Banks and Small Business: "Not everything I wrote yesterday appeals to me today."

by Charles Wendel

About three years ago I attended a Lendit conference at which Larry Summers, former Secretary of the Treasury, made a keynote address. Speaking about the growing prominence of alternative finance companies (now called Fintechs) in small business lending, he commented: "I would not be surprised if within ten years alternative finance companies generate 75% of non-subsidized small business loans [meaning non-SBA and other government supported loans]."

Many of those attending this alternative finance conference agreed (not surprising) and saw something like a tsunami about to overwhelm traditional banking. Back then, some of my writings approached the tone of Chicken Little warning about the sky falling on traditional banks that would lose the small business franchise to new entrants. Now, three years later a line quoted by Dale Carnegie best summarizes my current perspective: "Not everything I wrote yesterday appeals to me today."

What happened?

High cost of origination. To this day many of the Fintech lenders employ decidedly low-tech ways to generate loans, including a reliance on brokers and direct mail. Despite concerns over how Millennials view them, banks continue to dominate with many of the most attractive consumer and business customer segments. Willie Sutton was right about robbing banks because that was where the money was; it is also where the customers are; that is why Fintech lenders want to partner with them. Many Fintechs have struggled to keep origination costs down.

Explosion in small business Fintechs. I recently had a conversation with a Fintech colleague who expressed puzzlement at the willingness of investors to continue to pump funds into Fintech startups aimed at the small business segment. And, almost every week I hear of a new player entering the fray. Consolidation is inevitable with stronger players emerging from it. In the meantime some uncertainty exists for Fintechs and increases growth challenges.

Limited quality borrowers. Banks created the Fintech lending opportunity by limiting their lending to small businesses in reaction to the economic downturn of the last decade. Many banks did not cut back lending surgically but rather rejected many "good" borrowers as well as unreliable companies. Today, banks could be lending to a greater percentage of businesses, but a hangover from the past and valid concerns about regulatory oversight have limited lending activity. Yes, banks talk about tough competition for small business loans but in part that is because many are pursuing the same type of customer. As we will outline below, some banks are now increasing their enthusiasm for small business loans and broadening their target

markets, responding to Fintech lender inroads and perhaps leaving fewer quality borrowers for alternative lenders to fight over.

Fintech lenders need to pursue a targeted niche-oriented approach to lending that often focuses on loan types that most banks will continue to avoid. The best ones are developing cost effective referral programs with industry associations, business affinity groups and others (including banks) in order to lower acquisition costs. They are also focusing on one or more areas of expertise whether based on an industry, loan type, structuring ability, or other characteristics. That said, there are a finite number of these customers, probably sufficient to build some attractive businesses, but not necessarily threatening the lifeblood of the banking industry.

Continued bank stickiness. For the near term the stickiness factor remains a huge advantage for banks. Yes, baby boomers are aging and disappearing, but there are still a lot of them. And, yes, some Millennials and Gen Zers and others view traditional banks less favorably than their parents and are willing and even eager to bank with what one commentator described as the Four Horsemen of the digital economy: Apple, Amazon, Google, and Facebook.

But, this shift away from the banks, if and when it occurs, will take years to happen and during this time the best banks (maybe 20% of the total) will not simply be sitting by passively as their customers disappear. Some of the biggest banks have gotten the message and are acting.

Increased co-opting of alternative finance companies by banks and credit unions. Larry Summer's prediction might have been more on target if he had said that within ten years Fintech companies would generate or help traditional financial institutions to generate 75% of small business loans.

FIC has developed an ever expanding list of about 25 Fintechs that want to work with banks to streamline their lending process, allowing them to make "express" loans cost effectively. Earlier this year several conference speakers proclaimed that 2017 would be the year of bank partnerships, meaning in lending to small businesses. More "partnerships" will be announced but most center on a bank adopting Fintech-built technology that allows the bank to lever a Fintech's IT and less any third-party lending prowess.

Many banks continue to operate with a DIY culture. Some Fintechs have been created to meet those needs while others have pivoted from their preferred focus to meet bank realities.

A slow awakening to the value small businesses offer. A relative handful of banks have long understood the value that small businesses provide if they can succeed at capturing much of the business household's wallet. As banks look for growth paths and the need for low-cost funding, small business will jump out as a priority for consideration.

Fintechs lenders have made some inroads into the small business segment and, to a small extent, have stolen share from banks. More often they are lending where banks do not want to lend. And, in some cases, technology providers are allowing banks to compete successfully against non-traditional lenders. To a great extent, banks remain in the driver's seat.