One More Time Again: The Case for Small Business Banking
by Charles Wendel

While not hitting Miami, Hurricane Dorian caused outdoor plans to be cancelled and many shops and restaurants to close, as it turned out unnecessarily. I spent some of that indoor time reviewing past newsletters and trying to objectively consider which of them held up and which I wish I had not written.

I think the following column from February 22, 2016 holds up well. In fact small business may be more important to building a sustainable bank franchise than ever before. But, given my experiences over the past few years, it is valuable to highlight some topics I did not sufficiently focus on earlier. I put those edits in italics.

"Why should we bother with small businesses? Your own numbers say most banks lose money from small business loans." – Retail bank head, Northeast

"We are much more interested in the middle market than small businesses. We can make larger loans at a similar cost base. We are avoiding small business lending." – Retail bank head, Southeast

"We use SBA poorly and probably lose money doing those loans. It is one of the reasons we do not succeed at small business." – Senior marketing executive, West Coast bank

Nationwide, banks are continuing to struggle with whether to focus on the small business segment and how to manage those activities. Few retail banks are either honest or bold enough to admit they avoid small businesses, advertising that they love that segment while avoiding it to the extent possible.

The clichéd expression "talking the talk but not walking the walk" fits them perfectly. Some banks that focus on the middle market are more direct in stating their aversion to this segment: "It is a distraction"…"There are too many opportunities elsewhere"…"We don't want to dilute our banker's focus from bigger loans." That is fair enough since it represents both an honest and, for those banks, a realistic and strategic view.

At the same time a consulting friend tells me he has been talking with several banks to help them put in the organization and structure required to build small business volume. In some cases this involves banks that are reentering or reenergizing their small business efforts. God only knows how many times they have reentered or revisited small business over the years. One concern with those efforts is that they may focus only on structure rather than strategy and practical tactics, potentially resulting in yet another group of disappointed banks that fail to focus on the right segment with the right people and the optimal compensation.

Banks are facing the loss of an increasing number of clients to startups and Fintechs. These companies focus on niches, including Millennials and certain industry segments; most banks have seen little share loss, but customer erosion is happening daily as business owners react to a lack of support from their "relationship banks.".

Have the banks avoiding the small business segment made the right decision? Is this segment the banking equivalent of Vietnam, meaning that profitability will always be illusive or "is just around the corner?" In fact avoiding this segment makes sense unless bank management follows some fundamental success principles.

Small business leadership is not a way station. Over the 20+ years that I have headed FIC there has been at least one top five bank that during those same years had more than 12 heads of small business lending. Given the organizational changes at that bank, I think I have a better chance of naming all the prior small business heads than they do. Leading small business is not a two-year stint or, conversely, a career graveyard. Whether hired internally or externally, the head of small business needs to be viewed internally as a heavy hitter, whose selection demonstrates a bank's commitment to this business line.

***Hire small business bankers*.** I was a middle market banker and loved that job. However, middle market bankers are not small business bankers and few can make the required adjustment. Small business bankers need to be retail-oriented and extremely proactive in their selling approaches. I have completed more than one project that resulted in management transferring middle market bankers or middle market management to the small business group. *Ninety percent of the time that approach fails.* Middle market bankers, as good as they are at their jobs, like more structure and require a higher cost structure that small business cannot sustain.

It's all about the deposit*s.* When I asked one banker why his bank focused on small businesses, he immediately talked about the deposits they generate and that on an account basis they were five times or more average consumer deposits. Recently, a CFO at another bank mentioned the LCR or Liquidity Coverage Ratio that Basil proscribes for larger banks. Banks have to calculate what their potential deposit runoff will be (LCR). Banks with deposits in excess of $75mm from a single source need to assume that those deposits will runoff in 30-days. In contrast the retail deposit runoff rate is 10% per month, making those deposits more valuable in meeting the ratio requirements. As that ratio suggests, retain and small business deposits are usually stickier than larger deposits.

Increasingly, banks want and need the deposits that small businesses offer, but do not understand that getting the deposits requires businesses to believe that their bank will help them if they need a loan. Surveys FIC and others have compiled show this. Lending, or a small businesses' confidence that their bank will provide a loan if needed is a key determinant in their choice of a bank.

Building profitable lending partnerships is a necessity, not an option. Most banks will lose money on low dollar small business loans. Therefore, the number of banks partnering with Fintechs will increase. Many of these deals have been customized to the needs of the bank; all should reduce internal costs and increase productivity. Success with Fintechs requires a substantial time investment to structure the agreement and to make sure it provides value over the long term. Every bank should at least consider its options for working with these third parties.

Recent years have seen new Fintech entrants to the lending area and some exits. Banks that want to maintain maximum control over the customer relationship now have partnership options; others can farm out more of the small business loan responsibility to others. Those wanting a DYI approach can now purchase software platforms that can significantly reduce the cost of lending. Lots of options exist to make small loans profitable.

Leveraging SBA is critical to success. Yes, it can be difficult to master the rules of the SBA and, yes, its bureaucracy takes effort to manage, but the payoff for doing so is substantial. Some banks try to get the SBA stamp on most of their loans. But, I know of one bank that has lost money on SBA lending because they built up the infrastructure without putting enough loans through their system. Banks need to build an efficient SBA factory.

In particular 7a lending should be considered as it may offer the potential for a fuller relationship than other SBA loans.

Cross sell capabilities are critical. Small business profitability needs to be assessed on a household basis, not a single loan. The household includes: small business loans, deposits, credit cards, and cash management as well as personal loans, deposits, investments, etc.

If senior management is not supportive, fugetaboutit. Does top management support the time and energy required for success in this space or are their comments just PR gloss? Unfortunately, relatively few of them "get it" when it comes to the value of small business.

One of the smarter bank managers I know recently commented that his bank needed to reach out to more small businesses because the bank needed a source of new business customers, some of which would grow into larger opportunities.

Building small business success requires persistence and some pain. However, banks that fail to engage with this segment risk losing an important revenue stream and the support of their local communities. *This is truer than ever.*