3.* Companies' access to bank credit by size**

Source	USAID BEP Survey	SBRA Database
Size and sector	*Sought credit from bank*	*Presence of the interest indicator 2006-2012*
Sole proprietor	22	23
Micro	31	24
Small	44	46
Medium	55	63
Large	56	75
Total	**36**	**31**

Source: USAID BEP (2013) and CEVES calculations based on SBRA data for period 2006-2012

Overall 36 (31) % of all surveyed (reporting) SMEs have access to bank credit. This indicator should be interpreted with extreme care – as it is not likely to be truly representative of the entire population of SMEs. As the table 3 shows, access to credit increases with company size – hence, small changes in the size structure of the company sample can make a difference. This means that the actual access to credit by SMEs is much lower than in the figures shown, because sole-proprietors who do not submit financial reports, and who tend to be the smallest type of business, are much more numerous in the total population than in the BEP sample. They are not, of course, even represented in the SBRA data. Having this in view, the likely true access to finance of all SMEs, including all sole-proprietors, is approximately 25%.

We also investigated SMEs access to finance from the perspective of banks. The evidence on outstanding bank SME loans, defined as the shares of bank SME loans divided by total business loans, helps to set the above indicators on SME lending into the context of general business lending conditions. An OECD study implies that the share of SME loans in total loans in Serbia was 26.1% in 2011, significantly lower than for example in Hungary and Slovenia (54.4% and 54.3%, respectively). It is important to point out that this 26.1% refers to those business entities that banks in Serbia themselves classify as SMEs. This becomes very interesting, since the majority of banks in Serbia use a definition for medium-sized companies which are more in accordance with the EU definition than with the Serbian legal definition. It implies that the real share of loans extended to SMEs (under Serbian official definition) is even lower than 26%.

In order to properly assess the extent to which banks miss or doesn't recognize opportunities, previous two tables and findings must be integrated – company success and access to finance. Not every micro or small company can be considered as an opportunity for a bank, so the aggregate level of SMEs access to bank credit does not indicate as much about missed opportunities. Information about level of success of both the companies that banks have financed and companies that didn't have access to bank loans must be provided in order to assess the extent of missed opportunities .

Table 4 shows the level of success of two groups of companies - those that were and were not financed by banks, classified by size. Overall, as expected, companies that have been financed by banks are more successful. However, the difference in the success rate between two groups of companies is not very pronounced at 5.6 percentage points of the total. If a bank loan is a positive and stimulating factor for SME's business and development, than that loan has directly affected and stimulated the company's performance and success. Hence, the company that is financed by a bank has more chances to develop and improve its business, compared to company that didn't succeed to obtain additional financial resources. Thus, we would expect a much greater share of successful SMEs in the financed sub-group. Success rate of these two groups of companies might be equal if there were no bank loans, or, in other words, it is likely possible that success rate of first group would be higher (and maybe reach 31.4%) if those companies were financed by banks.

***Table 4*. Success rate of companies by size and bank financing**[8]

Not financed by banks				Financed by banks			
Size of the firm	Total number of firms	Successful firms	% Successful	Size of the firm	Total number of firms	Successful firms	% Successful
Sole proprietor	10.269	2.781	27,1	Sole proprietor	2.897	891	30,8
Micro	29.400	7.191	24,5	Micro	13.208	4.074	30,8
Small	9.320	2.823	30,3	Small	7.323	2.516	34,4
Medium	1.218	285	23,4	Medium	1.488	398	26,7
SME	50.207	13.080	26,1	SME	24.916	7.879	31,6
Large	342	63	18,3	Large	436	77	17,7
Total	50.549	13.143	26,0	Total	25.352	7.956	31,4

Source: USAID BEP (2013) and CEVES calculations based on SBRA data for period

Companies which were successful in observed period, without having access to a bank loan, represent for banks missed opportunities for profit. Besides directly visible missed opportunities, we should bear in mind that indirect missed opportunities exist as well. Some of unsuccessful firms, with quality products on markets characterized by growing demand, could perhaps be more successful had their business operations been supported with bank financing. However, because we can't estimate the size of indirectly missed opportunities, we are narrowing our focus only on directly missed opportunities.

Approximately 60% of successful SMEs didn't rely on bank funding, as it can be seen in table 4. Growth and development of some of these "unfunded successful" companies could be boosted with bank loans. Having in mind these companies have recorded both positive profits and increasing revenues in observed period, that business expansion could enable them to regularly pay debt to the banks. Welfare of both banks and enterprises would probably be increased, because companies would generate more profits, revenues and employment, while bank would generate higher profits.

[8] Estimation of both the number of companies financed by the banks and companies not financed by the banks is based on USAID BEP Survey and financial statement of enterprises.

Concerning potential broader effect, as it has been already shown in the report, in Serbia, relatively low number of fast growing small enterprises can produce significant changes and great progress in the structure of large (and medium) companies.

2.4. SME Challenges to Accessing Bank Loans

SME banking, from banks' point of view, has historically been burdened with challenges that are difficult to address.

First, SMEs are often young enterprises without at least medium-term operational track record. Their unstable revenues lead towards increased fixed costs and require sophisticated financial officers and first-rate auditors for proving SMEs' creditworthiness. This situation (known in economics as "information asymmetry"), coupled with difficulties to collect relevant market information on SMEs, especially in markets in transition, prevents banks from fully understanding the risks of lending to particular SMEs. Problems with credit assessment results in relatively higher interest rates or an SME credit supply crunch.

Second, SME loan sizes are usually small relative to the rather high fixed costs of client assessment and loan processing. While the situation is similar in retail banking, SME banking often requires relatively deeper and more numerous interactions between bankers and SME customers, further increasing servicing costs. The inability of banks to capture adequately economies of scale and scope accumulates high costs per revenue base of each transaction, thus reducing SME banking profitability.

Third, high interest rates in this market segment over time drive out safer borrowers leading gradually to an ever riskier pool of borrowers. These developments put further pressures on already high interest rates and lead banks to refuse SMEs that are able and willing to pay very high rates since they are perceived as overly risky (adverse selection).

Finally, although good collateral would address both information asymmetry and adverse selection problems, SMEs are often unable to provide these. From banks' point of view, SMEs that are willing to provide collateral signal that they are willing to repay their debt. Collateral also aligns the interests of the borrower and the creditor once the credit is granted. Yet, SMEs usually hold modest assets, so the collateral request becomes an insurmountable obstacle to access financing.

There are obstacles to bank borrowing also from the companies' point of view: companies avoid taking loans from banks for several reasons, such as no need for credit, bank requirements that are too costly or inadequate, or sometimes they believe that they will not meet bank's requirements (showed in table below).

***Table 5.* Reasons given for companies not borrowing from banks (share of total companies that did not borrow)**

Size	1. No need for credit (%)	2. Bank requirements too costly/ inadequate (%)	3. Believe will not meet requirements (%)	4. Rejected (%)	5. Other reasons (%)	6. Total – Firms that did not borrow from banks (%) (1+2+3+4+5)	7. Percent of firms that did not borrow from banks in total number of firms (%)
Micro	77	17	3	3	0	100	64
Small	75	20	1	2	2	100	48
Medium	79	13	8	0	0	100	37
Large	79	17	0	0	4	100	42
Sole proprietor	84	13	2	2	0	100	73
Total	**78**	**17**	**2**	**2**	**0**	**100**	**59**

Source: USAID BEP (2013)

Table 5 shows that 59% of companies in BEP's survey did not have access to bank financing or have not been interested to borrow from banks. It does not mean that 59% of companies never took loans, but rather that they avoid taking them even when they can.

What banks can do from their side regarding above mentioned issue is what CEVES's team tried to investigate through in-depth interviews and surveys with senior bankers from 11 banks operating in Serbia. One thing is certain, better conditions and less costly requirements from banks would definitely increase the demand for loans and expand banks' client base, but we try to describe other initiatives and activities which can be done by banks as to increase access to finance of SMEs.

3. General issues with SME financing

Recent developments make SME banking an industry in transformation. Strong competition in corporate sector and the global economic crisis have significantly reduced opportunities in this market segment and have created a necessity for the shift towards SME financing. Developments in retail sector and ever more common account switching create opportunities to take over a high portion of SME clients who use the same provider for business and personal banking. Further, governments begin to recognize the importance of SMEs for country growth and they therefore start developing legal infrastructure to support SMEs.

3.1. Specific challenges in Serbia – operating environment and high interest rates

Apart from micro challenges that are inherent to the nature of SME banking there are certain systemic challenges that affect SME lending primarily via high interest rates. In particular, in Serbia, the overall level of interest rates is very high due to systemic challenges that stem principally from

banks' operating environment. Specifically, the literature dealing with structure of interest rate points out to several main factors influencing the overall level of interest rates: **(1)** banks' cost of funding; **(2)** country's macroeconomic conditions; **(3)** institutional parameters and the country's legal system; and **(4)** prudential regulations, in particular loan loss provisions and reserve requirements. A detailed analysis of these challenges is beyond the scope of this paper. Yet, it is worth noting that these factors are country specific and that they should be analyzed as such.

