SMALL BUSINESS, BIG AMBITIONS

How Community Banks Can Embrace the Small Business Market

John Meyer

Senior Director, Cornerstone Advisors

November 2022

Table of Contents

ABOUT THIS REPORT

This report was commissioned by Amount to understand how financial institutions are prioritizing small-to-medium business lending, where they are investing resources in people and technology to target this segment, and what institutions can do to eliminate the friction involved with identity verification to decrease new account abandonment and increase funding.

The report draws on a survey of 260 financial institutions fielded by Cornerstone Advisors in Q3 2021 to understand their 2022 priorities. The report also draws on a Q4 2020 survey of senior executives at 75 mid-size banks and credit unions conducted by Cornerstone Advisors. The average asset size of responding institutions is $3.4 billion, with nearly half (47%) of the respondents in the $1 billion to $10 billion range.

In addition, Cornerstone Advisors surveyed 1,265 small business owners on their desires from their banking relationships. Cornerstone Advisors also conducted interviews with senior executives of 12 large (>$1 billion) institutions to gain a deeper perspective on the small-to-medium business lending challenges.

The Need to Diversify the Loan Portfolio

According to analysis of bank call report data, the average commercial loan portfolio for a community bank between $500 million in assets and $50 billion in assets is 55.2% of total loans. The second biggest loan concentration for these asset tier institutions is mortgages at nearly 20%. With rates increasing, the refi mortgage boom of the past several years has hit a brick wall and questions still surround just how much commercial real estate will be renewed as offices adjust to more remote employees.

For many institutions to remain competitive and profitable, they will need to diversify their loan portfolios. Commercial real estate (CRE) loans and commercial and industrial (C&I) loans will remain the largest profit drivers of community banking and will continue to be competitive. Yet for institutions looking for another source of lending, this means focusing their loan efforts on a segment that they have traditionally ignored: business banking.

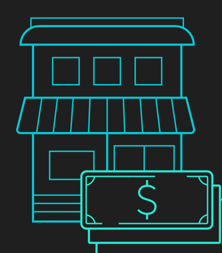
Many community banks and credit unions are getting the message. In Cornerstone Advisors' 2022 *What's Going On In Banking* survey, 56% of bankers cited small business loans as a high priority, virtually equal to the percentage listing C&I loans as a priority, and slightly higher than the number mentioning CRE loans.

COMMUNITY BANK LENDING PRIORITIES FOR 2022

Percentage of Banks Citing Loan Type as a High Priority

	2020	2021	2022
Commercial C&I Loans	70%	63%	57%
Small Business Loans	66%	60%	56%
Commercial Real Estate Loans	76%	45%	53%
Mortgage/Refi Loans	56%	47%	37%
Home Equity Loans/Lines of Credit	39%	9%	20%
Loan Participations	NA	5%	15%
Auto Loans	13%	6%	9%
Other Personal Loans	15%	5%	6%
POS/BNPL Loans	3%	1%	5%
Student Loans	1%	0%	1%

Source: Cornerstone Advisors surveys of U.S.-based community financial institution executives, 2019-2021



56%

of bankers cited **small business loans** as a high priority

Despite their stated priorities, a minority of community banks and credit unions with $500 million to $50 billion in assets have business loan concentrations greater than 20% for loans between $5,000 to $1,500,000—the typical range for the small to medium business (SMB) segment.

This vacuum in financing for the SMB market has allowed fintechs like American Express (Kabbage), PayPal, Blue Vine, OnDeck, Funding Circle, and Mercury to gain significant market share in small business lending. These providers can often enable a credit decision in less than a day, providing small business owners looking for loans with a rapid response to their loan requests.

> *With pressures on growth and net interest margin looming, it's time for community banks to reinvest in the people, process and technology necessary to make small to medium business lending a priority and a success.*

The Small Business Challenge

In large commercial lending opportunities —e.g., greater than $1,500,000— a bank's commercial relationship manager will work with a myriad of bank staff to ensure a smooth lending experience. Loan assistants and credit analysts work alongside the relationship manager to gather tax statements, income statements, balance sheets, insurance policies and other documentation to perform sophisticated risk-based underwriting and financial statement spreading.

Overall, these efforts are time-consuming and expensive, preventing banks from profitably scaling the process down to smaller loan sizes.

From a deposit perspective, the picture isn't any prettier. Although many banks don't know how much it costs them to open business deposit accounts, among those that do know, the cost ranges from $157 to $385, depending on the complexity of the small business.

