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A PLAYBOOK FOR SMALL BUSINESS LENDING

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Introduction

The small business lending market beckons but few financial institutions can respond. There are several reasons for this including high cost/low margins for small loans, operational inefficiencies and staffing bandwidth. However, none of these barriers are insurmountable. This playbook gives lenders a step-by-step guide to building out and scaling profitable, small-to-medium business (SMB) lending operations.

The Small Business Lending Playbook is intended to be used by lenders to understand key "moments of truth" for the borrower throughout the application and lending process. Key moments of truth could be major moments in the process such as uploading business documents, key communication points, or, unfortunately, common borrower pain points that need to be resolved. Lenders who can view the entire life cycle in the small business lending process through their borrower's eyes instead of from the perspective of their process and systems will ensure an elevated borrower experience. Lenders should identify the primary borrower interactions throughout the entire process, whether they currently exist or are touch points that need to be created because they do not currently exist.

This document can be used by any executive at the institution, including the small business lending leader or head of marketing, to understand the borrower life cycle in the small business journey and to ensure the activities in their lending process are aligned with the best interest of the borrower. Some borrower touch points, such as delivery and explanation of the closing disclosure, are major events in the process and should be handled carefully. Others, such as an introductory welcome letter, might not be major events but nonetheless contribute to the overall borrower experience.

To effectively use this Small Business Lending Playbook, leaders can compare the different activities and borrower engagement steps to their existing process to realize where potential pain points might exist. Once identified, the existing process can be revisited to implement the necessary keys to success and target corresponding key performance indicators (KPIs). This should ensure the lender's actual process is aligned to support the expected borrower's vision of the process. Institutions that do not offer small business lending can also use this playbook to design the right processes.

A key step in aligning these activities is determining and designing borrower engagement in advance. Each lender should be dictating the terms of the interaction with the borrower, not leaving it to the whims of each individual loan officer or processor to handle how they see fit. The best lenders in the market conform their systems and processes to match their expectations of the borrower experience, rather than allowing the process or systems to dictate it.

The typical small business lending workflow for loans less than $250,000 includes prospecting/business development, loan application, onboarding, cross-sell, and advocacy (Figure 1).

Figure 1: Small Business Lending Workflow

Advocacy

- Customer referral rewards
- Referral tracking
- Customer rewards based on depth and tenure of relationship

Prospecting/Business Development

- Branch-driven
- Leads generated by marketing based on data analytics
- Strong pipeline tracking and referral management
- 50% of branch manager time focused on business development
- Great digital attraction

Future Cross-Sell

- Cross-sell leads generated by marketing based on customer data analytics, particularly for deposit accounts and additional loans
- Team-based approach to generating referrals across the organization and subsidiaries

Loan Application

- Streamlined account process for applying for loans: in-person and digital
- Online tools to support product recommendations and initial cross-sell
- Simple, well-defined product set