A comparative analysis of the overall level of interest rates in Serbia and selected countries from the Region (specifically Bulgaria, Croatia, Hungary and Romania) showed that the interest rates in Serbia have been persistently higher than in the rest of the Region – according to the cited analysis, "for the median bank, the lending rate in Serbia in 2007 was more than 2 percentage points higher than in Romania and Bulgaria, and about five percentage points higher than in Croatia and Hungary" (Vasiljevic, 2014, p. 56-60). In 2012, after the crisis unfolded, this difference became somewhat smaller but still remained high – two percentage points higher compared to Romania, three compared to Bulgaria and around four compared to Hungary and Croatia (Vasiljevic, 2014).

How can we explain such high interest rates? To answer this question we should analyze the systemic factors impacting the overall level of aggregate interest rates in Serbia before (years 2006 - 2008) and after the outbreak of the global financial crisis (years 2012-2014). Such interest rate is a proxy of systemic risk and a credit analysis of a concrete borrower which will lead to its correction, i.e. to a further increase if that specific borrower is riskier. Since SMEs fall into more risky category of business entities (from the banks' point of view) we can only assume that this rate when charged to an SME will be on average higher to reflect inherent higher alpha risk (risk that each business carriers with itself). The effective lending interest rate in Serbia[9], as calculated from banks' financial statements, in 2006 and 2007 was about 13% and it dropped in 2012 to approximately 10% (Vasiljevic, 2014).

When it comes to **banks' costs of funding** two relevant sources should be mentioned – deposits and foreign sources of funding. Interest rates on deposits in Serbia increased with the first wave of the crisis from 4% in 2006 to 5% in 2008. According to the data of NBS, the weighted deposit interest rate per newly approved activities at the end of 2012 amounted to 6.3% (when the overnight deposits are excluded) (Vasiljevic, 2014). The analysis of factors influencing foreign costs of funding indicate that: (1) EURIBOR peaked at the beginning of the crisis in 2007 and 2008 and then declined sharply remaining significantly below its 2006 levels; while (2) the risk premium for Serbia (measured by EMBI index) grew systematically from 2007 until 2009 than dropped but remained well above what it used to be in 2006 (Vasiljevic, 2014).

Bad **macroeconomic conditions** in Serbia are another reason. Despite some progress from the beginning of transition, Serbia used to have, in a rather long period of time, volatile and relatively high inflation and unstable exchange rates. Today it still has high fiscal deficit and hampered economic growth. The global economic crisis only intensified downward pressures[10]. **Weak**

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[9]Note that this interest rate is the aggregate lending interest rate in Serbia and that it includes interest rates charged to ALL banks' loans i.e. those extended in RSD and those indexed in EUR.

[10]In 2013 and in first months of 2014, both the inflation rate and the exchange rate have been relatively stable. However, in May 2014, NBS reference rate (so called "key policy rate") is still as high as 9% (while on January 17th, 2013 it used to be 11.50%) (source: NBS website). The key policy rate is the highest and/or lowest interest rate applied by the National Bank of Serbia in repo transactions i.e. sale and/or purchase of RSD denominated securities performed by NBS. These securities are deemed by investors to be the safest. Yet, the key policy rate is high (despite the low inflation rates and the stable exchange rate) primarily since it is used by NBS as a means of securing indirectly the relatively stable exchange rate (thus preventing inflation). Such a high interest rate offered for the safest securities is expected to attract and sterilize the excess liquidity in the banking sector

institutions fail to protect creditors effectively despite some recent noteworthy legal reforms (e.g. new laws on enforcement and bankruptcy). In World Bank Doing Business 2014, Serbia ranks poorly in all indicators relevant for protecting investors: out of 189 economies, Serbia ranks 182nd in dealing with construction permits, 116th in enforcing contracts (100th in 2013), 103rd in resolving insolvency and 80th in protecting investors.

Out of **prudential i.e. regulatory requirements**, two most directly affecting interest rates are loan loss provisions and reserve requirements. According to Vasiljevic's analysis, during 2006 and 2007, the effective rate of reserve requirements in Serbia was as high as 28% and it contributed to the overall interest rate spread with 1.5%. To cushion the drop in the lending activity since the outbreak of the crisis, NBS reduced the reserve requirement in 2012 to 21% thus reducing the contribution of this component to the interest rate spread to 1.1%. Developments related to loan loss provisions had the opposite direction confirming that NPLs increasingly burden banks' operations. Contribution of this factor to the total interest rate spread was 0.9 % in 2007 and as high as 1.6% in 2012 (Vasiljevic, 2014).

Finally two factors internally influencing banks' lending interest rates are **(5)** banks' overhead costs and **(6)** banks' profit margin. Vasiljevic's analysis indicates that before the crisis began in 2008, the main factor behind the relatively high interest rates were **banks' overhead costs**, which were responsible for about half of the interest rate spread (they contributed to the interest rate spread with 3.8% in 2007) (Vaslijevic, 2014). During the period 2006-2012 the banks have improved their efficiency first due to rapid credit expansion and after 2009 due to aggressive reductions in number of employees and rationalization of branch network. Thus, the contribution of the overhead costs to the interest rate spread declined to 3% in 2012 (Vasiljevic, p. 24). High lending interest rates were also a consequence of a relatively high **profit margin** the banks realized in that period. Yet, pressures of the increased competition in the conditions of halted growth of the lending, further reduced the contribution of profit margin to the interest rate spread from 2.8% in 2007 to 0.4% in 2012 (Vasiljevic, 2014).

At the end it is important to stress that as long as the State sells its Treasury bills with annual interest rates as high as 8.82%[11] for RSD loans it is unrealistic to expect that lending interest rates for other borrowers in Serbia will fall significantly.

3.2. No alternative financing

A factor that puts further pressure on SME' access to finance in Serbia is a lack of a meaningful alternative to banks. According to a 2012 USAID BEP study on financing the growth of SMEs, only 21% of SMEs report using other financing sources more frequently than bank financing (USAID, p. 20). The study unambiguously shows that the alternatives to bank financing in Serbia are very poor. The study reports that non-bank credit institutions account for only three percent of total assets in the financial system. In addition, two-thirds of these assets are bank-controlled leasing companies. At

which would otherwise most likely transform into a demand for EUR. Keeping in mind that almost 70% of transactions in Serbian economy is already indexed in EUR (and the same refers to banks' lending) the key policy rate becomes an NBS's tool for influencing the exchange rate rather than the overall level of interest rates (Quarterly Monitor, 2013, 35, p. 50). At the same time if the safest securities in the country bear such a high interest rate it is unrealistic to expect that the interest rate charged by banks to commercial borrowers will significantly drop. Since SME fall into a category of relatively riskier commercial borrowers such a high interest rate "floor" prevents any stimulus to SME bank financing even if the intention of policy makers is to prevent the credit crunch.

[11]Source of data: www.javnidug.gov.rs (data relate to an auction held on May 27th, 2014).

the same time only one percent of SMEs reported using leasing (USAID, p. 20). Our research confirmed a USAID BEP finding that the use of factoring is very low and this is even the case for the period after formal adoption of regulation on July 16th, 2013. Trade credit, could be an important source of short-term financing for SMEs but it is a double-edged sword since SMEs are very often forced to extend it to their customers (medium and large firms) which puts further pressure on their working capital. In terms of informal sources of finance, one in four SME cite different informal networks and contacts from their immediate surroundings as the most frequent source of financing (USAID, p. 20).

Insurance companies and pension funds in Serbia, have sporadically engaged in lending to large corporates via buying their corporate bonds. Yet, this kind of financing was small in size and it is not available to SMEs since they are not listed at the stock exchange. The same reason coupled with a low level of development of Serbian capital market put also private investors' debt and equity placements out of reach of SMEs.

Although the bank financing might remain the most important source of SME financing in Serbia which is a bank-centered capital market, we need to acknowledge that there might be business entities that present an excellent opportunity for growth and that could contribute to the development of the economy but that are simply not "bankable" either because they are too small (e.g. sole proprietors) or because they are too risky (start ups, SMEs in IT sector etc). The absence or weakness of a developed regulatory framework for non-bank financial institutions in Serbia is one of major obstacles for a meaningful market response to needs of these non-bankable SMEs or to an eventual SME credit crunch. Currently, a lack of an adequate regulatory framework prevents microfinancing to fill this void in Serbia while suboptimal regulation does not allow factoring and leasing to mitigate further market failures in SME financing.

