SEGMENTATION OF SME PORTFOLIO IN BANKING SYSTEM (CONSIDERATIONS)

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Abstract: *The Small and Medium Enterprises (SMEs) represent an important target market for commercial Banks. In this respect, finding the best methods for designing and implementing the optimal marketing strategies (for this target) are a continuous concern for the marketing specialists and researchers from the banking system; the purpose is to find the most suitable service model for these companies. SME portfolio of a bank is not homogeneous, different characteristics and behaviours being identified. The current paper reveals empirical evidence about SME portfolio characteristics and segmentation methods used in banking system. Its purpose is to identify if segmentation has an impact in finding the optimal marketing strategies and service model and if this hypothesis might be applicable for any commercial bank, irrespective of country/ region. Some banks are segmenting the SME portfolio by a single criterion: the annual company (official) turnover; others are considering also profitability and other financial indicators of the company. In some cases, even the banking behaviour becomes a criterion. For all cases, creating scenarios with different thresholds and estimating the impact in profitability and volumes are two mandatory steps in establishing the final segmentation (criteria) matrix. Details about each of these segmentation methods may be found in the paper. Testing the final matrix of criteria is also detailed, with the purpose of making realistic estimations. Example for lending products is provided; the product offer is presented as responding to needs of targeted sub segment and therefore being correlated with the sub segment characteristics. Identifying key issues and trends leads to further action plan proposal. Depending on overall strategy and commercial target of the bank, the focus may shift, one or more sub segments becoming high priority (for acquisition/ activation/ retention/ cross sell/ up sell/ increase profitability etc.), while others (risky/ non-profitable etc.) may be left aside. This entire shift in strategy is considering also growth potential per sub segment. Examples are provided for different strategies considering growth potential of each sub segment.*

Keywords: *SME; banking; marketing; strategy; segmentation; lending.*

JEL classification: *M31; G21; L22.*

1. Introduction

The segment concept (including also the sub segment concept) is related to a division (or subdivision) of an overall data base (portfolio). It has similar and easy to define characteristics.

Any segment is related to a specific potential and is relevant in terms of the number of members. From the authors perspective, the segmentation, referred to as an action (or method) has the aim to identify similar behaviours and the scope of estimating potential growth, overall and split (in smaller clusters - in our case, we

are referring to segments, sub segments, clusters of a bank's SME portfolio). By creating clusters and applying different thresholds scenarios, important conclusions (such as correlations with the commercial results in terms of impact) may be found, leading to a more accurate estimation of potential. From a bank perspective, the potential is defined in terms of turnover, revenues, lending and liabilities volumes. By analyzing existing portfolio and potential estimation, an extrapolation (of the conclusions) can be applied also to the potential data base; therefore, an overall estimation can be done.
This is why, segmentation is an essential step in defining the marketing strategy (for existing clients' portfolio, but for potential clients also). Calculation of profitability per each segment (even by the simplest method of average net revenue generated to the bank by a client), is leading to establishing the most profitable segments from the existing portfolio. It also leads to identify the highest potential segment (in terms of business increase), while correlated to other criteria (for example, comparison between the company annual turnover and the turnover made by the company through the bank in the same year of analysis). Based on the segmentation analysis and conclusions, different strategic alternatives are suitable for each important segment (for example: retention and loyalty increase for very profitable clients of the bank; turnover increase, loan volume increase, cross sell, up sell for non profitable clients with high potential and so on). On the other hand, segmentation process and calculation of profitability leads to identification of clusters which are generating loss. For sure, it is important to consider also these clusters/ segments and to establish an action plan in order to minimize the loss and increase the profitability of the overall SME portfolio.