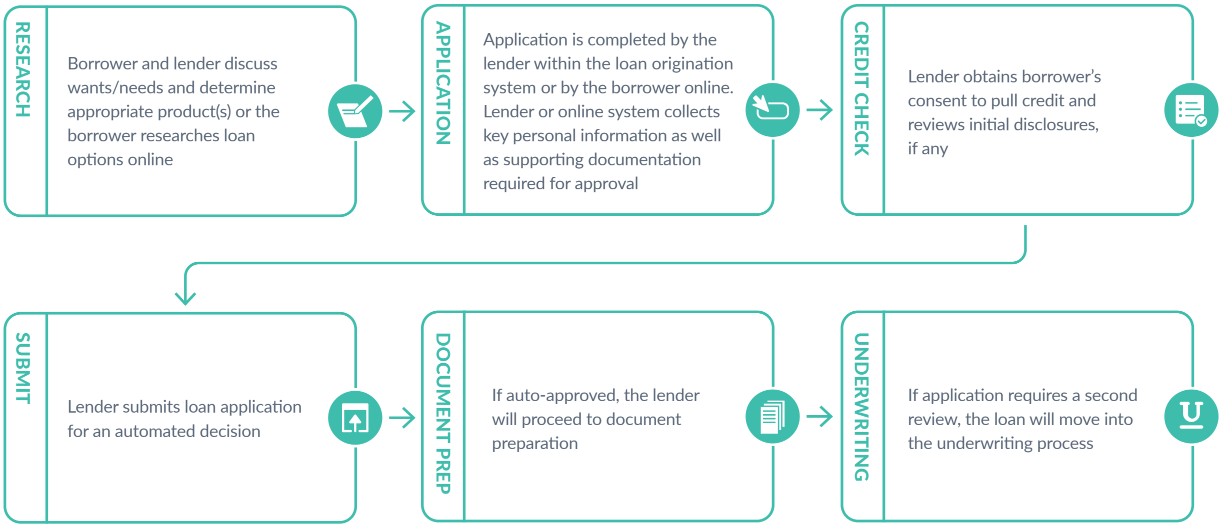
Onboarding

- Multi-channel messaging and interaction to maintain dialogue based on customer preference
- 30-45 day multi-touch program

Source: Cornerstone Advisors

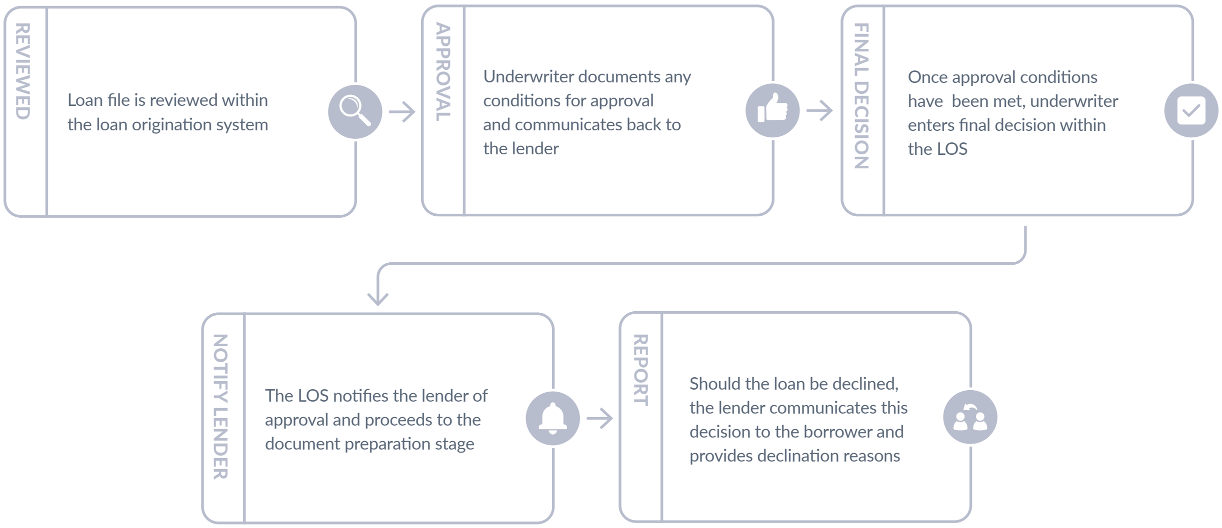
From the borrower's perspective, the journey encompasses four steps: 1) Application (Figure 2), 2) Underwriting (Figure 3), 3) Document Preparation (Figure 4), and 4) Closing and Funding (Figure 5).