Although factoring existed as an option in Serbia for a few years now, a new legal framework (the Law on Factoring) came into force in summer 2013. However, it will take some time for the first positive results to be achieved. Additionally, the serious problem of collection of past due receivables cannot be solved by factoring, and is still remaining one of the main liquidity problems of SMEs in Serbia influencing their needs for short-term financing.

Leasing is focused on the lessee of the cash flow from business operations rather than on collateral making this instrument advantageous for SMEs. Yet, USAID research in Serbia indicates that although regulated, leasing firms cannot grow due to regulatory restrictions (prudential regulations are too strict; the leasing industry in Serbia is obliged to pay VAT on the "interest" component of leasing payment which creates a significant cost disadvantage for this instrument; there is no specific regulation of operating leasing etc).

Finally, in other countries, while SME financing by banks has been somewhat declining, there has been rapid growth in the area of microfinance. Despite some attempts, Serbia has not regulated microfinancing as of yet. Microfinance institutions in Serbia are usually supported by some other bigger foreign financial institution and loans are extended via banks.

3.3. Financial illiteracy

Financial illiteracy is a serious obstacle for significant improvements of SME financing as it predominantly limits demand side in its attempt to secure financing. Unless the banks take a more active role in financial literacy projects, as it has a direct impact on the quality of their portfolio, there

is less space for improvements in all other aspects. Banks would need to find a way to offer trainings in an effective and efficient manner (e.g. via their business centers or once quarterly etc). Despite challenges related to costs, ever stronger competition might eventually force banks to attempt to proactively improve borrowing capacity of their potential customers. Otherwise, it might be better to organize trainings in cooperation with SME associations, chambers of commerce and similar entities that more likely have tools, capacity and relevant experience in this type of outreach activities.

Training of SME managers (owners) is usually much neglected relative to training of managers (owners) of large companies. SMEs, unlike large companies, usually have only one director, who is in most the owner and has limited time away from his/her business. SME owners usually opt for training (if any) which is directly connected to business activities of his/her enterprise. At the same time, it is crucial that these directors/owners have knowledge which could help them present their business case and their needs for funds to the banks. In other words, they need to be financially literate to make their project attractive for bank financing.

Financial literacy is not only important for directors, but also for other employees who are involved in an SME financing project. Some SMEs do not have adequate accounting tools, educated employees, or do not keep their financial records at all. This could lead to inaccurate financial statements and business results, which is directly connected to the outcome of the bank's decision on borrowing funds.

If banks engage in activities that would improve SMEs financial literacy, the following crucial obstacles to SME financing could be mitigated:

- transparency and consistency of SMEs financial reporting could be increased;
- establishment and/or upgrade of the capacity of the accounting and financial functions in the enterprise would allow a continuous and timely monitoring of the business operations of the enterprise. Persons in charge of finance within an enterprise could and should be more than just accountants;
- key man risk could be mitigated;
- greater respect would be shown towards contractual obligations with the banks since managers would recognize importance of long-term trust and sustainable relationship with the bank;
- managers would be better able to perform detailed monitoring of the cyclicality of their business and appropriate management of working capital; and
- managers would be able to perform better financial structuring of enterprise's investments (long-term loans for capital expenditure and short-term loans as means of financing working capital).

Consequently, it would lead to substantial reduction of information asymmetry and transaction costs in the process of collection of data and credit assessment.

3.4. Serbian banks on SME financing

The purpose of our research was to assess the access to finance for Serbian SMEs. As already mentioned, the research had two components. The first component was focused on the demand side and tried to assess whether there are healthy SMEs in Serbia with good potential and whether they have access to financing. Relevant findings show that SMEs access to credit in Serbia is generally low, that it consistently declines with the decline in enterprise size and that there are noteworthy missed profit opportunities for banks among unfunded SMEs that have exhibited vitality and resilience despite the economic crisis and other unfavorable developments. Even more important, our results

indicate that there is a low correlation between the profitable growth potential of an SME and the likelihood of its accessing credit. SMEs that were interviewed by our researchers cite as main obstacles to obtaining a credit: high interest rates, overly stringent collateral requirements, endless and exhausting credit application procedures etc.

The second part of our research was focused on the supply side. As mentioned before, we interviewed heads of sales and risk departments responsible for SMEs in 11 banks in Serbia, which comprise almost ¾ of the Serbian banking market, asking them to evaluate financing opportunities that they offer to SMEs. The rest of this paper will primarily deal with major findings of this research component. Specifically, we have noticed that the greatest room for improvement relates to SME market segmentation and acquiring, screening and servicing SME clients. Thus we intend to focus on findings and recommendations that relate to these segments of the bank value chain. However, as means of introduction we will here provide a brief overview of other major issues identified in this research component as to provide meaningful context for the presented findings.

Serbian banking sector is dominated by large banks from the EU. The market behavior, business practices, products and services offered, acceptable risk profiles and risk management policies and procedures, are for banks in Serbia determined by their mother banks or they are to a great extent subject to their strong influence. Through interviews and results of certain questions it was obvious that, in our sample, influence of the mother banks on their subsidiaries is quite high, that most of the practices related to SME financing are prescribed and imposed by mother banks and that local subsidiaries are not even aware of the level of influence of their mother banks since they consider their mother banks behavior and their influence as given. Therefore, we can conclude that mother banks have strong influence on their subsidiaries and that this influence becomes much stronger in the period of crisis due to greater centralization. Thus, mother banks define the level of independence and freedom of their subsidiaries in Serbia.

More and less friendly SME practices. Despite the fact that all banks in our sample aim at servicing SMEs, during the course of the research it became obvious that some banks have more sophisticated SME financing practices than others, and that they are more successful in servicing this market segment. In the rest of the paper we will analyze in greater details SME friendly practices and explain why they yield better results. Here we will mention the greatest differences between SME friendly practices and less sophisticated approach. It is important to emphasize that this distinction does not categorize banks but rather their practices although some of the interviewed banks that are better in targeting this market niche include a far greater plethora of SME friendly practices in their business model. In addition, there is no value proposition behind this categorization. We do not imply that banks should opt for SME friendly practices at any cost. We just claim that theory and practice consider these practices as better way to service the SME market segment if that is the bank's intention.

In the following paragraphs we will first shortly describe SME friendly practices that relate to a particular segment of the bank's value chain. These practices present a benchmark which theory and practice identified as a superior way of financing SMEs. Then we will contrast our findings against the benchmark. Finally, in the next chapters we will deal in depth with these parts of the value chain where (1) practices of Serbian banks are most divergent from SME friendly practices and (2) we believe that banks have capacity and maneuvering space to introduce improvements.

If a bank aims at successfully servicing SMEs the first step that bank should undertake is **identification of the SME market segment as a priority at the very top of the bank**. Moreover, it is good to define expressly the bank's SME focus and goals in the bank's strategy and allocate necessary resources for implementation of that strategy. It came as a surprise to the researchers that

a majority of the interviewed banks claimed that their business strategy was SME focused. Similarly, almost all interviewed banks reinforce this commitment by stating that they plan to expand their SME portfolio in the forthcoming years. Related to this is an SME friendly practice of having, at the top of the bank, a person who is primarily responsible for SME financing. Most of the banks in our sample have an executive board member who is primarily responsible for SMEs which implies high level of commitment to SMEs.

To serve successfully SMEs it is important to be capable of **defining and sub-segmenting the SME market**, researching SME needs and preferences. Our research has shown that banks in Serbia have a very different approach to defining the SME sector which makes an attempt to compare them challenging. In addition, banks usually have neither adequate data nor internal capabilities to perform the SME market segmentation in a sophisticated way. This prevents them from fine-tuning their SME service offer. As already mentioned, market segmentation will be elaborated in details further in this report.

Acquisition of SME clients requires tailor-made approach depending on the segment and sub-segment of the market that SME belongs to and its specific needs. **SME friendly sales culture** requires a proactive approach to client acquisition rather than reliance on walk-ins. It also requires an efficient usage of branch network and low-cost delivery channels. Since branches are an important, but potentially costly delivery channel, banks need to maximize efficiency by focusing branches on sales and client service, centralizing back-office functions, and specializing branches or staff for the needs of priority target segments. Banks needs to develop dedicated staff, a group of sales staff dedicated to business development, as distinguished from traditional relationship management (as well as from back-office staff). Our research shows that Serbian banks consider themselves as sufficiently proactive. However, bankers do not pay sufficient attention to their own portfolio as a starting point for learning and development of critical industrial expertise and understanding of SMEs. Additionally, banks in our sample are highly centralized with regards to SME banking business. Interviewed banks have decentralized sales, while they have kept a high level of centralization in loan approval, risk management and NPL recovery.