2. Banking System Service Model for SME Clients

The SME Service Model of a Bank implies the presence of the customer: face to face with the service provider (usually a financing advisor or an operational staff from a branch), but also self-service, while using online banking, other applications of equipments provided by the bank.
Usually, pro-active selling by need identification and maintenance of the portfolio of clients is the financing advisor's responsibility, while the operational staff is involved in re-active responses to transactional needs of the customers in a certain moment of time. For acquisition and offering to potential clients, the responsibilities can be split, and even the branch manager can take initiative if the client value or client potential is high.
With the purpose of helping the branches in structuring the "consolidated" offer for a client, the Marketing Department can design commercial campaigns, with predefined target, or special offers to be applied based on different criteria. In order to better address the offer, before designing the campaign, portfolio analysis and segmentation is done. Commercial campaigns may be different for each identified sub segment; this differentiation may occur when different strategies are designed.

2.1. SME Portfolio Analysis and Segmentation

The banking services are very different when considering segments of clients. The segmentation strategy and process can be done based on many criteria. The banks may address specific offers (and have different divisions and departments) to the following categories (Sources: Romanian banks official sites): Low revenue

Individuals; High revenue Individuals; Private clients; Micro, Small and Medium Enterprises (SME); Large companies (Corporate); Freelancers; Non-Profit Organizations; Public Institutions.

While designing a marketing strategy for SME clients, the first step is to analyze the behaviour and potential of the clients from the (existing or potential) target. If on the market, information about the potential target is limited (meaning expensive of lack of information), a good solution is to deeply analyze the existing portfolio of clients. In this respect, it is important first of all to clean up the portfolio data base, by flagging and excluding the clients with negative signals (categorized as "non-active clients"). At this stage, the portfolio analysis focuses on identifying the unwanted "behaviours", the clients that generate losses or who have a high potential to generate losses.

The first step consists in analyzing the clients' portfolio structure and eliminating from the database the clients that have one or several problems (negative signals). An example for the structure of an SME portfolio and the most common negative signals met are shown in the figure below. The figure reveals the split of an SME portfolio into two major categories (active and non-Active Clients), as a prior mandatory step before the segmentation. In authors' opinion, the active clients of a bank are those resulting through elimination of clients with negative aspects from the portfolio data base. In this respect, identifying all "bad" clients is mandatory; for simplification, negative signals were categorized into: legal negative aspects, financial negative aspects, banking perspective negative aspects. Details regarding each category are shown:

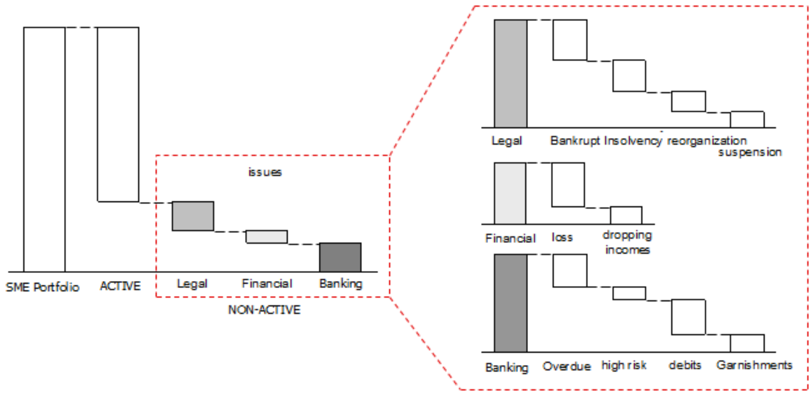


Figure 1: Active and Non-Active Clients
Source: Personal Contribution of Authors

The second step of segmentation may refer to clean the data base (portfolio) by eliminating the non-active cluster. After cleaning up the data base, the next step consists in establishing the segmentation of the remaining clients (so called active portfolio of SME clients). The segmentation takes into account different criteria, the most common being the related to company characteristics and banking behaviour. The purpose is to identify common behaviours, in order to establish the categories of clients with a high potential in terms of profitability (in the specific sense, of

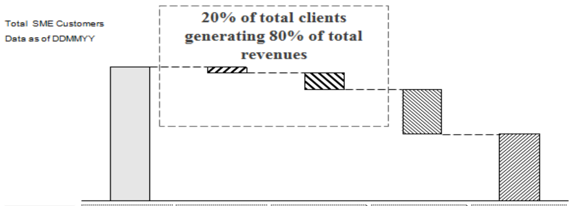
course, of the profitability gained through offering a crediting facility).
The most common segmentation criteria are related to company characteristics:

- Company turnover, profitability and other financial Indicators;
- Field of activity (because the credit risk policy could impose to avoid offering lending facilities to clients belonging to industries with a high risk; it's well - known that, once the economic crisis appeared, the building field of activity suddenly became a sector where credits were being offered only as an exception);
- Geographic Region;
- The debt service (including the debt payment to the state budget).

