Microbusinesses: Small in Size But Not in Potential

by Charles Wendel

This week we continue our exploration of the four segments that comprise SME banking, beginning with the segment that is largest in total number of businesses but, typically, smallest in individual dollars generated by each company for a bank.

Summary. Microbusinesses comprise a large and potentially attractive segment for banks. However, to achieve strong returns banks need to be very targeted in their approach and emphasize a consistent, factory-like approach in how they sell and service this segment.

Financial Institution (FI) lenders must rely on excellence in technology to identify prospects and originate, underwrite, and monitor loans. But, technology goes hand-in-hand with strong branch sales and support capabilities providing the personal touch when needed. Too much emphasis on technology will alienate some customers (big bank issue) while too much "touch" will result in per loan losses.

Key elements of bank profit dynamics:

- Deposits and related cash management fees
- Efficiency in operating expenses
- High tech over high touch
- Standardized products, streamlined processes, little to no customization of loan requests
- Branch provides sales leverage; separately, Business Bankers focus on larger companies
- Use of Big Data and referrals for focusing on priority targets

While the numbers vary by information source, most analysis indicates that over 90% of businesses generate less than $1 million in annual revenue. Depending on the definition used, the total number of these businesses ranges from 10 million on the low end up to 30+ million. That higher number includes the millions of home-based and part-time businesses that operate out of the proverbial basement or garage.

Individually, none of these customers is likely to be a big revenue or profit generator for a bank. Product needs tend to be simple and straightforward with a checking account often serving as the lynchpin of the bank relationship. Typically, no more than 30-40 percent of these companies are borrowers. Some need no financing; others self finance or finance through friends, family, or even personal credit cards. Oftentimes, owners access home equity, rather than applying for business specific loans, when they require cash.

How do banks make money from these businesses? At the best banks, deposits total two-three times loan outstandings from this group. On a portfolio basis microbusiness loans are not only self-funding but also help to reduce interest expense across the bank, even in a low interest rate environment. Balances can exceed personal DDA levels by three-five times. While of limited value now, *if and when* deposits rates rise back to anywhere near their high levels of about ten years ago, business deposits will again play a major role in branch and bank profits.

Capturing as much as possible from the total business and person household is also critical. Personal deposits and consumer loans help to build relationship profitability. However, exploiting this opportunity requires an ability to cross sell and cut through internal silos that few banks can manage successfully.

Beyond real estate, working capital and term loans, possible key (standardized and streamlined) products include:

- Equipment finance loans and leases
- DDA
- Business savings
- Cash management, including merchant acquisition
- Credit cards
- Retirement investments
- Wealth Management
- Insurance

Many banks view this segment as either largely credit unworthy or, at a minimum, dangerous to lend to. Microbusinesses lack substantial equity or cash flow, many of the business operators have limited management experience, and some of the major industries in which they operate, such as restaurants or personal services, are notorious for their volatility and short life spans.

Without a heavy reliance on using technology for screening and selling, marketing to this group can also be expensive. Business Bankers (BB) and Relationship Managers (RM) need to focus on larger clients in order to justify their costs and provide an acceptable return. Banks must rely on the branch system and technology to sell and service this segment. But, even though many of these companies are closer to personal accounts than larger businesses in their banking needs, branch staff may be out of its depth in selling to these customers. Many branch personnel continue to emphasize passive consumer service, no matter the opportunity. This involves a fundamental issue that many banks say they have addressed, but in reality have not.

While branch staff needs to play the role of salesperson and service provider, when required, increasingly, rather than personal contact, banks are emphasizing self-service to this segment, leveraging digital origination and other processes to reduce costs and push more responsibility to the end customer. Banks hoping to generate

loan profits from this segment will find they must operate with a digital platform both for economic and marketing reasons.

Regarding sales culture, one memorable story told to me by as senior regional bank executive exec summarizes one problem related to branch staff. Earlier in his career he was traveling with a branch manager (BM) to visit prospects. This manager had handled business clients with specific requests coming into the bank but had little experience in proactive, out-of-bank selling. The exec told me that the BM was clearly nervous about making the call, so nervous that in fact she vomited before arriving at the target company. No surprise, they cancelled the appointment. OK, while admittedly an extreme case, we still see branch systems in which 50% or more the branches generate virtually no small business loans.

Another story that underscores the lack of sales culture at many branches involves my need for a notary resulting from FIC moving its incorporation from one state to another. When I went to obtain a notary from a bank the banker asked me if I had an account there. When I answered "No" I fully expected the banker to discuss the bank and why my company should open an account. Instead, she said, "It's $2.50."

When banks do lend, the best ones follow an approach and structure often emulates the bank's consumer activities, using short applications, no exception structures, streamlined processes, and credit scoring. Owner personal guarantees and, as appropriate, UCC-1 filings are often the norm, more for their moral suasion than practical worth. However, even today, many, if not most banks originate, underwrite, and monitor the $25,000-50,000 loan (or smaller) with much the same process and intensity applied to the $250,000 or $2.5 million loan.

This continued reliance on "high touch" even when lending economics demand "high tech" can result from one or more factors:

- If small loan lending reports into the commercial lending area, the tendency is for those lenders to underwrite each loan as if it were middle market in size.
- Some banks continue to eschew technology or rely more on human rather than machine-based decision making. Given bank traditions, that emphasis is understandable, but it also likely creates negative economics.
- Past losses due to an overreliance on credit scoring have not been forgotten nor should they. However, those losses often resulted from poor bank management of the credit-scoring process rather than issues with the quality of the third-party score. The quality of machine-based decisioning for smaller loans has improved, whether from tradition credit scoring sources, but in particular from some of the new entry alternative finance providers.

Serving microbusiness can be profitable, but it requires marketing discipline, enhanced branch focus, and a willingness to embrace technology across the microbusiness "lending system." Many FIs are unable or willing to do so. Some

focus only on deposit gathering from this group, others largely ignore them, while a third group has begun to embrace alternative finance providers as a way to serve the smallest customers. Given its skill base, internal priorities, and culture, each bank needs to decide which of these paths makes the most sense for it and then commit to fierce execution.