One of key differences between more and less friendly SME practices is a **role of a relationship manager (RM)**. Banks with SME friendly practices employ relationship-lending approach that relies heavily on RM's role in acquiring and assessing potential SME clients, since RMs are those who are directly responsible for development of personal contact with existing and potential clients. RMs are there to provide help with loan application, give advice that goes beyond bank products and gather relevant qualitative information on the client. They also play an important role in case any problems in bank-client relationship emerge. In short, RMs are those who set and execute a client relationship strategy that actually defines which issues to focus on, which opportunities to pursue, and consequently which SMEs to credit. On the other side, banks with less friendly SME practices also rely on RMs, but mainly to extent of acquiring new clients (sales function), while much more weight in client assessment procedure is given to risk officers (risk function) and their quantitative and risk-centered approach. Results of the survey from all interviewed banks support tendency of standardization of RMs role – all banks have RMs and descriptively RMs have the same responsibilities in majority of banks, but through in-depth interviews it became obvious that the role, responsibilities and importance of RMs is quite different among banks.

Since SMEs have stated that they experience major problems with **credit application process** due to its burdensomeness, SME friendly business models would assume proactive support from the bank's side. Banks that dedicate time to train client's staff for preparation of credit request, that organize training for potential and existing SME clients, and that provide support in collection of necessary

documents are deemed to be SME friendly. Our research findings indicate that most of the banks in Serbia do not organize training or do it in an ad hoc manner. In fact, we believe that there is room for significant improvements in the outreach practices in this respect and that there are possibilities to organize trainings in a cost-effective way.

Banks that have SME friendly practices have built good **product development skills**. These skills allow them to offer a range of products that go beyond lending. Experiences from other countries show that loans are rarely the major driver of profitability in the SME market segment. They are usually a bait to attract and retain a client but real revenues come from the right combination of value-adding products that are cleverly bundled and that respond sophisticatedly to real needs of the client. Our research has shown that business development capacities in our banks are yet modest and that primarily banks in foreign ownership rely on mother banks to provide them with a complete and standardized menu of products.

According to good practices in SME friendly **credit risk management**, banks should invest in underwriting capability. They need to learn how to assess the credit risk of SMEs in the absence of complete information. This process requires time and accumulation of both data and knowledge. Some banks opt for volume-based approach and for development of statistical models that enhance their ability to estimate risk for SMEs in a more aggregative, objective and quantitative way. These models are usually provided by foreign mother banks and they rely not only on data series from the local market but also on regional data that mother banks manage to collect through their subsidiaries. Yet, from our interviews, we have seen that banks with SME friendly practices do not rely (or do not rely primarily) on typical scoring models but rather conduct relationship and face-to-face approach in the process of acquisition of their SME clients. These banks also have more sophisticated approach to **the usage of qualitative factors in credit assessment**.

Since the main source of payment of loan is the cash flow created by companies, in client's analysis banks mainly focus on the correlation between financial performance of the client and probability of default. In this regard, a system of traditional financial indicators, which includes the indicators on the liquidity, profitability, growth, operating ability and debt-repayment ability, has been established and is widely used among the banks. This analysis is regarded as a minimum effort in first assessment of the client, but the main difference between more and less SME friendly banks becomes obvious when it comes to the level of understanding of **the limitations of quantitative analysis that is applied to SMEs**. Purely quantitative analysis does not capture very important SME aspects or risks that are immeasurable by a number - things like the value and the vision of an executive/owner of the enterprise, management team, and their reputation, or potential risks that the enterprise faces with legal issues. Although relatively more difficult to analyze and understand, the qualitative factors should be very important part of the SME credit analysis. Banks with SME friendly practices seem to be better in identifying an optimal set of qualitative factors and then deciding which of these factors add value to the enterprise's credit analysis. Also, it is noticeable that banks which employ more friendly SME practices take into account larger number of qualitative factors and that their final lending decision relies more heavily on the assessments of the owner's potential, vision, approach to business, experience, his reputation etc. Know-how of these banks in approaching SMEs is in the development of reliable mechanisms that enable qualitative side to put quantitative analysis into much better perspective. What we have seen is that less SME friendly approach tends to choose SME clients based mainly on hard data, with quite limited understanding of trustworthiness of qualitative data.

In the rest of the paper we focus on the key differences among more and less SME friendly practices. Specifically, we will analyze in depth practices that if adequately developed might help banks to serve

much better this market segment. We have identified two main groups of issues that bank can readily address through their improved practices: 1) market segmentation and 2) acquisition, screening and servicing of the clients. First reason for considering these two aspects as the most relevant for our study is the fact that risk analysis, even though critical for SME financing, is highly centralized and predominantly controlled by mother banks that have increased the level of control over the risk departments in the post-crisis period. In addition to this, our survey has shown that the biggest discrepancy between the best banking practices and the practices of banks in Serbia exists in the domain of market segmentation (which lacks) as well as in acquisition, screening and servicing of the clients (which contains ample room for improvements). Therefore, it is our impression that mother banks would allow improvements on local level in these two aspects as they would lead towards greater efficiency, better understanding of client risk profiles and would hence lead towards improvements in their profitability.

4. Understanding the SME market

Understanding the SME market is a key prerequisite for development of SME friendly practices which will reflect the specific needs, problems and risks associated with different sub-segments of the SME market. Banks with strategic focus on SME market segment are the ones that manage to serve this market segment most effectively (IFC, 2010). As to be able to create SME friendly practices it is necessary to have one person in the highest level ranking position responsible solely for SME market (IFC, 2010). Moreover, different research studies showed that sub-segmentation of the SME market is crucial for better understanding of risk profiles of SME clients, their specificities, as well as their needs and problems (IFC, 2010).Therefore, it is of a crucial importance for banks to perform SME market sub-segmentation according to: industry environment and dynamics, geography, risk profile, personal characteristics of the owners and managers, business characteristics etc.

SME market sub-segmentation creates higher benefits than costs in the long-term. Even though market sub-segmentation generates costs in the first phase of the process due to the necessity of additional training of the current staff, employment of high profile specialists from different industry sectors, gathering, processing and analyzing of market data, benefits in the form of the lower NPLs, greater client base, better market positioning and profits, prevail in the long run.

The level of SME market sub-segmentation determines to the great extent the level of development and employment of SME friendly practices by banks. Therefore, we will here present in depth analysis of bank practices in Serbia regarding SME market sub-segmentation, any deviation of those practices from the best practice, differences in bank approaches and presence/absence of more friendly SME practices in this regard.

4.1. Importance of the SME market segment for banks in Serbia

As stated by respondents in our survey, SME market segment is the most important for the majority of the interviewed banks (7 banks) and it represents their strategic focus. Notwithstanding, OECD study implies that the share of SME loans in total loans in Serbia was 26.1% in 2011, significantly lower than for example in Hungary and Slovenia (OECD, 2013). On one hand, this may indicate that although banks state that SMEs are their priority they still lag behind real exposures to SMEs. Moreover, in several interviews it was emphasized that corporate market

segment is currently struggling to survive due to the consequences of the prolonged crisis, unpredictable business environment and illiquidity. Because of that, banks are currently facing more problems with corporate segment and have therefore started shifting their priority towards SMEs. On the other hand, low level of SME loans in total loans can be explained by the fact that large companies, unlike in more developed countries, do not have alternative ways of financing and were therefore a primary focus of banks in Serbia.

All banks within our sample (11 banks) have appointed a high level official responsible for SME market segment. For almost all banks this is the member of the Executive Board. Good practice implies that the banks that service SMEs effectively usually have a strategic focus on the sector and a highest level ranking person responsible for SMEs. Therefore, banks within our sample have made an important step towards becoming successful in servicing SME market segment.

Almost all interviewed banks (10 banks) plan on expanding their SME portfolio. This standing of the banks can be due to some of the following reasons: 1. in developing countries banks focus their attention on the large corporate segment in the first years after their establishment, then in the second phase they concentrate on retail banking and in the third phase, as market becomes more sophisticated, SMEs gain in their importance; and 2. the number of large enterprises to which they can lend has lowered significantly either because the banks are already at the verge or above the verge of exposure limits towards them or because these enterprises are already heavily indebted and are struggling to survive. Therefore, SME market starts becoming a window of opportunity for banks in Serbia. Some of the banks have recognized the opportunity for expanding the SME portfolio through signing agreements with IFIs as to offer SMEs specialized credit lines for agriculture, energy efficiency etc. On the other hand, some of them have employed experts for certain industry sectors as to be able to better understand market sub-segments and expand their SME portfolio into targeted sub-segments.

4.2. Do banks in Serbia sub-segment the SME market?

For all interviewed banks (11 banks) the primary criteria for segmenting SME market is enterprise annual revenue. This kind of sub-segmentation of the SME market implies that most of the banks still do not perceive SME segment as a key part of their growth potential. It was also notable that only couple of banks employ further sub-segmentation based on industry sector, but this sub-segmentation is rather superficial as they have not developed specific approaches and tailor made products for these sub-segments. Moreover, through interviews we got the impression that banks do not quite understand the SME market due to the absence of proper SME market analysis. The absence of SME market analysis is closely related to the absence of adequate sources of data for the SME market, poor transparency level of SMEs and poor presentation of data within SME balance sheets and business plans (further explained in the section 4.3).

