Will Banks Ever Figure Out Small Business Lending?
by Charles Wendel

In response to a recent newsletter, a financial services executive emailed:

"I wonder if deregulation will enable the banks to profitably fund <250k transactions again?

Do you think that banks will continue to do <250k deals or those will all eventually be outsourced?"

The short responses: Not likely and more outsourcing will occur.

Of course deregulation will help. The current over regulation of banks negatively impacts small business lending and small businesses. Banks have come to avoid business loans that may survive solid underwriting but which examiners would classify on day one. And, capital requirements for small business loans are onerous, making attractive returns on these loans difficult if not impossible to achieve. As noted in prior newsletters, the credit box has narrowed.

While regulations are often problematic, the reticence of banks to lend to small businesses goes beyond governmental hurdles. They involve some fundamental business issues that regulatory relief will not address.

Why do we think more banks will work with a third-party to provide small business loans?

Bank approaches to this segment are cumbersome and costly. In a worst instance some banks underwrite small loans using the same manual processes as for larger loans, misaligning costs versus loan revenue potential. Too often (and even in recent days) I have heard a banker tell me: "We underwrite a $100,000 loan just like it is a $1million loan." Other cost factors include unacceptable sales expenses due to a bank's dependence on a small business sales force of relatively high priced personnel.

*Bank profitability analysis dictates a new appro*ach. As banks continue to improve their accounting and develop business line P&Ls, the losses generated by lending to this segment either has or will become apparent to the CFO and other senior management. Banks make small loans using an employee-intensive model that loses money. And the monitoring, compliance, and other costs have been increasing.

Few banks can invent the solution themselves. Banks could address the cost issues if they had the time and resources to do so; most do not. For example, one bank turned to a small business platform provider as a partner after many months and dollars spend trying to develop an internal digital approach. Only the largest banks or those willing to invest in a DIY approach can play in this arena.

Alternative providers can offer an enhanced customer experience. Alternative finance companies lever technology across all aspects of their business system, but the best alt fins also provide close phone-based follow-up and customer service. They know they need customer and bank partner satisfaction to survive.

Non-lending activities drive the positive economics that small businesses offer banks. Small business provides a bank with the opportunity to capture significant deposits, cash management fees, investment management and mortgage business from owners and employees, etc. More banks should give preference to these lower risk and higher return businesses while allowing other to take business loan risks.

*Top management is often uncomfortable focusing on small loa*ns. Small business is simply not an attractive area to many top bank execs. They may all say they love small businesses, but in reality many prefer larger loan amounts and companies with bigger revenue numbers, neither of which individual small businesses can provide. If anything, more banks are heading up in size focus rather than aiming at small businesses. For example, a friend recently told me of a bank "bake off" he ran at his $100mm and growing company. A top five bank told him his company was too small for them, as they were redefining the middle market segment upwards.

Reputation risk is lower and customers are open to working with third parties. A recent Moody's survey shows that 20 percent of small businesses below $1mm have applied for a loan from an online lender. Banks can either team up with alternative players or risk losing customers to those that do.

T*hird-party partners are becoming increasingly experienced and effective in working with banks.* During 2017 some consolidation will occur in the small business space while new entrants will also arrive. However, a core of strong partners is emerging who know how to work with banks and prize the value that banks can provide them.

An alternative finance company only succeeds if you succeed. Most of an alt fin's economics are tied to loan volume from closed loans. If they are not successful in helping a bank generate new loan volume, then, they fail.

Alternative finance companies give banks great flexibility. With alternative finance companies banks have the option of taking a loan onto its books or getting a fee for providing a loan to the alt fin lender. Banks that know what they want from an alt fin can work with their partner to design a structure that meets their near and long-term goals.

Yes, regulations will improve a bank's economics in lending to small businesses, but the barriers to profitability remain substantial. Banks will find that, more than ever, they need to focus on their areas of expertise and exploit the opportunity to work with lending partners just as the have learned to work with partners in multiple other areas. The net impact of doing so can be a happier customer and an enhanced bottom line.