Figure 2: Application Workflow



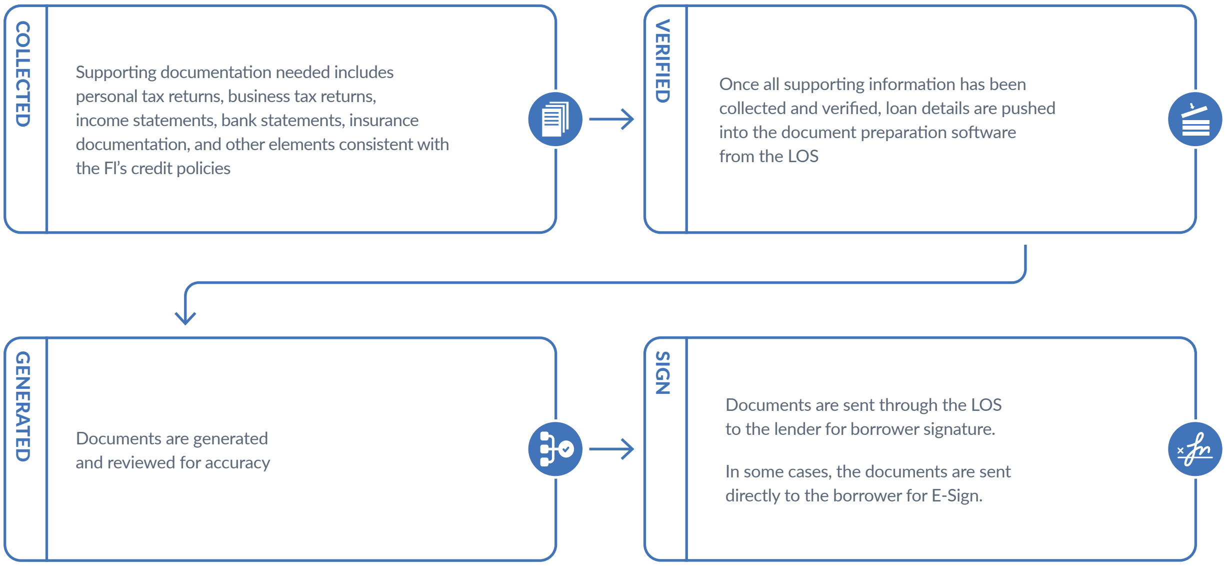
Source: Cornerstone Advisors

Figure 3: Underwriting Workflow



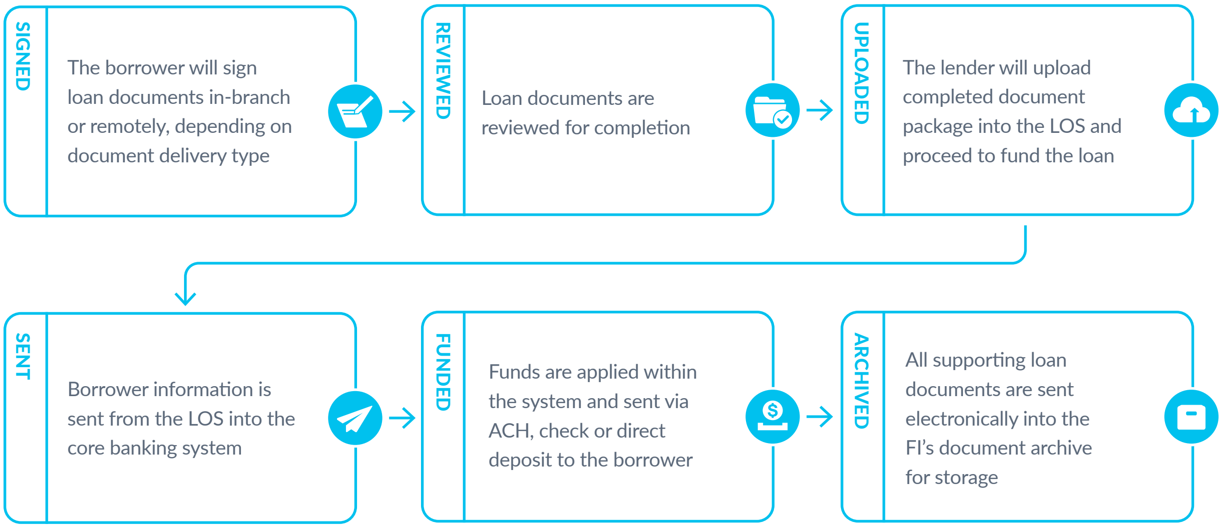
Source: Cornerstone Advisors

Figure 4: Document Preparation Workflow



Source: Cornerstone Advisors

Figure 5: Closing and Funding Workflow



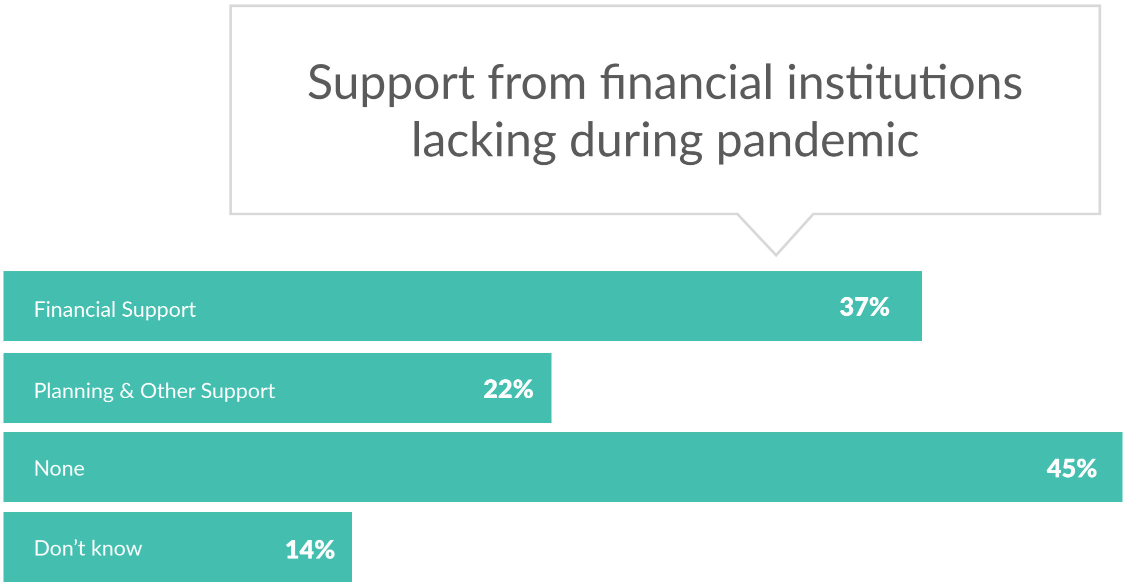
Source: Cornerstone Advisors

Why Small-to-Medium Business Lending

According to the U.S. Small Business Administration (SBA), small businesses make up 99.9% of U.S. businesses, employ 47.1% of U.S. employees, and produce 60% of job growth. While COVID-19 forced many businesses to close, it also brought a flood of new business applications. In 2020, some 4.3 million business applications were filed, up 24% over 2019 and 51% higher than the 2010-2019 average.[1] The numbers point to a golden opportunity for financial institutions to step up and support a blossoming demographic.

Despite the many challenges faced by most small businesses, most community financial institutions have not proven to be responsive to their needs. In a study by Phase 5 as reported in The Financial Brand, nearly half of surveyed small businesses had not received any offers of support from their banks and credit unions during the pandemic. Another 14% could not remember if they received any (Figure 6).

Figure 6: Support from Financial Institutions During the Pandemic



Source: Phase 5

[1] https://cdn.advocacy.sba.gov/wp-content/uploads/2020/06/04144224/2020-Small-Business-Economic-Profile-US.pdf

In total, there are over 32 million SMBs with less than $10 million in annual revenue in the U.S. with funding needs of loans between $5,000 and $1,500,000. Currently, these SMBs are finding funding sources such as SBA loans, equipment financing loans, or other lines of credit from fintechs and niche players in the market like American Express (Kabbage), PayPal, Mercury, Blue Vine, and OnDeck.