Banks that have defined lower limits, based on annual revenue, for SME market segment, have developed more sophisticated SME financing practices and are therefore better at servicing SMEs. Reasoning stemming behind this, can be related to the fact that banks which have set lower limits have managed to understand their SME clients to the greater extent, have been able to recognize their needs and develop flexibility through creation of tailor made products. Contrary to that, banks with greater span between lower and upper limits for SME market segment, without any further sub-segmentation, are not being able to devote sufficient resources for insightful understanding of the nuances that exist in the needs of their SME clients. Result of research of several banks from developing and transition countries showed that only banks that have developed practices which led

to profound understanding of the SME market and have performed the SME market sub-segmentation that goes beyond annual revenue, have managed to create appropriate services for the SMEs and accomplish high level profitability in this segment.

Industry specific market segmentation was ranked as least important by most of the interviewed banks. This is the first indicator that banks do not see the importance of industry sub-segmentation and that they still employ superficial sub-segmentation based on annual revenue, enterprise size and bank product. Only few of the interviewed banks have explained that they have a focus on specific SME market sub-segments. These banks are primarily focused on agriculture, food production and energy efficiency. Through interviews it became obvious that banks that have stepped deeper into the SME market and have a focus on certain SME market sub-segments have developed to the greater extent SME friendly practices. Those banks have acknowledged specificities of SMEs that come with the industry of their operation, they have recognized differences in their needs for financing and have been able to fine-tune services offered to them. Moreover, they have deepened their understanding of the specific context of businesses, their sector, strategic position, internal structures and pressures as to be able to engage with SMEs to the greater extent.

Agriculture stems out as important SME market sub-segment. For several banks (5 banks) from our sample agricultural lending is quite important. Those banks have explained that potential of this sub-segment implies possibilities for further increase of the allocated funds. They have therefore developed separate credit lines streamlined towards agriculture within which they have created tailor made products that suit SME financing needs. We also need to mention that through interviews it became obvious that there are certain obstacles for increase in agricultural lending and those are related to: 1. the lack of human capacity (lack of bank employees' expertise in this area); 2. large number of small land owners which are hard to target; and 3. presence of big players who take loans and then conduct crediting of smaller players through for example provision of necessary pesticides, fertilizers, seeds etc. Energy efficiency was also mentioned in two interviews as SME market sub-segment that could gain in importance in the years to come.

Certain SME market sub-segments are not financed either due to internal rules which prohibit their financing or due to the consequences of prolonged crisis on these sub-segments. For all of the interviewed banks it is prohibited to finance SMEs whose operations are related to gambling, cigarettes, weapons and alcohol. Moreover, our research has revealed that banks are hesitant to lend to IT companies (because of their performance that highly varies from year to year), fruit producers (because of the lack of knowledge of bank employees on cyclical behavior of the businesses), pharmaceutical companies that are heavily dependent on the state budget and oil traders, wholesalers and distributors which operate at low margins by nature of their business. Several banks emphasized that due to the current situation in construction industry they are not willing to finance SMEs from that specific industry. Results of our research also indicate that banks which employ SME friendly practices did not have that rigorous attitude towards all SMEs operating in certain industries. Interviewees from those banks have explained that their approach is case-based and that their assessment relies mainly on appraisal of relationship that the bank had with the specific SME and its potential, putting aside and lowering the weight that industry as whole brings with itself. They have also explained that this kind of attitude has enabled them to have excellent SME clients from "problematic" industries as well as low level of NPLs amongst them.

There are certain geographic regions within which the level of NPLs is lower. Certain regions are better performing when it comes to SMEs and are therefore more appealing to banks - lower number of NPLs in Belgrade and Vojvodina, while south and east of the country are more problematic.

4.3. Factors underlying the absence of market sub-segmentation

Lack of available and reliable data for the SME market analysis put constraints on the bank's ability to segment the market beyond fundamental approach based on annual revenue. Only one bank uses industry specific data in the process of acquiring SME clients, while for all banks primary source of data for market analysis is SBRA and SORS. Beside these two sources of data in the process of assessing SME clients the banks use data from Credit bureau, NBS regarding company frozen accounts, Matrix, solvency agencies, Google, tax office etc. The fact that sub-segmenting SME clients is rare may suggest that most banks have accumulated little information on the nature of the SME market and this can be due to the: 1. lack of sources of relevant data; 2. lack of reliable data; and/or 3. lack of industry expertise within banks. Therefore, unavailability as well as lack of reliable data leads towards the absence of SME market sub-segmentation that goes beyond segmentation based on annual revenue.

The banks overemphasize basic indicators for SME market segmentation. The quality of the client, exposure size, enterprise size and expected profitability are the most important criteria for depicting SME clients within interviewed banks. Contrary to that, industry sector to which it belongs as well as geographic area where it operates seem to be the least important factors for the majority of the interviewed banks. But usage of basic tools for SME market segmentation is not sufficient because: 1. SME market is not homogenous category easily addressed by one-size-fits all approach; 2. SME clients do not have the same banking demands and problems, nor do they respond well to the same banking practices; and 3. there is behavioral distinctiveness among SMEs since some SMEs require low level of investment to generate revenue, whereas other require significant capital investment in order to start generating revenue – diversity of operation requires different lending requirements, different interpretation of the cash flow, liquidity and capital strength and different approaches to credit risk assessment (Gildert, 2009). Moreover, segmentation within the SME market is important since in some regions, the dynamics of SMEs' growth may be less important than the industry sector of the SME for determining the riskiness of the loan.

The banks lack industrial expertise which restrains them from better understanding the SME market sub-segments and from properly evaluating risks imposed by them. Almost all of the interviewed banks (9 banks) do not have SME dedicated teams with industrial expertise and they do not perform industry analysis. There is a little doubt that a major contribution to the low priority given to industrial knowledge stems from the low quality and availability of existing data. This prevents specific industry knowledge to develop, outside or inside the banks, dampening any possible demand for such knowledge despite the fact how useful it can be. Lack of SME market sub-segmentation seems to be a consequence of some kind of vicious circle where unavailability and unreliability of the data leads towards the deficiency of industrial knowledge and industry expert analysts resulting in the absence of more sophisticated SME market sub-segmentation.

4.4. How banks in Serbia can improve their practices regarding SME market sub-segmentation?

SME market needs to be defined as priority market segment within which more sophisticated market sub-segmentation will be performed. Successfully serving SMEs requires a strategic investment of resources and effort by the bank, which will require the buy-in and leadership of senior management, but also adaptation of banks' organization to serve the SMEs in the most efficient and cost-effective way.

Granular understanding of the SME market needs to be developed as to be able to perform SME market assessments that will contribute to better understanding of opportunities and the competitive landscape. The assessment can be divided into three components: (1) quantifying and qualifying customer demand, (2) evaluating the competitor landscape, and (3) estimating the value of serving the SME market.

Superior economic and industry sector analysis need to be performed in order to sub-segment the SME market properly. In this regard banks can undertake one of the following approaches: 1. they can create a collective agreement and establish a joint research center which will gather, systematize, process and analyze the SME market data and each month send the same report to all the banks which would than use it for their internal assessments; and 2. each of the banks can establish its own internal research unit which would gather, process, analyze and assess the SME market data. First scenario is mostly used in developing and transition countries within the first phase of banks entering SME market sub-segmentation. Reason stemming behind this scenario are primarily related to the low costs associated with joint research center since all of the banks participated equally in the financing of this center. The only potential drawback that banks may see in this scenario is the level of trust that they can have regarding the information they receive each month. The second scenario, on the other hand, generates much greater costs, but at the same time provides banks with a certainty that their employees will work in the best interest of the bank.

The most commonly used sub-segmentation is based on industry as suggested by the literature, but further sub-segmentation can be based on any of the factors listed in the table below (usage of one factor does not exclude usage of other). Trough SME market sub-segmentation and focus on certain sub-segments the banks would be able to maximize their service quality and increase their cost-effectiveness.

Table 6

Segmenting the SME Market

The personal characteristics of the individual involved or being targeted	- Experience of the founder - The personality of the individual entrepreneur - The motivation to start a business - The type of entrepreneurial activity undertaken: portfolio or parallel, serial, single - Venture-focused - Education and skill level - Ethnicity - Gender - Age - Disability - Unemployment
The characteristics of the business	- Size - Stage of development or lifecycle - Type of entrepreneurial business activity: lifestyle, survivalist, limited growth, high potential - Performance - Economic sector - Non-economic sector: co-operatives, social enterprises, community enterprises, public enterprises - Origin: indigenous, foreign, incoming

	- Industry sector - Age of business - Location - Industry environment and dynamics - Formal or informal businesses
The activity and processes undertaken within and by business	- Market development including international market development and internationalization - Business function including human resource management, quality management - Information technology, marketing, research and development and strategy - Technology and innovation - Take-up of support - Type of support used - Patterns of use - Provider perspective - Nature of support offered - Forms of business-to business collaboration - Business processes - Business performance stance or strategy
Business support needs	1. By type of resource, or 'capital', needed: human, social, organizational, physical or financial. 2. Based on a specific incident or experience, focusing on: a specific problem, a particular crisis, or an identifiable opportunity.

