

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

“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 have failed to focus on the right segment with the right people and the optimal compensation.

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 21 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 deposits. 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 Basel proscribes for larger banks. Apparently (I am no expert on this), 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, retail and small business deposits are usually stickier than larger deposits.

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 alternative finance companies (AFC) increases monthly. Many of these deals have been customized to the needs of the bank; all should reduce internal costs and increase productivity. Success with AFCs 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 AFCs.

BTW, the government plays an unwanted but significant role in pushing for small business loans due to CRA requirements. A number of banks are currently or are considering working with AFCs to meet that hurdle.

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.

If you cannot cross sell, fugetaboutit. 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. This additional business is hard to capture which could be one reason why it is critical to success for most banks.

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. If anything, the trend may be going in the wrong direction. Small business executives need to demonstrate the economic, community, and regulatory value of a strong effort.

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.