More banks recognize the opportunity for SMB lending, making commercial and industrial loans a top lending priority for the past three years (Table A).

Table A: Banks' Lending Priorities, 2020 to 2023

Percentage of Banks Citing Loan Type as a High Priority

	2020	2021	2022	2023
Commercial C&I loans	70%	63%	57%	62%
Commercial real estate loans	76%	45%	53%	49%
Mortgage/refi loans	56%	47%	37%	20%
Home equity loans/lines of credit	39%	9%	20%	17%
Loan participations	NA	5%	15%	11%
Auto loans	13%	6%	9%	6%
Other personal loans	15%	5%	6%	3%
POS/BNPL loans	3%	1%	5%	3%
Student loans	1%	0%	1%	0%

Source: Cornerstone Advisors surveys of bank and credit union senior executives, 2019 to 2022

This interest is significant given how closely it aligns with commercial lending priorities—the bread and butter of most community banks. However, despite this interest in SMB lending, only about 600 community banks in the U.S. have SMB loan concentrations greater than 20%.

But don't let the low number of community banks in the market fool you—according to banks' call reports, the amount funded by those banks for SMB borrowers is a whopping $72 billion.

Small business owners, too, desire easier funding from their primary banks. In a survey conducted by Cornerstone Advisors of 1,265 small business owners and executives during the pandemic, nearly 70% preferred to get loans from their primary banks.

Given the interest from SMB owners and bankers alike as well as the significant dollars at play, now is the prime time for community banks to strengthen their small business lending practices.

Keys to SMB Lending Success

For bankers to be successful in the SMB lending market, they need to execute on several key tenets: strategy, people, process, and technology.

Strategy: Choosing Your Niche

Making the most of an investment in business services requires a strategic approach. No two markets are created equal. Community banks need to analyze the demographics and varied business segments to identify the growth potential of each market. They should seek out “white space” opportunities, those underserved segments such as start-ups focused on sectors like healthcare professionals, cash-oriented businesses, and SMBs that are not actively pursued by large national banks that can disrupt established financial services with new offerings. These businesses will often appreciate a more personalized relationship than the large players can provide. Identifying openings in a new market requires a creative approach to service and risk. A competitive product analysis can pinpoint gaps in serving the needs of businesses in these white spaces and form a basis on which to build the product and service offerings to move into this territory. The solution is not about extending consumer products to business members. A holistic go-to-market strategy encompasses branch and contact center delivery with support of well-trained business consultants who represent the “boots on the ground” necessary to connect in a personalized way with small business owners.

People: Employing the Whole Team

Regarding “boots on the ground,” in interviews with nearly 30 community banks, responsibility for small business lending varied from institution to institution with some leaving it up to the branches and others assigning relationship managers to named accounts.

On the topic of relationship managers, most community banks are used to assigning relationship managers to their commercial loan portfolios as these loans are usually large dollar amounts. However, successful small business banks that have large concentrations in SMB lending find ways to assign relationship managers to borrowers with loans of $100,000 and up while fully automating the process for loans less than $100,000. While maintaining a portfolio of at least $10 million in loans, these relationship managers are also responsible for sourcing at least $1 million in new loan activity each month.

Another key player for successful SMB banks is the vice president of business lending, who manages the relationship managers and reports to the chief lending officer. This individual is also responsible for pricing loans and understanding the competition. Since fintechs are the primary competition for community banks in this space, the VP of business lending needs to pay special attention to this segment. American Express’ Kabbage loan rates range from 18% to 120% annually on outstanding balances, and Lending Club charges a 5% origination fee, so there is plenty of room to make money.