Source: Blackburn, 2012 adapted from Atherton and Lyon (2001).

Banks need to define specific SME market sub-segments that they will target. The selection of SME market sub-segments should be based on their attractiveness in terms of the size of their profitability potential and risk-return characteristics. Individually, each of the banks need to define its own risk appetite as well as evaluate their business model in terms of capacity and readiness to create tailor made services and products for specific SME market sub-segments.

Banks should undertake in depth market research of selected sub-segments, through market surveys/observations on the spot/interactions with SMEs, in order to identify the individual needs of SMEs within targeted sub-segments. Since banks have difficulty of obtaining reliable information on SMEs they need to use the above stated methods as to build their institutional knowledge.

They need to perform operational diagnostics which help in highlighting bank strengths and weaknesses in order to assess capabilities for servicing newly defined sub-segments.

They need to develop sector specific knowledge and teams with industry expertise. Existence of industry experts will provide banks with competitive advantage since they will be able to better define needs of SMEs within certain market sub-segments and create bundle of products that will meet those needs. On the other hand, presence of industry experts will provide banks with proper analysis of market sub-segment profitability and better understanding of risks associated with it. Moreover, some banks have also hired former owners/managers of the SMEs as they have acknowledged that they significantly contribute to understanding of different processes and functioning of the SMEs, as well as their risk assessments.

5. Acquire, Screen and Service SME clients

The second group of issues that are recognized as critical factors for potential improvements in SME financing are related to three elements of a life-cycle of the customer: acquisition, screening and servicing of SME clients. All three elements contain the same dilemma: What is an appropriate and cost-effective approach to SME clients and whether a bank should impose relationship based or volume based lending?

The conventional wisdom regarding SME finance was that small and domestic banks are more prone to finance SMEs because they are better suited to engage in “relationship lending”, a type of financing based primarily on “soft” information gathered by the loan officer through continuous, personalized, direct contacts with SMEs, their owners and managers, and the local community in which they operate (Berger et al, 1995; Keeton, 1995; Berger and Udell, 1996; Strahan and Weston, 1996; Berger et al, 2001; Mian, 2006; Sengupta, 2007). However, studies prior to financial crisis have begun to dispute this conventional wisdom and proposed a new paradigm for bank SME finance, arguing that large and foreign banks, relative to other institutions, can have a comparative advantage at financing SMEs through arms-length lending technologies (e.g., asset-based lending, factoring, leasing, fixed-asset lending, credit scoring, etc.) and centralized organizational structures instead of relationship lending (Berger and Udell, 2006; Berger et al, 2007; De la Torre et al, 2008). However, post-crisis period has urged for new solutions and strategies and change of focus of the banks toward SME financing. Existing approaches were two rigid and inefficient for unique and diversified demand of SMEs. Nowadays, in a very competitive environment, banks are required to take a tailor made approach to each and every client and based on its position along the scale of the value chain, to impose an appropriate strategy. This approach is called Customer management approach (IFC, 2012).

SMEs, more than any other banking segment, vary by size, sector, financial sophistication, and business maturity. As a consequence, a best-in-class customer management approach is critical to profitable growth. This entails an in-depth understanding of customer needs and the ability to apply these insights to shape offers and services to different segments and to different critical moments of a client life-cycle. For instance, through intimate knowledge of their customers, banks can optimize their risk and pricing decisions, cross-sell more products, develop sophisticated collection strategies, and identify customers for retention measures. Customer management is a value-increasing strategy for both sides of a banking relationship. Through customer management, banks establish a deeper relationship with their clients and are able to serve them better (IFC, 2012).

5.1. Acquisition and Screening of Clients

There are two main challenges that banks are facing within acquisition of clients: **(1) cost-effectively marketing their product offering,** and **(2) managing credit risk.**

Customer management strategy offers solution through a thorough and systematic approach to identified challenges. The pillars of this strategy are: 1) targeting effectiveness, which secures successful acquisition of the clients; 2) screening effectiveness, which selects profitable borrowers despite incomplete information; and 3) efficient customer on-boarding, product service and optimization.

5.2. Targeting Effectiveness

Targeting effectiveness is the capability of the bank to understand clients' potential and to contact them with the best combination of product, price, and contact channel to maximize the return on marketing investment. For instance, high-value customers can be contacted in person and more frequently, since the expected return from a marketing contact is sufficient to justify the higher costs involved in this level of effort. In contrast, a low-value client might be contacted primarily via short message service (SMS) or email. Banks that prioritize their activities based on value are said to follow a value or customer value management approach (IFC, 2012).

Bank that is capable to achieve such targeting effectiveness has several distinctive characteristics with respect to its organisation and strategy toward SME clients: 1) organization of the bank is positioned to emphasize sales; 2) bank has proactive approach in acquisition of the clients; 3) bank has adopted SME specific approach to customer acquisition starting with dedicated staff (and sometimes branches) solely to SME sector; 4) bank has ensured efficiency of the branch network as a delivery channel; and 5) bank utilizes low-cost delivery channels as an efficient and cost-effective way to reach and serve clients.

1) Organization of the bank is positioned in such a manner to emphasize sales. Sales orientation is reflected in the management culture of successful SME banking operations, in hiring criteria, and in the organizational structure. Responsibilities for business development and back-office functions are separated, with mechanisms to find the right balance between sales and risk. The results of our survey imply that sales orientation is embodied in the management culture, with most of the banks (more than 90%) stating that they have financial incentives for achieved sales targets. However, in order to get better understanding of clients' needs and specifics of SME business models, sales as well as SME specific skills should be envisaged in hiring criteria. Successful banking practices in the world found way to institutionalize client value through customer process orientation, by specifically hiring former small business owners and managers as SME banking specialists. One expert estimates that 40% of the bank's RMs come from the ranks of SMEs themselves (IFC, 2012). In our survey majority of the banks (nine out of eleven) claim their devotion to SME values through high emphasis on hiring, training and developing staff with required SME specific skills. Nevertheless, the same banks do not have as their banking specialists former owners/managers of the SMEs.

When it comes to organizational structure, the positioning of SME banking business within the organization chart has often been a cause for contention, with competing arguments from Corporate and Retail. Neither is usually an ideal fit, and most banks with successful SME businesses position them independently, and rank equally with other major business divisions. Majority of banks in Serbia place Micro and SEs in Retail division while MEs are covered in more corporate style approach. However, it does not mean that this is the reason why Serbian banks miss certain opportunities among possible SME clients. Moreover, their organizational structure is typical for the level of SME market development and is expected to change once Micro and SEs become more serious players as for now they are negligible in their portfolio. Also, lack of unique approach to definition of cut off criteria makes data incomparable and difficult to match. As there is no perfect solution, it seems that a cut off criterion for separation of Micro, SEs and MEs determines how one SME will be serviced.

2) Bank has a proactive approach in acquisition of new clients. They cannot wait for walk-in clients. Decision maker in SME is often an owner himself. He is less likely to go to bank to shop for banking services. In such situations, especially in emerging markets, bank sales staff relies on direct visits to SMEs' premises to present the bank's offering to prospective clients. When it comes to banks in Serbia, initiative for proactive approach toward new and existing clients is claimed through their

confirmatory replies on the question if they are performing site-visits or other forms of interactions with the owners of SMEs. More friendly oriented banks base their sales strategy mostly on personal contact while less friendly banks use more volume based approach. Success in proactive approach in both cases requires the collection and mining of internal and external market data, and following a well-organized process to make sure all potential clients are contacted.

Bank should start with its existing portfolio of individual clients. Once a bank gets deeper understanding of the business characteristics of SMEs in its own portfolio, after analyzing other opportunities on the market through external data and having performed proper segmentation of the market, bank is apt to build a new client portfolio that is diverse in terms of SME size and sector representation. Diversity enables banks to stagger loan maturity cycles and to manage the risks of economic shock to a certain industry or business segment. Our research has shown that most of the banks heavily rely on existing data bases (credit bureaus, SBRA, chambers of commerce, business associations) and consider them as the most important (for four banks) or third most important source (for four banks) of information when seeking for the new clients. Serbian bankers find other clients' recommendations as a valuable indicator of clients' reputation based on the ranking (3 banks ranked it as most important while by average ranking it holds third position together with "internal ratings of the clients"). Existing SME clients and the companies they are cooperating with are ranked as a second most valuable source by average ranking. However, distribution of the rankings may imply that the banks do not approach their portfolios in sufficiently systematic and analytical level even though they found it as a valuable starting point in client acquisition.

