How To Fix Small Business Loans
by Charles Wendel

As discussed in FIC's last newsletter, we all know that almost all banks (roughly 99% of the total number) lose money on small business loans. The difficulty of lending profitable has resulted in many banks avoiding this customer need. However, avoidance also threatens a bank's deposit stream, pushes away potentially attractive relationships, and opens an opportunity both for other banks and Fintechs.

Last week, a colleague was discussing this topic with a banker who immediately replied that using technology was **the** solution. It is **a** solution, but it may be the **wrong** one unless a bank begins by addressing more fundamental questions. Ultimately, yes, most banks need to lever third- party technology to capture the efficiencies required to make profitable small loans (less than $250k). But, before making technology decisions, some additional hard work needs to be done.

At the end of the last newsletter I wrote that banks need to understand their bank's current portfolio and process flows, well before considering a technology solution. Here is what banks we know have found when they evaluate their current small business loan portfolios:

- **The bank may have more small business loans than it thinks**. It is not just the branch that is putting on small loans, but at many banks various commercial groups are also doing so, either for accommodation or relationship reasons. *Implications and actions*: This may be a bigger issue than the bank originally realizes and the losses from small loans may also be more significant. Someone (one person who is on the hook and has authority) needs to capture the small loan data and be in charge of turning this area around.
- **Risk-based pricing is not uniformly applied**. *Implications and actions*: Revenue dollars are being left on the table. Management should be all over this issue. This is one area in which Fintechs may be able to help, if internal resources are insufficient.
- **Too many loan products are being offered**. One bank we know had close to 20 different offers when various permutations, e.g., secured and unsecured, pricing options, etc. were included. *Implications and actions*: Too many products create underwriting and operating costs and confuse both the banker and the borrower. Product people should be tasked with eliminating low value products.
- **At the same time sales teams often do not sell the right loan product for the right need**. At one bank some of the most profitable and lower operating cost products were being largely ignored by sales staff that could make loan goals selling the products they knew best. *Implications and actions*: First, get

managers up to speed on the best products for the bank to sell to various customer types; then, train, incent, and monitor banker performance.

- **Some line bankers provide discounts to borrowers even when those loans lose money for their banks**. *Implications and actions*: This issue needs to be communicated to bankers and a no exceptions policy introduced.
- **Credit use on approved lines is often low; bankers are incented for loans closed, not for usage**. *Implications and actions*: Change incentives. Fast. Product groups should develop programs to increase utilization. Fast.
- **Loan applications are often abandoned or withdrawn in part due to complexity**. *Implications and actions*: Simplify; demand that every question and info request has a real purpose. Push compliance and other groups to justify their requests; don't assume all compliance requests are appropriate.
- **Paper still in use**. We save seen banks that that have invested in digital applications technology allow their bankers to continue to fill in forms by hand. To use a sophisticated consulting term, That's nuts! *Implications and acti*ons: Demand that technology be used both for efficiency and to enhance the customer experience. Bankers cannot choose to opt in. Management needs to manage.
- **Data completeness and integrity is often a problem.** *Implications and actions*: Make correcting this issue a top priority. Banks are often operating with insufficient knowledge about profits and clients, a clear competitive disadvantage. Banks need to appoint someone senior to be in charge of data integrity.
- **Some portfolios show below industry charge-off rates and little to no losses for some loan products**. *Implications and actions*: The bank may be turning away good some quality borrowers. Risk is about the most sensitive issue to discuss, but we see some banks with a low tolerance for credit products that have produced almost no losses. Banks should *pilot* and *tes*t the possibility of offering loans to more borrowers. Consider whether your bank can take more risk for higher returns.
- **Use technology holistically**. Of course technology plays a critical role in making small loans profitable, but banks should focus on this area at the same time as or after they deal with many of the above issues. Banks are almost universally interested in working with Fintechs to "digitalize." The problem is that banks differ on what "digitialize" means at their bank. That can vary from a digital application to documentation to an end-to end solution. *Implications and actions*: The end-to-end solution is where most banks should head, but internal reticence and cultural roadblocks slow that path, causing banks to take incremental steps. That is usually better than nothing, but also means that internal changes and customer experience improvement take longer to accomplish.

Small loans can be profitable. Banks that address pricing, rationalize the product set, encourage loan usage, and consider the other topics above will be best positioned to determine their needs and select the optimal technology solutions that third-parties offer. Don't blame small businesses for a lack of loan profitability; assess the numbers and take the steps to turn losses around.