Lastly, a high concentration SMB lenders also employ a solid business banking product manager to determine what products and services best fit the strategic niche the bank will pursue. Products and services for the target customer include checking, savings, loan types, business credit and debit cards, online loan applications, and digital banking features and entitlements for small business owners.

Process: Lowering Costs, Speeding Up Decisions, Complying with Regulations, and Sourcing Leads

For small business lending to make sense, community banks need to keep the cost of origination down compared to more time-intensive commercial lending. Likewise, small business owners are less likely to have all the documentation that larger commercial clients will have on hand such as business tax returns, income statements, and balance sheets. Regulations like the Community Reinvestment Act (CRA) are creating incentives for more banks to pursue small business lending. And many commercial bankers have told us that their best leads come from their board of directors—people who know people who lead large organizations. Sourcing leads of small business owners cannot be reliant on word of mouth and depends on more automation.

About 50% of U.S. community banks have automated their commercial loan origination systems. Even fewer banks have deployed automation for the SMB market. However, automation is a critical step in lowering costs associated with these smaller loans. Automation is an overused term and can mean everything from an electronic loan application to full origination workflow that passes the "paperwork" digitally to underwriting, processing, document preparation, and core system account boarding. For the purposes of this playbook, Cornerstone advocates that at a minimum, a focused SMB bank has automated workflow to eliminate keying data from one system to another, especially for document prep; decision engine technology that can rapidly determine credit risk; and lead generation technology that can assist a banker with sourcing loans.

Workflow automation was fairly similar across the successful SMB lenders we interviewed. What was different was the decisioning engine and lead generation capabilities of the various providers. Decisioning engines for SMB lending require fewer data points than the complex spreading tools involved in commercial lending. Many small business owners had only a few bank statements and a personal credit score for their bank to consider. Likewise, the speed at which a decision was rendered was critical for the successful lenders to compete with the fintechs that often had loans decisioned and funded in 24-48 hours.

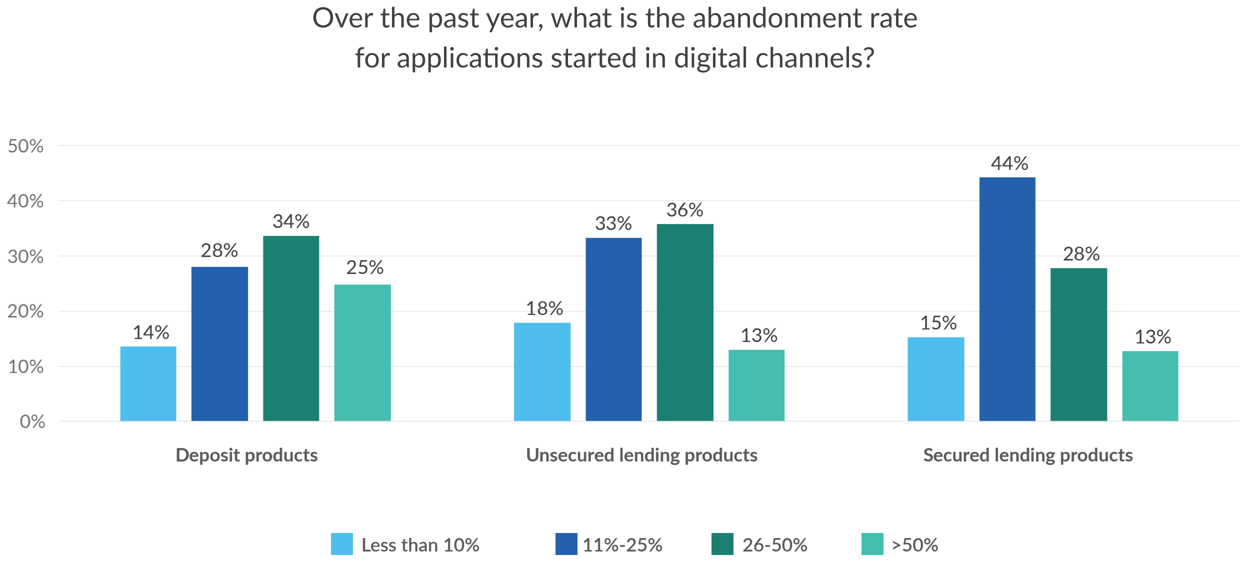
Many of the executives we interviewed shared that as their institution became more digital, they needed a way to comply with the CRA across a larger footprint than they were operating in with just their branch network. SMB lending helped them in their need to invest in Low-to-Moderate Income (LMI) census track communities by offering loans to the businesses within these geographic areas.