Best banking practices emphasize the importance of proper analysis of the bank's own portfolio. Having identified the size of existing SME clients, the bank can segment and profile these clients according to both business characteristics and financial needs in the same way as the overall market analysis. Moreover, bankers can learn specifics of their business in certain industries, impact of seasonality, cash-flow cycles, management of the working capital and etc. It would help decrease the information gap they have toward this particular group of clients. At the moment, it is evident that there is no industrial expertise in Serbian banks. Consequently, as long as the bankers do not have specific criteria what they should be looking for, they might have been missing certain opportunities they are not even aware of.

3) Bank has adopted SME specific approach to customer acquisition starting with dedicated staff (and sometimes branches) solely to SME sector. Because there may be no substitute for personal contact, banks streamline sales for efficiency by dedicating a group of sales staff to business development, as distinguished from traditional relationship management (as well as from back-office staff). In this "hunter and farmer" model, relationship managers (RMs) focus on cross selling and customer service, while business developers (BDs) work at efficiently generating new business (IFC, 2010). A different sales approach will be required by BDs and RMs to make the most of SME customers. They need to develop appropriate marketing tools and distribution methods, and train front-line staff to identify customers' product needs and win their business using "consultative selling" techniques.

Bankers need to go an extra mile, provide advisory and training services and support potential client in preparation of documents needed for loan request. Financial illiteracy among SMEs is serious obstacle that only through continuous consulting and training programs can be overcome. Our research has shown that more than 70% of the interviewed banks have dedicated units/persons for SME segment for all key functions from origination to back office, while only few banks have dedicated units/persons for origination but not for the back office. Position of BDs has not been introduced yet which is why the current role of RMs in our banks varies from bank to bank.

Furthermore, establishment of Business centers with the focus on particular geographic region that encompass dedicated sales force (BDs), internal risk division as well as RMs for clients service is also a module for efficient acquisition and servicing of SME clients. According to our research, there is a single example of the bank that has developed five business centers with the focus on SME in the respective regions they cover. However, this model requires specialized staff with SME and industry specific skills in order to achieve its full effectiveness.

All interviewed bankers believe that they provide sufficient support to their clients in collection of documents needed as well as explanation on the reason why they are rejected, if that is the case. Also, majority of the banks (8 banks) stated that they organize trainings but only on ad hoc basis. However, it seems that they are not eager to bring into their relationship with the client an educative role. Banks could teach them what they should improve in their managerial habits and how to prepare a proper business plan that would position them more favorably in front of the bankers. It would directly increase the quality of the documents prepared as well as decrease the rate of declined loan requests. The best practice banks provide a variety of different non-financial tools and services to SMEs to help business owners and managers develop practical business skills and better grow their enterprises (further explained in the section 5.6).

4) Bank has ensured efficiency of the branch network as a delivery channel. Outreach capacity of the bank is measured by the number of branches and the level of their distribution. Since branches are an important, but potentially costly delivery channel, banks need to maximize efficiency by focusing branches on sales and client service, centralizing back-office functions, and specializing branches or staff for the needs of priority target segments (IFC, 2010). If we look at the outreach capacity of the interviewed banks the average number of branches per bank on our market is 103. This number differentiates from bank to bank and the range goes from 23 to 230. Based on the answers on the question what is the smallest town/village in which they have branches, we can conclude that, as expected, branch network is unevenly distributed and some of the banks have limited outreach capacity as they seize only to quite large towns. Results of our survey also clearly show that banks in Serbia are highly centralized with regards to SME banking business. Interviewed banks have decentralized sales, while they have kept a high level of centralization in loan approval, risk management and NPL recovery. In this kind of bank business models branches have a primary responsibility for selling both lending and non-lending products and they are usually always involved in loan documentation pre-screening and gathering of information regarding purpose of the loan. At the same time, headquarters are typically in charge of the later stages of the SME banking business – credit risk appraisal, loan approval, oversight of NPLs and their recovery. Several research studies which have tackled the issue of centralization/decentralization of SME banking business throughout the world have showed that decentralization of sales and high level of centralization in banks' loan approval, risk management and NPL recovery function is characteristic for banks which operate in developing countries (IFC, 2010).

5) Bank utilizes low-cost delivery channels — such as direct marketing, internet banking, call centers, card centers, and point-of-sale banking — **as an efficient and cost-effective ways to reach and serve clients**. Leading banks are able to develop these channels and create incentives for clients to use them. Moreover, best practice banks are very proactive in **conducting systematic marketing campaigns to attract new SME customers** and cross-sell across all the channels (e.g., relationship managers, branch, internet, mobile, call centers). Marketing campaigns of the best practice banks are typically managed centrally, in that they are planned and coordinated with the distribution network by a central unit across different channels. From an organizational standpoint, campaigns are managed with a completely different approach depending on the segmentation used. Small enterprises are more conveniently targeted with retail-style approaches that involve value models,

mass campaigns, and a segmented approach. As clients' needs become more complex, and their enterprise sales grow larger, the account management approach should become more effective. Relationship managers dedicated to larger SMEs will follow a smaller group of clients, typically in the same sector, with whom they will have a direct and personal relationship (IFC, 2012).

Even though majority of the interviewed banks state that they use both, call centers and internet banking as delivery channels for SMEs, it is hard to estimate if they are adjusted to proper target groups and if their usage is effective. Even though multiple delivery channels make it possible for banks to segment their service approach, and redefine the role of relationship management from its traditional meaning in corporate banking, there is no much evidence that the position of RMs in banks in Serbia has moved significantly from its traditional role due to efficient use of low-cost delivery channels.

5.3. Credit Scoring

From our interviews, we have seen that banks with SME focus do not rely on typical scoring models since they conduct relationship and face-to-face approach in the process of acquisition of their SME clients. This is in line with SME focused banks' approach of putting much higher weights on qualitative factors than quantitative. All interviewed risk officers emphasized that additional human judgment and human oversight was crucial to give meaning to the scoring process and to correct the assessment by including factors that are relevant but are, because of their nature, outside the scope of the scoring model.

Generally there are two approaches to credit analysis: **(1)** mass-market and **(2)** more conservative approach. Mass-market approaches are often effective for SEs and retail clients. They are usually supported by an automated credit scoring tool built from bank and external data that are publicly available. The assumption behind the scoring model technique is that it allows for meaningful assessment of risks related to borrowers and transactions, i.e. that it provides a reasonably accurate quantitative estimate of credit risk. A scoring model is a formula that assigns points based on known information to predict an unknown future outcome. A credit score rank orders banks' clients by the probability they will default and this probability helps the bank to determine whether to accept or reject a customer's application, as well as how to price a loan if granted. Naturally, a credit analyst needs to be able to use and cross check the scoring tool assessment with some informal and qualitative sources of information.

Among banks in developing countries, larger number of banks does not use scoring models, probably due to less sophisticated markets and lack of reliable information. In developing countries like Serbia, foreign-owned banks are more likely to rely on scoring models due to their presence on more developed markets, better statistical models, access to better information, higher level of technical knowledge etc. It is important to emphasize that scoring is used primarily as one input in the lending decision process, and relative importance of this input differs among universal and SME focused banks.

In general, when lending to SE segment, banks mostly use credit scoring models, which are one version of the internal rating based approach (IRB). This is partly because the use of scoring models, based on rather mechanical rating procedures, significantly reduces transaction cost and speeds up credit decisions. The central principle behind the design of scoring models is that it should provide a meaningful assessment of borrower and transaction characteristics, an adequate differentiation of risk and reasonably accurate and consistent quantitative evaluation of risk. All things considered, credit scoring models play a progressively important role in modern financial and risk management.

Adequate implementation and use of credit scoring models can increase the efficiency and accuracy of credit granting, and optimize banks' client selection process. Regrettably, the details and the exact know-how on building optimal credit scoring models is scarce due to the traditional confidentiality among banks regarding this matter.

Nevertheless, from our interviews we have seen that banks with more SME friendly practices use scoring models that are both country and sector specific. This means that the level and the depth of this local adjustment in the process of designing of credit scoring models directly determines competitive edge and advantage that some banks have over others, in terms of better selection of the SME clients and better risk management.

5.4. Customer on-boarding, Product service and optimization

Customer on-boarding is the process through which banks introduce and integrate new clients in their franchise. Surveys consistently show that the elements of good on-boarding are the speed of processing the first product and the ease of doing business with the new bank (IFC, 2012). Short disbursement times are particularly important for new clients as they send a message of trust and customer care. Interviewed banks are aware how efficiency is important especially in competitive environment as it is. However, certain internal hurdles, such as slowness of internal system especially in expansion periods, bottlenecks in analysis, risk department and legal department in charge of agreement preparation, prevent them from being as efficient as they would like to be. Risk department is often under huge pressure with lack of sufficient human capacity in credit approval procedure. Obviously, there is an ample room for bankers to improve their organization within departments that would save significant amount of time and money, and improve the quality of the service toward clients.