Other criteria refer to the banking behaviour:

- Incoming payments - turnover on current accounts;
- Revenue generated for the bank in a certain period of time;
- The banking products held at a certain period of time (usually, the last available reports), compared with the identified products potential
- Volumes (Loans and or Deposits);
- The seniority of the client (beginning with the date when the account was opened);
- The payment behaviour, for clients with loans;
- Collateral coverage level;
- The commercial campaigns which had an impact upon the client/which didn't have an impact.

An example of segmentation analysis from banking behaviour perspective is shown in the following figure.



Segment/ sub segment	Overall SME	Sub segment 1	Sub segment 2	Sub segment 3	Sub segment 4
# Clients.	10.000	500	1.500	4.000	6.000
Total Revenue per year (mio. units)	10	5	3	1	1
Average Revenue per year per client (units)	1.000 Loans: 500 (50%) Deposits: 200 (20%) Bk. services: 300 (30%)	10.000 Loans: 6000 (60%) Deposits: 1000 (10%) Bk. services: 3000 (30%)	2.000 Loans: 1.000 (50%) Deposits: 400 (20%) Bk. services: 600 (30%)	250 Loans: 50 (20%) Deposits: 50 (20%) Bk. services: 150 (60%)	167 Loans: 17 (10%) Deposits: 17 (10%) Bk. services: 133 (80%)
Loans Volumes (mio. units)	2.000	1.000	500	300	200
Deposit Volumes (mio. units)	1.800	800	700	200	100

Figure 2: Banking Behaviour as Segmentation Criteria
Source: Personal Contribution of Authors

Segments become real targets when the potential is considered large enough and when the characteristics and banking behavior of the segments allow a special positioning which can create a value proposition for the clients in the segment.
From authors' perspective, a market watch analysis is mandatory, so is a qualitative research in order to identify the most adequate solutions for the implementation. If needed, a testing session will be set up. Before roll-out of the new strategy, a pilot

might be done in order to identify aspects to be improved/removed/added.
After the implementation, the monitoring of the results and the constant communication is very important. Sometimes lack of monitoring may influence the profitability.
Negative signals can be identified after the segmentation is already designed and the strategy is already set up. This happens because the risk profile and the eligibility of the client is analyzed only after receiving detailed information from each client; for example, some filters will include the rating, the debt service, possible to be made only based on documents (usually financial and legal documents) provided by the client's representatives.

2.2. Characteristics of SME Banking Products

Each SME is different and therefore the banking services are unique. The dependency between the company's characteristics and the service is very high. For some companies, the service is standard; for others, is tailor made (this approach is appropriate to be used for more complex companies and needs).
The quality of the banking services for SMEs is very hard to analyze, especially because the customers' expectations are hard to anticipate and the evaluation of the customer satisfaction can be done only after the banking service is purchased. However, requesting constant feed-back during service providing is very helpful.
How a customer perceives the value of the banking product is directly related to customer satisfaction with the condition of meeting the expectations. This leads to a need of standardizing the service in order for the customer satisfaction conditions to be met.
When addressing to small companies, customer satisfaction standards are easier to identify, anticipate and design. For a medium company, for example, it is recommended to address a combination of standard features and tailor made ones.
A banking service feature is designed and established through the document called product card (to be noticed that the concept of banking service was replaced by banking product. Any new product or modification of existing products is approved through this document. The product card contains all the standard features of the product and also details about the non-standardized approach (rules of approval, criteria to consider etc.).
Sometimes the same product card will be used in order to offer standard products to a specific segment of clients, while for other segments, the same product card will become a tailor made offer through applying the existing non-standard rules.
Another special feature of the SME banking product is related to the decision process.
The term of customer has in the end an individual person that will take a decision. That person could be an administrator, shareholder or general manager of the company. For bigger companies, the decision can be taken also by the Financial Manager. Even so, when appreciating the quality of the banking product, or when taking the decision of acquiring the banking product, the customer (individual decision maker) is influenced by his own experiences, claims and expectations; the influencers can be someone from the family (for example, if a family member had a similar experience with the same bank/ branch of a bank etc.), a business partner (client, supplier etc.), even subordinates (financial manager, accountant etc.) and other parties (brokers, consultants etc.).