Finally, most of the successful small business lenders also required their relationship managers to source leads from within their communities by networking with local agencies. However, a few of the highly successful institutions used their decisioning technology to prequalify existing customers and create campaigns to win their business. Several of these banks had SMB lending approval rates hovering around 20% for non-prequalified applicants, so the prequalified lists yielded much higher lift with much lower effort.

Technology: Delivering Better Experiences

Speaking of qualification, online account abandonment remains a problem. Nearly half of the banks surveyed had abandonment greater than 25% for unsecured loans, and four in 10 had greater than 25% abandonment for secured loans (Figure 7).

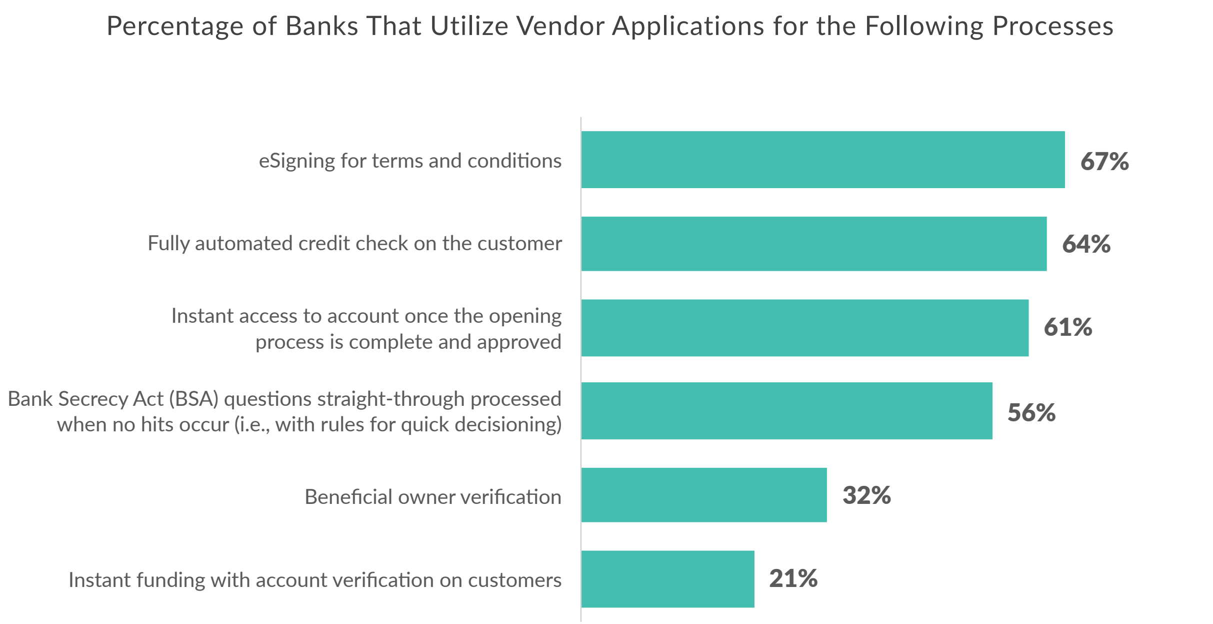
Figure 7: Digital Account Opening Abandonment Rates



Source: Cornerstone Advisors survey of 184 financial institutions, Q3 2020

What's the answer? In that same survey, Cornerstone discovered that abandonment went down significantly for providers that deployed e-signature, credit decisioning, digital account access, automated identity verification, know your customer (KYC) and fraud checks, and rapid funding. Despite these findings, another survey of bankers conducted by Cornerstone found that very few institutions had fully deployed these features (Figure 8).