COST TO OPEN A SMALL BUSINESS DEPOSIT ACCOUNT

	Description	Average Cost to Open Deposit Account
Low-complexity SMB	Startup sole proprietorship with less than $1 million in revenue, typical loan size less than $250,000	$157
Moderate-complexity SMB	Mature business with a partnership structure and revenue between $1 million and $25 million, typical loan size $250,000 to $750,000	$274
High-complexity SMB	LLCs or corporate entities with needs for services like letters of credit, sweeps, and Electronic Data Interchange (EDI) and $25 million to $100 million in revenue, typical loan size $750,000+.	$385

Source: Cornerstone Advisors surveys of 300 community-based financial institutions, Q4 2021

PERCENT OF SURVEY RESPONDENTS' CUSTOMERS

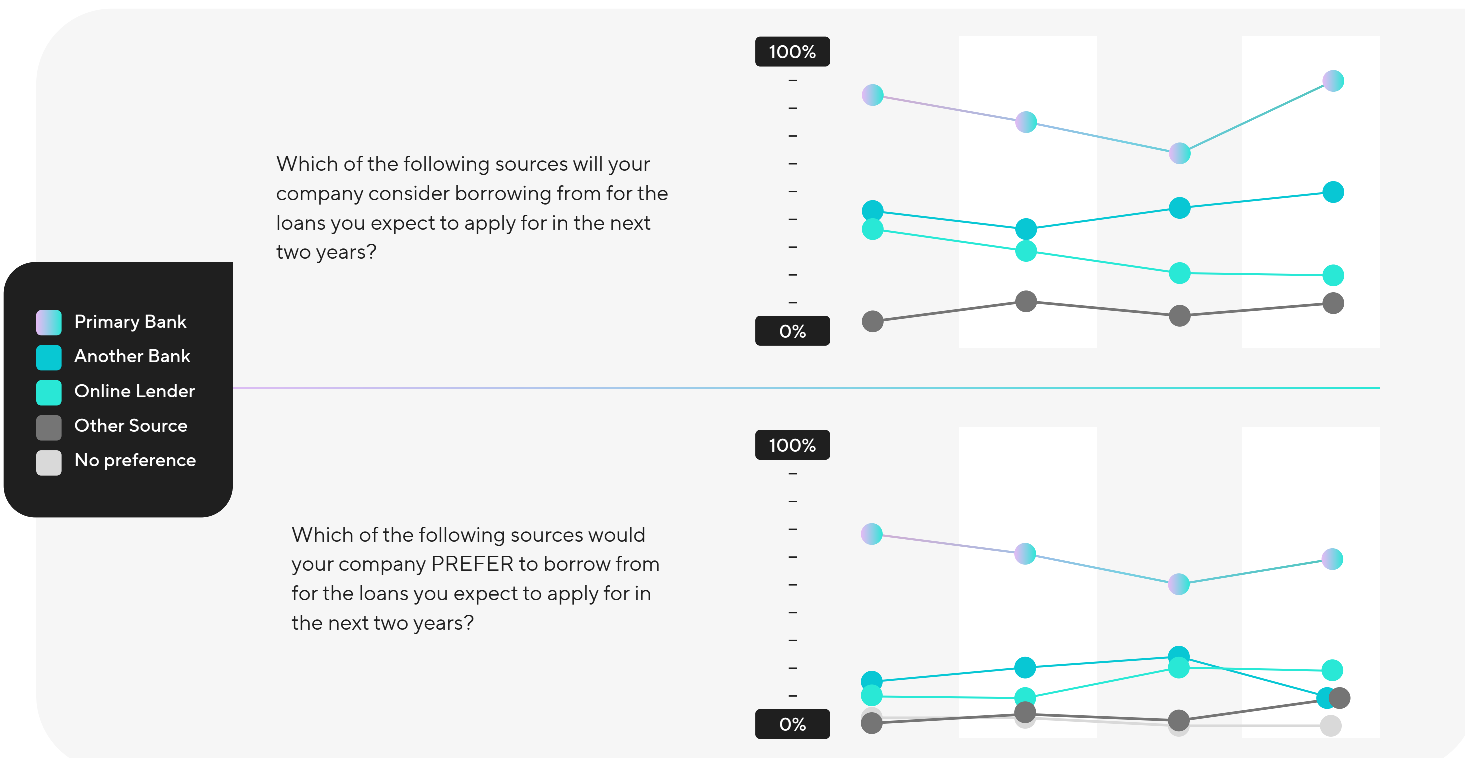
While deposit costs are hard to quantify, loan costs are even harder. None of the interviewees had estimates for how much it cost for them to originate a business loan. However, they were able to generate fee income from these loans to offset the costs. While SBA lenders cannot charge origination fees, they can charge reasonable packaging fees. The banks we interviewed typically charged packaging fees ranging from $2,000 to $5,000. For non-SBA business lending, most of the interviewed institutions charged between 3-6% for origination.

