Fixing Small Business Loans
by Charles Wendel

Banks lose money from small business loans, typically, loans below $250,000. Not all banks, of course. But all banks except maybe five-ten of the biggest banks that stress high touch and have invested heavily in data analytics, streamlined end-to-end platforms, decisioning scorecards, etc.

In fact losses have likely increased in the past five years as more regulation and internal compliance activities pile on additional costs. Loans that should be the lowest touch are being reviewed by more functional areas. At one client they recently found that several small business loans typically offered by their branches generated negative ROAs. Ironically, those loan types were also their highest growth loan products. FIC's analysis points to losses on $100+K loans even before internal overhead allocations and loss reserves.

One bank approach might be to avoid making these loans, but loans of this size are unavoidable if you are serving the business segment. Most businesses are small and have small loans needs. If you want their stable and steady deposits (you do), you need to meet their occasional loan needs. And, banks find themselves lending suboptimal amounts to larger targets as well. In some cases a smaller loan may serve as a relationship starter; in others, a larger relationship has a need for a specific-purpose smaller loan.

The value of these attractive clients is dragged down by the cost of onboarding and monitoring a smaller loan. The bank may not know this, however, if it lacks good product profitability reporting. It is smart for banks to reach out to deposit-only customer to offer them loans, but not so great if each of those loans loses money for the bank.

Small business loans provide a classic example of a value destroyer that banks fail to address with the rigor they deserve. Organizational issues, the apparent complexity involved in finding a solution, lack of an "owner" or "Executive Sponsor" to lead the effort, and other factors result in the continued existence of this situation. Solutions attempts are often piecemeal and fail to get at the root cause.

Where to start? It makes sense to begin by creating a process map that details the current end-to-end path for a small business loan today. Who and which bank groups touch it, beginning with the original application through loan closing and monitoring. How may touches? How long does each step take? Is each step essential? How can it be shortened? Can any be eliminated? Which loans make money and which don'ts?

Banks also need to consider the loan products themselves. Are there too many? Are they too complex? Are they "easy" for the bankers to sell and for the internal operations people to administer? Can the products be simplified? In some cases product groups have created offers that are difficult to sell and for the banker and customer to understand.

Pricing demands focus as well. Some level of risk-based pricing needs to be introduced. To this day pricing is not sufficiently differentiated by quality of borrower. And, many customers will pay more to get a loan quickly and with minimal hassle. Years ago, working for a PE firm that was considering buying a Merchant Cash Advance (MCA) company, we found that many of the MCA customers were bankable, choosing to pay more for quick turnaround.

Profitability issues also involve many banks are failing to encourage the level of use that would turn a loser loan into a winner. Others need to reconsider their risk criteria to take *some* additional risk for the potential of substantially more reward.

Banks should understand how competitors are targeting these loan needs. Banks like Wells Fargo have created a small business credit card for lines up to $100K, leveraging the lower cost of the card platform. Can your bank do the same? With what degree of ease or difficulty?

Deliberately, I have not mentioned technology until now. Banks should start by understanding their current processes, cut out or ease as many manual touches as possible and, then, consider how to apply technology. Unless you do this, technology is just digitalizing bad processes, not a winning approach. Technology can enhance data analytics, offer a streamlined process, improve pricing, and bring other benefits to a bank's small business efforts. But, the wrong technology choices may be worse (and more costly) than making no choice at all.

But understanding the bank's current portfolio and process flows comes first, well before considering a technology solution.

In some cases large banks look at their internal processes and decide that the best route is simply to outsource small business loans to a third party Fintech experienced in this area. The recent announcement by OnDeck regarding PNC and Fundation 's relationship with Citizens Financial provide examples of this approach. These banks looked at their performance, assessed what they were good and not so good at, considered the competitive dynamics and customer needs and decided to partner up. They found that the cost and time required to bring an internal IT solution to the problem simply did not make sense. These banks are certainly big enough to "build" and develop their own solution, but they and others are smart enough to "buy" and leverage the program offered by a specialist firm.

Next week, we'll recommend a fact-based approach to assess and fix your bank's small loan problem.