Figure 8: Banks' Use of Third-Party Applications in the Lending Process



Source: Cornerstone Advisors survey of 75 financial institutions, Q4 2020

The challenge for community bankers is to match the experience of the challenger banks and fintechs that are utilizing technology to differentiate. The most successful SMB lenders had deployed the right technology to enable: 1) prequalification of SMB borrowers; 2) digital application experience; 3) digital identity verification, KYC, and beneficial ownership capabilities; 4) auto-decisioning by analyzing bank transactions and cash-flow calculations; 5) documentation creation and electronic signing; and 6) core account boarding.

One of the hardest components of successful SMB lending is identifying and targeting potential customers. A simple way to gain confidence and volume in SMB lending is to review existing small business owners that already have deposit relationships with the institution and prequalifying these account holders for loans under $250,000. This generates an instant book of leads for branches and business lenders to conduct follow-up.

Conclusion

While many community bank executives cite small business lending as a top priority, few have developed the strategy, people, process, and technology to successfully engage this market of over 32 million potential customers. Those that have are leveraging smarter prospecting and lead generation, loan application technology, loan decisioning engines, and document management to capitalize on nearly $72 billion in additional loans utilized by the small business segment in the United States. It's time for more bankers to recognize the opportunity and deploy the talent and tools that will empower them to take advantage of this market.

About the Author

As a senior director with Cornerstone Advisors, John Meyer leads the firm's Business Intelligence and Data Analytics practice. In this role, he helps community banks and credit unions better use the data they have to make smarter decisions with risks and opportunities.

Before joining Cornerstone, Meyer was chief strategy officer and chief product officer at Abrigo (formerly Banker's Toolbox). His experience includes developing product strategies for anti-money laundering and fraud detection for over 1,000 U.S. financial institutions and ALLL solutions for over 1,200 institutions. Before Abrigo, Meyer was with Harland Financial Solutions, where he held several senior positions including general manager over the branch automation and internet banking team. In this role, his group served over 2,500 community financial institutions with tellers, new account origination, internet banking, mobile banking, and CRM systems.

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About Cornerstone Advisors

After more than 20 years in this business, Cornerstone Advisors knows the financial services industry inside and out. We know that when banks and credit unions improve their strategies, technologies, and operations, improved financial performance naturally follows. We live by the philosophy that you can't improve what you don't measure. With laser-focused measurement, financial institutions can develop more meaningful business strategies, make smarter technology decisions, and strategically reengineer critical processes.

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About Lendio

Lendio is the nation's leading small business financial solutions provider. With its diverse network of lenders, Lendio enables small business owners to apply for multiple business financing options with a single application. The company has facilitated more than 330,000 small business loans for more than $12 billion in total funding, including $9.8 billion in PPP loan approvals as part of government COVID-19 relief. As the first financial services business to successfully incorporate artificial intelligence (AI) into small business lending with its AXIS tool, Lendio has become the fintech company to watch in the industry, helping reduce bias in lending and cut back on loan approval time exponentially. In addition to creating access to small business capital, Lendio offers time-saving financial SaaS products designed to streamline business operations. Lendio is a values-driven organization striving to provide equal access to capital to underserved communities and America's smallest businesses. For every new marketplace loan Lendio facilitates, Lendio Gives—an employee-contribution and employer-matching fund—provides a microloan to low-income entrepreneurs around the world. In addition, Lendio ranks on Fortune's Best Workplaces in Financial Services & Insurance and *Inc.'s* Best Workplaces three years in a row. More information about Lendio is available at www.lendio.com.

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