Sometimes, situational factors influence the decision (for example lack of parking space in the proximity of the branch, no privacy and so on can lead to a negative decision).
While taking the decision to contract a loan, maybe the most important factor is the credibility and confidence inspired by the Relationship Manager. The explanation is simple: the financial situation of the company is important for any administrator/ shareholder (profit is source of dividends and so on) and the risk that a wrongly granted loan could destabilize the financial balance leads to the need of competent advice. That is why professionalism of the Relationship Manager (proven by very well knowing the products, understanding the business, financial indicators knowledge and so on) may also influence the decision.
In authors opinion, the decision is influenced by the ability of the Relationship Manager to inspire confidence, by:

- Very well knowing the banking product, with all its feature (including all costs)
- Understanding the business of the client and correctly identifying the need (a common mistake of low experienced Relationship Manager is offering a Working Capital line instead of an Investment Loan; experienced clients know very well that the company's financial situation can be seriously damaged if acquiring, for example, fixed assets with 5 years amortization, with a working capital line with maturity of 1 year)
- Continuously providing consultancy and advice
- Interactivity and relationship management; the clients need to be involved in the structuring of the banking product (when tailor made approach needed). Face to face meetings are a great premise for identifying further business opportunities for cross selling and future financing (for example, in the meeting, the client may mention a small detail regarding a future investment for building a new warehouse)
- The quality of the banking product cannot meet the clients' expectations unless the Relationship Manager demonstrates fairness; this approach needs to be part of organizational culture, as the values reflect in day to day activity
- Trained on soft skills development: communication, sales, negotiation etc. are a must
- Becoming a single point of contact with the client, "the bank is me"; high expertise and very well knowing the business, together with financial advice and well knowing to identify the needs, are the features that make a Relationship Manager become the face of the bank in front of the customer. That is why the entrepreneurship skills are also very important.

As a conclusion, the skills and know-how of the Relationship Manager might be defining for the decision taking regarding loan facilities. Knowing very well these aspects, the members of the marketing department could be very interested in applying the marketing strategies first of all by "selling" them to the Relationship Managers. The scope is very well illustrated in the figure below.

Figure 3: Marketing Strategy Leading to Commercial Results Increase
Source: Personal Contribution of Authors

3. Applying Segmentation and Designing SME Lending Strategies

3.1. SME Lending – Characteristics

The loans are some of the most complex banking products, especially because the diversity of financial needs of the companies, but also because the approval process. European Commission (in Silivestru, 2012: 178) conducted a survey revealing that SMEs are highly dependent on bank loans for financing current activity and reaching their development ambitions.

From authors perspective, loans for SMEs can be categorized as follows: Working capital lines (Revolving facilities, the limit stays the same), with general expenses purposes (usually: payments to suppliers or state budget and so on); Working capital loans (Non-Revolving facilities, the limit diminishes while paying the principal), for financing current needs; Factoring Facilities, based on Assigned Debtors (no other collaterals requested); Discounting instruments (cheques and promissory notes, invoices); Investment Facilities (with different purposes: building a warehouses/ premises of the company, acquiring a fixed asset and so on).

Oncioiu (2012: 49) suggests that there are two significantly different concepts at the basis of the design and operation of financing scenarios for SME:

- Financing schemes based on governmental policies, with priority on some categories of SMEs;
- Financing schemes based on market requirements, with same or very close market conditions.

