Losing Money with Every Small Business Loan?
By Charles Wendel

With the input of Bill Phelan of PayNet and after the review of our numbers by a half dozen bankers knowledgeable about the small business space, FIC recently detailed the cost of and likely return from a "typical" $100,000 bank loan.

While each bank differs in its cost and economics, overall we believe that most banks are either losing money or generating sub-par returns from the small business loans they make. This negative situation may not be true of the handful of banks that have invested millions in streamlining operational and risk management processes. It is also not true of the alternative finance players that risk-base price. But, those are the exceptions.

Rather than accepting the numbers below, every bank should dig deep within its institution to develop cost numbers that reflect its own experience. No excuse exists for not knowing the cost and return from a small business loan, but our experience is that too often anecdotes take precedence over rigorous quantification. When banks complete their analysis, more times than not, banks will find a disturbing story, one that should require immediate action.

Costs of a $100,000 Loan

Banks need to quantify six key components as part of determining the cost of a small business loan: origination, underwriting, loan review, operations, monitoring and collections, and compliance.

We estimate that it costs between $3,000 and $4,000 to obtain, set up, and monitor a small business loan of $100,000 or less. These are mainly fixed costs that, depending upon the bank, can apply to loans as small as $25,000.

Loan origination:	$1,000-1,500
Underwriting:	1,000
Loan review:	100
Operations:	250
Monitoring and collections:	500
Compliance:	250-350
Total:	$3,100-3,700

Comments: Loan origination costs can vary dramatically. We know banks that are very efficient and focused in their marketing practices and others at which the bankers and the branches make only a handful of small business loans, inflating origination costs. Some alternative lenders state that their origination costs exceed the above range, but they make up for it with risk-based pricing, a concept most banks seem largely unaware of. In recent years Underwriting costs have increased at many banks in light of regulatory pressures. A few years ago Compliance costs were small; now they are prominent and growing as a category.

Locking in a Loss?

Let's take this analysis a step further and consider the impact of a loan with the above cost on a unit's bottom line, assuming a 6.25% interest rate and an interest charge to the small business unit of 3.0%

Interest Income on a $100K, 6.25% loan:	6,250
Loan cost charged to unit:	3,000
Total non-interest costs to generate loan:	3100-3,700
PT Net Income and pre-capital costs for $100K loan:	(450) to 250

Comment: First, most of the small business loans banks provide are for less than $100K, meaning that with their fixed costs to generate these smaller loans likely destroy economic value for the bank. Second, capital requirements make many "profitable" loans unattractive as low single digit returns fail to justify required risk. Third, the natural tendency of a bank with this cost structure is to move upmarket to make larger loans that can cover the fixed costs and allow a bank to make a favorable return.

Next steps

There is no doubt that the above numbers are wrong and incomplete for your bank. Banks should set a clear priority to immediately develop an internal analysis that represents their own unique situations and cost structures. However, in most cases the end result will be the same as above: *most banks are losing money or making inadequate returns from small business loans*.

Management can address this situation in one or more of several ways:

- *Evaluate the profitability of the small business effort on a more holistic basis*. In effect, lending serves as a loss leader for other product sales and the overall relationship with deposits, personal loans, owner investments, cash management, etc. making the entire small business and business owner relationship attractive.
- *Increase cross sales*. Given the above, banks need to sell more to each small business customer to justify a loan's cost. However, most banks are mediocre at best at cross selling.
- *Process improvement*. Like barnacles clinging to the bottom of a ship, banks often allow processes to become too complex and once established fail to revisit them in order to simplify. Today, that situation seems particularly true

at many banks with their “belt and suspenders” attitude to risk and compliance.

- *Outsource or partner on lending*. Alternative finance players may provide banks with a way to reduce their costs, increase productivity, and meet the borrowing needs of their customers. Depending upon the company they can provide banks with enhanced operational and risk management platforms and/or buy loans from the banks providing fee income.

Banks need to determine how they can break out of the trap many of them find themselves in today: a high cost/low profit small business lending model. As a result, too many banks have chosen to limit their focus on a critically important constituency, one that needs a bank more than most other segments. Rather than ignoring this group, banks need to begin by understanding their current cost structures and profit dynamics. Then, they need to determine the best path or paths for profit improvement. Otherwise, the frustration expressed by management with their small business efforts will continue.