When it comes to product and service optimization, best practice banks distinguish themselves through: 1) tailoring product/services to diverse SME needs; 2) systematic in-market tests and continuous innovation; 3) coordination of marketing, sales and back office activities. Through systematic in-market testing, product characteristics such as term, grace periods, fees, and pricing are getting refined. Best practice banks continuously test their products and depending on the level of success, they determine best products for each segment. Once the products are defined, proper marketing campaigns support their placement on the market among targeted group of clients. The results imply that banks in Serbia are ready to go extra mile for their SME clients since eight out of eleven banks within the sample stated that they analyze each SME individually and create tailor made products based on its financial and asset capacity. But all of the interviewed banks have also stressed out that tailor made products are more present in the ME than in SE segment. In some cases internal procedures and risk management department can be limiting factors for creation of SME tailor made products. In our survey, the most limiting factors according to statements of the interviewees are high transaction and operational costs. Furthermore, bearing in mind that more or less the same banking products are on the market for the last several years, this implies that innovation is not the strongest chain in the banks. Moreover, as long as banks do not have product development units and specialized industrial teams that would, based on characteristics of defined market segments and needs of the clients, prepare tailor made products, innovative approach of the bankers in servicing of the clients can hardly be noticeable.

5.5. Serving of the clients

In their attempt to effectively serve their clients, the banks are faced with two main challenges: **(1) SMEs have unique demands and value personal and attentive service,** in some cases even more than corporate clients, and **(2) meeting demand can be costly given the frequency of contact required** and the potentially lower revenue earned per client. Given the two challenges, banks must balance the importance of keeping operating costs down with the risk of under-investing in service, which could lead to customer attrition, higher default rates, and lost sales opportunities.

Banks that have begun to serve the SME market have found that SMEs place a high priority on being perceived as a valued customer by the bank. While banks may not be able to afford the level of dedicated services offered to their largest clients, they cannot treat SMEs entirely as retail customers — with limited personal contact. **Banks serving SMEs have found ways to cost-effectively meet and even capitalize on the unique demands of SMEs. They do this by (1) using direct delivery channels, (2) segmenting and redefining relationship management, and (3) turning demands into opportunities through cross selling.**

In contrast to wholesale banking, where most transactions are channeled through a relationship manager, SME banking often relies heavily on a bank's branch network as a direct delivery channel. More than half of the banks in the Around the World survey reported decentralizing at least the sale of non-lending products primarily to their branch network (IFC, 2010, pg.49). Branch service of SMEs provides clients with the availability of personal contact while utilizing economies of scale and freeing dedicated RMs from involvement in every transaction. Whereas a traditional RM might dedicate more time to evaluating collateral or collections, these functions are now often performed by dedicated teams. This enables the RM to focus on client service and cross selling, which are often one and the same. The ability to understand and offer solutions to a full set of SME needs can be the difference between a profitable and unprofitable service model. Deeply understanding the customer also enables RMs to foresee and even prevent problems with existing loans. For this reason, most banks also include loan monitoring as a key responsibility of RMs.

Result of our survey show that all banks have RMs and for eight of them RMs play very significant role in their SME lending strategy. Moreover, in seven of the interviewed banks RM judgment determines the banks' lending decision as explained by interviewees. Within most of the banks RMs are more focused on acquisition of new clients and they are in charge of foreseeing problems with existing loans, while for only few banks the primary focus of their RMs is on servicing existing clients and preventing problems with existing loans. Role of RMs is not the same in case of SEs and MEs. **The typical model for MEs comprises RMs residing in all branches and business leadership and credit risk appraisal functions operating in headquarters**. Branch-personnel typically concentrate on building relationships and on customer service-related issues, rather than sales. RMs are close to becoming a standard. They are looking for new clients, trying to develop relationships and preparing information for the regional centers or at headquarters. They are the ones that maintain a relation with the client and, typically, prepare credit applications. In some banks, they participate in pricing products and are involved in the process of credit appraisal. They also play an important role in case of any problems. **Typically part of retail business, the SE operations have a bit different structure.** They also maintain some sort of relationship managers, but with a more sales-oriented focus.

Results of the survey from all interviewed banks support abovementioned tendency of standardization of RMs role – all banks have RMs and RMs have the same responsibilities in vast majority of the banks. But difference exists. Through interviews it became obvious that the role, responsibilities and importance of RMs is quite different for banks that are less SME friendly in

comparison to banks that are more SME friendly, which is in line with mentioned approaches depending whether the bank is SE or ME focused. SME friendly banks employ relationship-lending approach that relies heavily on RMs. In those banks RMs are responsible for development of personal contact with clients, providing help with loan application, giving advices that go beyond bank products, gathering soft information, giving assessments regarding clients, playing important role in case of any problems and their decision regarding loan approval is high on pedestal etc. For less SME friendly banks, even though they have RMs their primary role is still related to acquisition of new clients.

Given the high level of operational costs in servicing SME clients, one way to lower these costs is by cross selling different services to SMEs. Single product offering to SME client bears significant transactions costs that might be reduced through product bundling. If the bank becomes a customer's primary bank, it brings significant advantages as it allows better understanding of customer needs, thus improving cross-selling and increasing overall profitability. **Cross selling increases revenue per client since it increases sales through reliance on existing relationships.**

All of the interviewed banks think that they can assess and ensure overall profitability through this process. The most common combination of cross selling in the case of SMEs constitutes of the following bank products: 1. current account and e-banking; 2. business credit cards and overdrafts; and 3. deposits, loans and bank guarantees. Six of the interviewed banks have stated that they have quantified incentives for cross-selling of products to SMEs, while nine of those enforce them. However, given the limited scope of products and services that can be offered to SME clients, we can conclude that real potential of cross selling and the benefits it brings to one bank has not been seen yet.

5.6. Acquire, Screen and Service SME clients –Recommendations

Organization of the bank should be positioned in such a manner to emphasize sales. The positioning of SME banking business was often subject of debate, with competing arguments from Corporate and Retail. Neither is usually an ideal fit, and most banks with SME-friendly practices position them independently and rank their SME sector equally with other major business divisions. Sales orientation should be reflected in the management culture of successful SME banking operations and in hiring criteria.

Banks should have a proactive approach in acquisition of new clients. Banks should start with their own portfolio of individual clients and get better understanding of typical behaviour of SMEs in particular industries via deep analyses of their own data. Banks need to develop industrial expertise, prepare internal industrial reports and newsletters to be distributed to bankers and clients.

Banks should have SME specific approach to customer acquisition starting with dedicated staff (and sometimes branches) solely to the SME sector. Banks should establish Business centers with the focus on particular geographic region that encompass dedicated sales force (Business Developers - BDs), internal risk division as well as RMs for clients service. This model requires specialized staff with SME and industry specific skills to achieve its full effectiveness.

Banks should ensure efficiency of the branch network as a delivery channel. Branches should be equipped as one-stop shops that offer the full range of the bank's products. Sales staff should be able to advise and educate clients and provide support in preparation of required files and business plans. Successful practices recommend development of business plan templates and financial analysis tools as well as tips for the owners how to "look better" in front of the bankers.

Banks should utilize low-cost delivery channels — direct marketing, Internet banking, call centers, card centers, and point-of-sale banking — as an efficient and cost-effective ways to reach and serve clients. The best practice banks are very proactive in conducting systematic marketing campaigns to attract new SME customers and cross-sell across all the channels (e.g. RMs, branch, Internet, mobile, call centers). Role of RMs should be refined, focusing them more on servicing and monitoring of the clients.

Banks need to increase speed of processing the first product and the ease of doing business. Banks need to develop standardized application forms specific to SME clients to facilitate a fast application process without having to provide excessive documentation (within limitations imposed by NBS). The best banks' practices suggest an automated process of sending emails to explain the features of the first product purchased.

For product and service optimization, best practice banks distinguish themselves through: 1) tailoring product/services to diverse SME needs; 2) systematic in-market tests and continuous innovation; 3) coordination of marketing, sales and back office activities. Banks should conduct one-on-one interviews with current and prospective SMEs in order to understand their needs. New ideas should be evaluated with respect to feasibility and originality, to avoid launching poor products that will burden the sales force. Banks could use focus groups with SMEs to collect qualitative impressions from small groups (10-12 people) on product or service concepts.

Banks can reconcile the trade-off between service and efficiency by moving SME operations from a product orientation to a customer process orientation.

Banks could lower operational costs in servicing SME clients by cross selling different services to SMEs.

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