Will Big Banks Ever Be Good at Small Business?
by Charles Wendel

Big banks created the alternative finance industry. They handed a growth opportunity on a silver platter to entrepreneurs and private equity investors. How? As the economy soured in 2007 and beyond, many banks in effect abandoned small businesses. Management felt that these companies lacked the capital required to survive and within most large banks few champions existed for the small business constituency. At many banks more reasons existed to minimize exposure to this group rather that stick with them, as the downside of sticking up for this segment exceeded any tendency to be a small business hero.

During the downturn, both local and national media focused on the plight of small businesses and how banks, in particular big banks, had abandoned the businesses that most needed bank financing to survive. Rather than helping their business customers ride out the storm, many articles and TV news segments recounted how banks were pulling the rug out from the neediest borrowers. Bank of America, in particular seemed to be featured in many of these stories. During this period I remember being startled in one client senior management meeting when the CEO suggested, “Maybe we should not lend to small businesses.” And, coming out of the recession that is exactly what many banks did, if not explicitly eliminating lending, implicitly doing so by increasing the internal hurdles a borrower needed to jump through. Hence, the opportunity for entrepreneurs to pick up the lending slack.

Big banks like and need big numbers, moving them toward middle market and corporate customers and away from smaller companies. Bank leaders like prestigious clients and, as important as small businesses are to the U.S. economy, they do not possess big powerful names like the largest corporations. Career oriented bankers want to go where the big numbers and names are so, too often, the small business segment becomes a way station or stopping off point for a banker on his way to corporate banking or other higher profile areas. That’s too bad for the small business segment that deserves a higher profile of personnel engagement and senior management commitment. The good news is that those banks that bucked that tendency typically produced stronger small business results.

Today, banks are reengaging in small business lending. The best banks see an opportunity not only to lend but also to capture the additional personal and business related opportunities that each small business provides, including deposits, consumer loans, credit cards, and investments. They are also aware of sometimes not so subtle government pressure to demonstrate their service to the local community.

But to do so successfully, more of them are recognizing the need to partner up with an alternative finance company (AFC). AFCs emphasize digitally enabled lending across their business systems from origination through servicing. Even many big banks lack a digital origination and process platform for small business lending; in a number of cases those banks that have a digital platform dismiss it as clunky and inadequate. (One banker commented, ”It is digital in name only.”) In addition, banks that have done the analysis realize that, given the high touch nature of their origination, underwriting, closing, monitoring, etc., their bank is likely losing money on each loan they make.

Still, the nature of banks involves their being cautious. Just two years ago a high level of skepticism existed concerning the value and viability of AFCs. The recent JP Morgan Chase small business relationship with OnDeck opened the eyes of many top bankers. If Chase was working with AFCs, many execs thought, so should they. The number of banks now looking at partnering up has jumped considerably in the last six months.

It is no surprise that the natural tendency of banks is to move slowly and proceed with caution. Unfortunately, that has caused some banks to just stick their toe in the AFC waters rather than taking full advantage of what these partnerships have to offer. For example, turndown relationships, whereby an AFC reviews loans that the bank has rejected, is often a first-step for banks with AFCs, but provides less value to a bank than a fully integrated relationship. By that we mean a situation in which the AFC and bank are closely linked.

Fundations's deal with Regions Bank and Kabbage's offshore bank relationships with several players provide good examples of those approaches. When a small business applies for a loan on Region's website they are directed to a Fundation website where they enter their information and complete their request. The application is then screened for its acceptance by, first, Regions, and if Regions rejects it, then, Fundation. In effect, Fundation provides the digital platform and streamlines the application and approval process.

Even then, however, that may not be sufficient for big banks to succeed with small businesses. Just because a bank creates a digital experience does not mean that it will increase its small business lending. Banks love magic bullets. During my career the magic bullet concept has included reengineering, total quality management, CRM, and Six Sigma, among other miracle cures. If banks view partnering with AFCs as a magic bullet that will solve their small business lending issue, they are making a mistake.

Working with an AFC can help move a bank in a new direction, but it is only a part of the change process that requires a bank to reconsider some of its fundamental approach to small businesses. AFCs do not make up for the too frequent changes in small business leadership that occurs at some big banks. AFCs cannot overcome poor hiring practices that fail to attract and retain top performers. AFCs cannot succeed in the face of compensation programs that fail to encourage loan sales or refuse to pay top performers substantially more than mediocre players.

Banks may need to go outside their comfort zones and give more up responsibility to AFCs if they truly want to grow their loan outstandings. We know of one bank that had been considering working with an AFC that provided a true end-to-end solution. The AFC would provide marketing assistance, loan underwriting, servicing, and other key functions. Basically, the bank's role was narrowed to following the leads provided by the AFC and ensuring that its underwriting practices were aligned. Most of the heavy lifting would be handled by the AFC. However, the bank rejected this approach wanting to maintain greater control of the loan process, even though that likely meant lower volumes and profits.

Big banks need to avoid pride and tradition getting in the way of profitability and an improved customer experience.