Each financing structure has one or more loans, each with limit and exposure (also called outstanding). The loan limit is the maximum limit amount which can be granted to the client (for revolving loans, this is the amount that appears in the loan contracts). The loan exposure (outstanding) is the amount utilized by the client at a certain moment. The limit is always above the exposure, the only case when the outstanding exceeds the loan limit occurs if the client didn't pay its debts to the bank, being in overdue.

The risk management is a very important feature of each loan. In general, small companies have higher risk than bigger ones, but a good rating is only given by a strong financial situation.

The collateral coverage is also a very well known feature of a loan; depending on the collateral type (mortgage, cash, contract, equipment etc.), a certain weight is applied to the value of the guarantee, so the coverage is usually >=100%.

Rating and collateral structure and coverage determine the amount of the provisions that the bank needs to constitute for each loan. The provisions are costs (cost of risk, calculated as the percentage of the provision evolution applied to the amount of the exposure).

While calculating the profitability of a loan, there are three components: the interest rate and the fees paid by the client (IF), the funding rate of the bank (cost of

financing; F) and the cost of risk (as described above, CoR).
For calculation of the profitability of the loan, the authors are proposing the following formula:
RL = IF- FC - CoR, where:

- RL = net Revenues generated through the Loan;
- FC = financing cost;
- CoR = Cost of the Risk.

3.2. SME Lending – Strategies
Every banking product strategy follows at least three essential stages: the Design stage, the Implementation stage (which includes: the release itself, the testing – before and/or after the release – and the "technical" implementation) and the subsequent Monitoring (with the purpose of identifying the strengths or the possible optimization alternatives; sometimes it leads even to a radical strategy change).
The effort while designing a strategy is orientated towards the existing clients' portfolio. This is widely accepted as being an efficient strategy, being less expensive than the strategy of attracting new clients. It is also profitable to simultaneously focus on various transactional segments. The portfolio selection (clean-up) and segmentation is applied for developing a model, taking also into account a perspective based on risk management - clients with less risk and high profitability are preferred.
Once the market segment/segments have been defined, the establishment of the crediting strategy target is made taking into consideration the potential of the chosen segment (which has to be large enough), but especially the possibilities of creating a special positioning, that will be able to generate a value proposition for the clients within the segment.
After establishing the target segment characteristics, the companies whose risk profile don't meet the eligibility conditions will be eliminated from the database. The conditions will always include the company's financial rating (based on the scoring developed by the financial institution), the debt service, the client's profitability and so on.
A competition analysis is a mandatory step, especially when the target segment is composed of small companies. In this case, the strategy will be a standard one, generally available for all companies included in the segment. For larger companies, where a level of service personalization appears, the competition analysis becomes harder, reflecting through the clients who are willing to offer information regarding the offers which they received from the competing banking institutions.
The strategic alternatives when offering credit facilities may regard any aspect below, but the decision regarding optimal strategy could be taken at segment level:

- The market share increase, by increasing the number of clients with credits and/or the total volume of granted loans; if focusing on volumes, the segments with highest potential should be attacked.
- Optimized version/ new version or product to be included into the product catalogue of one or more segments; segments with low results and potential can be attacked by offering optimized products which meet their expectations.
- Client portfolio migration from credit products with a higher risk to credit facilities with lower risk and/or higher profitability (transforming the credits with work

capital into factoring facilities, for which the default risk is lower); segments with high risk (sensitive portfolio) always need a special strategy and action plan.

- The creation of products and services "packages" (for cost optimizing); elite and complex segments can be attacked with innovative products which are leading to turnover increase through the bank (and therefore to non-risk revenue increase); for example, a package with unlimited incoming and outgoing payments and a lot of banking and non- banking benefits included, at a monthly fixed price.
- The establishment of loyalty methods for the existing clients/acquisition of new clients through a simplified flow of offering certain credit facilities (for example, preapproved facilities); segments with good financial performance and with loan appetite will be attracted through a pre-approved limit of money (working capital or credit card), granted by a very simple flow, with no bureaucracy.
- Encouraging certain favorable behaviors (the turnover increase through the current account, which leads to the banking institution's profitability increase), by offering preapproved working capital lines (according to the client's previous behavior)
- Some modifications of the existing products are mandatory due to legal rules (especially NBR Regulations, Available: http://bnro.ro/Legislatie-financiar-bancara-735.aspx).