> *In a survey conducted by Cornerstone Advisors of 1,265 small business owners and executives in the pandemic, 69% preferred to get loans from their primary bank. 62% of these small business owners planned to borrow an average of $2,000,000 over the next two years. These numbers suggest a huge opportunity for community banks.*

LENDING PREFERENCES FROM SMBS

SME Interest in Obtaining Accounting and Payments Services from a Bank

	Definitely Yes	Maybe	No	Already Do
Intend to borrow in the next two years	62%	32%	21%	16%
Amount expected to borrow in the next two years ($ in millions)	$1,992	$1,088	$1,880	$2,598



Source: Cornerstone Advisors surveys of 1,265 small business owners and executives, Q1, 2020

SO WHAT?

With 32.5 million small businesses in the US today, banks have an opportunity to diversify their heavy concentrations in CRE and C&I lending. Nearly 70% of small business owners prefer to borrow from their primary financial institution. To become that primary institution, community banks need to invest in cost-effective deposit account strategies as well as small business loan opportunities.

Small Business Lending Best Practices

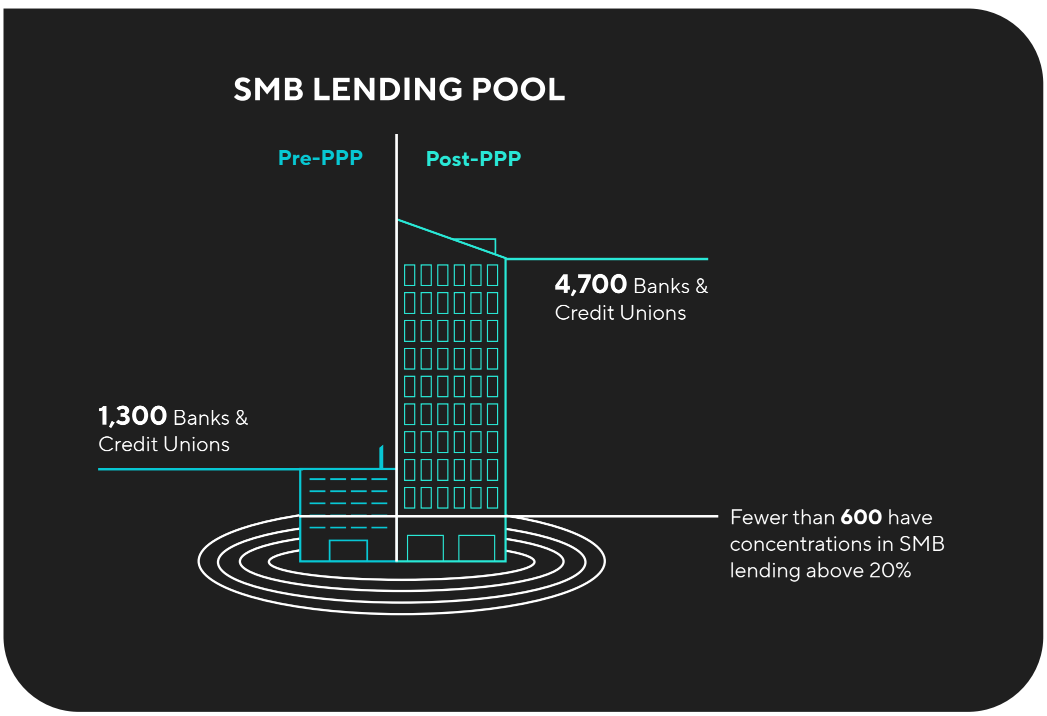
PPP OPENED THE DOOR, NOW WHAT?

While the Paycheck Protection Program (PPP) increased the Small Business Administration lender pool from 1,300 to more than 4,700 banks and credit unions, fewer than 600 institutions have concentrations in small business lending above 20%.

As PPP loans are forgiven, these businesses still need financing. One of the clients we surveyed saw an 86% lift in SBA loan applications post-pandemic just by being the go-to bank when these PPP loan customers could not get service from the larger banks during COVID.