Different strategic alternatives for each segment will be proposed, taking into account also the cluster specificities and the objectives that derive from the analysis. For profitable clients but without growth potential the optimal strategies are focused on retention; for unprofitable clients but with a high potential, the optimal strategy will consider the increase of the turnover through the bank, the increase of the product penetrating degree or the increase of the credit volume.

4. SME Strategy Efficiency – Final Testing

Based on criteria defined in segmentation activity, and also through different scenario defining, final thresholds for each numerical criterion will be defined. In order to estimate the results of the marketing strategy, worst case and best case scenarios will be set up. An example for 3 months evolution is provided in the figure below.

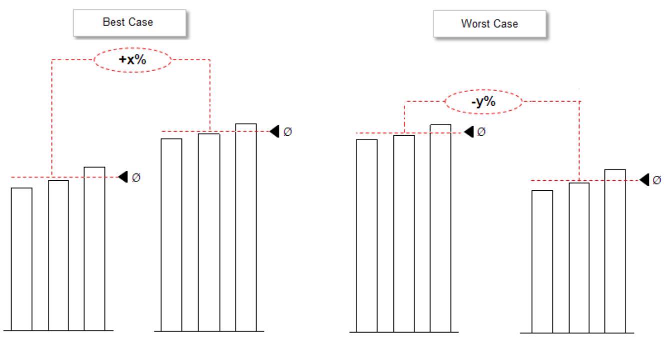


Figure 4: Three Months Evolution: Best and Worst Case Scenarios (Estimations)
Source: Personal Contribution of Authors

Usually, the final estimation for the strategy is somewhere in between worst and best case. The next step is represented by testing the matrix of criteria, which is usually made through a pilot (branch/ region/ indicated financial advisors, in a limited period of time). After the pilot period, a "Before and After" analysis should be performed, with the purpose of comparing the average (monthly/ quarterly) before launching to the average of the same indicator, but after launching. This is the final analysis, through which, the efficiency/ inefficiency of the designed segmentation is determined (as per the below figure).

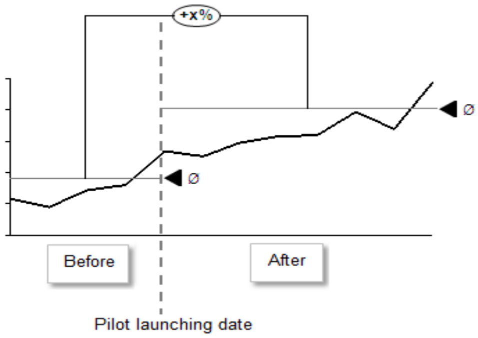


Figure 5: Before and After Analysis of the Strategy Impact
Source: Personal Contribution of Authors

Depending on the strategy profitability and success, further analysis and monitoring of the segments will be done. Best Practices for sub segments may be identified, and, therefore, an optimization of the strategy could be done.

Concluding Discussion

Considering the methods and strategies presented in the current paper, one can identify correlation and impact between portfolio analysis, market watch, best practice identifying, gathering feed-back (from best sales representatives and clients), analysing the clients profiles and the action plan (as a starting point) of an efficient segmentation process. In this respect, the defining of segments and sub segments may be based on different criteria identified as important during the previously mentioned analysis. If willing to determine if a segmentation structure (matrix) is efficient or not, business case scenarios could be tested. Tailor made strategies may be designed for sub segments by very well knowing the profile, characteristics and behaviour. This is why authors consider that segmentation has an important impact in finding the optimal marketing strategies and service model.
SME specificity and characteristics may be found not only in Romania, but also in other countries and regions. Targeted products, behaviour similarities identification and profitability estimation could be done for clusters of companies all over the world. This is why, one can conclude that segmentation methods and strategies presented in the current paper could be applicable to any commercial bank, irrespective of country or region.

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