So, if there is demand, how can an institution take advantage of the small to medium business opportunity?

Cornerstone Advisors sees four areas where banks and credit unions need to transform to take advantage of the SMB lending space: people, product, process and technology.



PEOPLE

For SMB banking to work, an institution must set up the human infrastructure to support this line of business. Many institutions have SBA teams already set up, but the organizational structure for business lending is different. Some institutions will defer these smaller loans to the retail banking team and this, too, is not enough. Business banking needs to be a stand-alone business with a leader, Director level or above, that focuses on expanding relationships with SMB owners. This leader directs a team of effective relationship managers.

Most institutions assign a relationship manager to greater than $1.5 million commercial loans, whether these are CRE or C&I. The same is true for small to medium business lending.

The Business Lending Product Manager of a $38 billion bank told us:

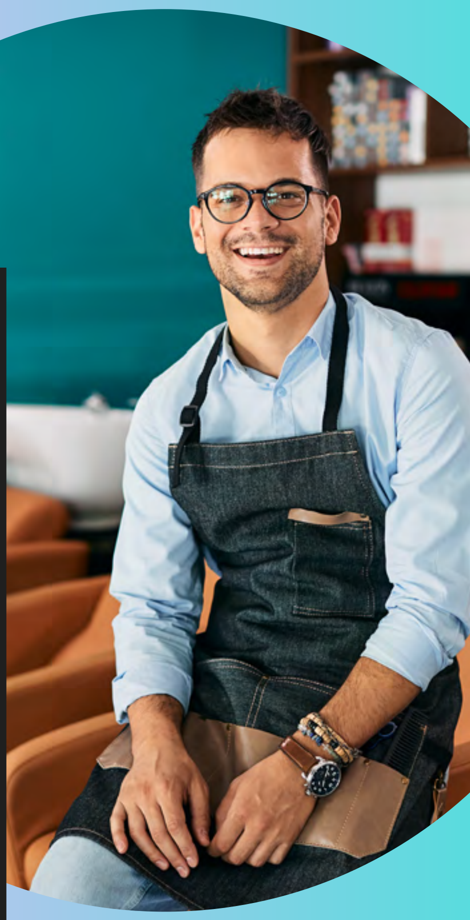
> "*We had to find a way to differentiate our bank in the business banking segment. In our area, Wells Fargo would not assign a $6 million/year business a relationship manager, but we did. We ultimately hired twenty-two relationship managers to handle all business loans under $1,000,000 and we really do not see any competition from the larger players in our market.*"

Lastly, the institution needs to assign a strong business lending product manager to optimize the products and services that appeal to the SMB market. This product manager should report to the Business Director and focus on lending, deposit, digital, and add-on products and services for the SMB market.

PRODUCT

Lending products and services that appeal to the SMB market include installment/term loans, SBA loans, business checking reserve accounts, online loan applications and credit cards. While most bankers tend to think that rates are the number one driver for loan opportunities, our interviews revealed that many of these SMB owners were not as rate conscious as commonly believed. For example, fintechs such as Kabbage have loan rates ranging from 18% to 120% annually on outstanding balances, while OnDeck's average loan yield is 32.6%.

Deposit products for the SMB market include small business checking, business checking with or without interest, business savings and business debit cards. Most of the banks interviewed indicated that they waive all domestic ATM fees for small businesses and they waive monthly account fees if the balance is greater than $5,000 each month.



An exec at a $9 billion bank shared:

> *"In our area, US Bank and Zions have the best rates. We can't compete on rate, but we can compete on speed. Small business owners—particularly those with serious cash flow needs—prefer to pay a higher rate if they can get their loans approved and funded sooner."*

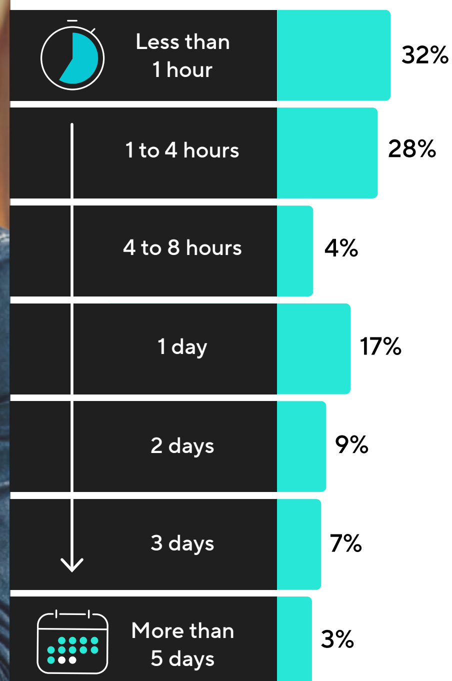
Another Business Banking leader said:

> *"Don't underestimate the power of a good loan application online that feeds into an automatic decision engine. We receive over 600 applications a year and have a 19% approval rate. That's 120 loans we never would have seen had we not put the right tools on our website."*

In a study conducted by Cornerstone Advisors during the pandemic, one of the biggest issues in the deposit account opening process for the SMB space is the amount of time it takes for a customer to be able to use the account. In that study, 88% of the SMB deposit accounts were opened in the branch and only 32% were ready to be used within an hour.

ELAPSED TIME TO OPEN SMB DEPOSIT ACCOUNT

Elapsed time from when a deposit account application is started to when the account is ready to be used



Source: Cornerstone Advisors survey of 75 community-based financial institution executives, Q4 2020

Digital products include mobile banking, business online banking, remote deposit capture (RDC) and QuickBooks via WebConnect or DirectConnect. Many of the interviewees indicated that they might assign a Treasury Management team member to work with the small business owner to drive adoption of services such as cash management, fraud management, including Positive Pay for ACH and checks, ACH origination and wire origination.

However, we found that the SMB market does not adopt full treasury management tools. In one case, we saw only a 3% adoption of treasury management by SMB loan account holders. In another, we saw that only eight customers out of the over 1,300 SMB account holders were using commercial RDC—the rest were using the consumer RDC product. When we asked the interviewees why adoption of treasury management was so low, they judged that treasury management account fees far outweighed the benefits for most SMB customers.

> *There are many add-on products for the small business market that can drive revenue, including accounting services, business payments services, health savings accounts and business insurance services. Together, these services make up a $370 billion revenue opportunity.*

PROCESS

Smaller dollar lending requires efficiencies over the traditional commercial lending cycle at most institutions. The primary driver for efficiency is underwriting, where many people and process steps consume cycle time and resources. The key to driving efficiency—automating the decision process and changing the data requirements for small business lending. According to one business banking executive:

> *A lot of our small businesses did not have the two tax returns, two personal tax returns, many of the income statements, etc., that we typically require for a commercial loan. Our bank only requires three bank statements for us to make a decision with our automated system."*

Another indicated:

> *For loans under $250,000, we have the businesses apply directly, and then our small business banking software vendor does the automated decisioning. Most rejections are based on credit score being too low, active collections or bankruptcy history."*

Credit score remained a large factor in decisioning whether a loan applicant qualified. In the interviews we conducted, most institutions used a credit score between 670-700 as the cutoff for whether a borrower qualified for a loan.

Most institutions used a **credit score between 670-700** as the cutoff for whether a borrower qualified for a loan.

But auto-decisioning based on credit scores and bank statements were not the only process changes that successful small business lenders made. According to Glenn Grossman, a Cornerstone Advisors Director with more than 30 years of leadership experience in data analytics, product management and product development in the banking and technology industries, the key to successful small business lending requires:

> *"First, get rid of the swivel chair, where someone takes the loan application data and rekeys it into a loan origination system and automates that process. Next, add workflow engines into the small business lending cycle so all of the key people at the institution have on-demand triggers to speed the process. Good institutions have 50% of their loans auto-decisioned and approved in a matter of minutes with the paperwork following within just hours for funding."*

Another significant process change for smart small business lenders is in lead generation. As one of our business bankers shared:

> *"Sourcing leads is every small business lender's responsibility. At our institution, everyone has to have at least five centers of influence that can drive opportunities. Centers of influence include accountants, nonprofits that work with hiring, and others that serve a lot of businesses."*

Another indicated:

> *"We automate the loan process every month based on cash-flow and other sources in our core systems to create a list of cross sale opportunities. This gives us a pre-qualified list of leads to follow-up of our own customers whom we can serve better."*

Some institutions shared that one of the biggest obstacles for SMB lending approval is medical collections. Several institutions are piloting programs that eliminate these types of events for women and minority-owned businesses to aid in the Community Reinvestment Act (CRA) lending goals.

Speaking of CRA, many interviewees indicated that small business lending in their communities aided them in meeting their low-to-moderate (LMI) census track or <$1,000,000 in revenue clients for CRA compliance.

Lastly, loan draw management practices were key in SMB lending. To aid in draw management, many of our institutions focused on segmenting their customers by North American Classification System (NAICS) code. As one institution shared:

> "*We target small businesses right before inventory needs for small retail stores. For example, we ask these stores if they have the inventory for Christmas sales in September. We use NAICS for contractors as well, targeting them just in time or their starts in construction. Other industries where targeting helps are manufacturing, healthcare, auto repair, etc."*

TECHNOLOGY

As discussed, one of the key technology components to expanding into SMB lending includes auto-decision engines. Several stand-alone decision engines exist for financial institutions to enable faster loan approval.

However, decision engines were not the only technology that many of our institutions changed to meet the needs of the SMB market. We are seeing more and more institutions invest in small business lending systems that automate the decision as well and embed workflow for the key institution experts to help the SMB market get funding faster. For these institutions, the solutions that enable SMB loan application through approval to funding assist them in capitalizing on this emerging market. As one institution shared:

> "*We participated in a study with like-sized banks for SMB lending. By deploying a full SMB lending suite, our lifecycle time for funding went to nine days vs. 31 days for the rest of institutions in the study."*

SO WHAT?

Community financial institutions have to redefine the people, product, process and technology of small to medium business lending to ensure they can remain competitive with the large banks and fintechs attempting to serve this market. Investment in these four areas ensures that an institution can drive opportunities, speed the decisioning process, and accelerate the funding process—all key drivers to ensuring successful SMB lending.

Looking Ahead

Community financial institutions are facing potentially strong headwinds with their CRE concentrations as office space renewals look to shrink in the next five years. Likewise, the current rate environment is pressuring mortgage refinancings and pushing banks to pursue a very competitive purchase mortgage market. For many of these institutions, alternative sources for lending involve the 32 million strong SMB marketplace.

However, if banks and credit unions want to be successful in winning the SMB marketplace from the larger banks and fintechs serving this space, they will have to adjust the people, product, process and technology that they deploy to attack the SMB customer needs. Significant changes in relationship management, SMB-friendly products, lead generation and technology investment for automated and streamlined decisioning and workflow will be required for these institutions to grow and thrive within the SMB landscape.

About the Author

John Meyer joined Cornerstone as Senior Director, BI/Data Analytics Practice Leader. John Meyer was the Chief Product Officer and Chief Strategy Officer for Abrigo (formerly Banker's Toolbox) where he managed the product management and development teams responsible for building a commercial lending solution and anti-money laundering system used by over 2,300 community institutions. Prior to that role, John was the general manager for a team that developed and supported teller, new account origination, internet banking and mobile banking for over 2,500 US institutions.

ABOUT CORNERSTONE ADVISORS

Cornerstone's multidisciplinary team is backed by the experience that comes from hundreds of thousands of in-the-trenches client hours. We live by the philosophy that you can't improve what you don't measure. With laser-focus measurement, financial institutions can develop more meaningful business strategies, make smarter technology decisions, and strategically re-engineer processes.

Cornerstone Advisors takes financial institutions from strategy to execution through an array of Solutions offerings, including Strategy, Performance, Technology, Mergers & Acquisitions, Payments, Risk Management, System Selection & Implementation, and Delivery Channels.

Cornerstone publishes GonzoBanker, our blog; an annual What's Going On In Banking study; and a variety of research reports and white papers. Cornerstone hosts Executive Roundtables for bank and credit union CEOs, CFOs, CIOs, CLOs, and HR, Marketing, Risk, Retail and Payments executives.

ABOUT AMOUNT

Amount helps financial institutions make banking simpler, safer and more convenient with a full suite of end-to-end omnichannel consumer, small business and BNPL solutions. Developed by lending industry experts, Amount's fully integrated and flexible platform is underpinned by enterprise bank-grade infrastructure and compliance, enabling banks to securely power new and differentiated offerings within months — not years. With Amount, banks can optimize performance across product categories while tapping into various service offerings including customer acquisition, funnel and performance assessments, and risk analytics. Amount clients include financial institutions collectively managing just over $3.1T in US assets and servicing more than 50 million U.S. customers.

AMOUNT

Deliver the digital offerings small business customers desire.

www.amount.com
sales@amount.com

Have questions regarding this report?

Contact:

John Meyer

Senior Director
Cornerstone Advisors
jmeyer@crnrstone.com
407.790.9015

Cornerstone ADVISORS