Whitepaper

Digital Drives Segmented Small Business Lending Strategy for Community Banks

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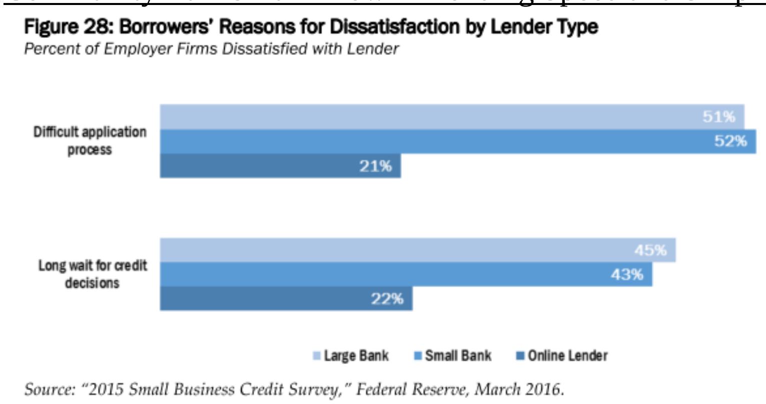
"Full digital technology allows delivery of loans under $100,000 to small business in three minutes for less than $200 per loan."

Small business lending and banking is the bedrock of competitive strength for community and regional financial institutions, as documented in industry studies. Community and regional institutions, typically defined as those under $10B, have 21% of deposits and 18% of assets in the industry according to FDIC data. But the FDIC also shows community institutions hold a whopping ***50%*** of small business loans, defined as business loans under $1 million.

However, this competitive strength is challenged by rapidly growing digital lending that has captured 20% of the market volume already. The technology advancements of large institutions as well as new non-bank lenders are adding **speed** and **simplicity** to small business relationships, eroding the community institution's historical customer relationship strengths. 2016 industry studies state that technology deployed by large institutions or non-banks is one of the major risks to community institution competitive strengths. The small business lending study by Harvard Business School documents that while community institutions are generally preferred as a lender, they receive very poor ratings compared to non-bank lenders in application simplicity and speed of response, opening a window to competitors.

Community Banks Rank Low in Lending Speed and Simplicity



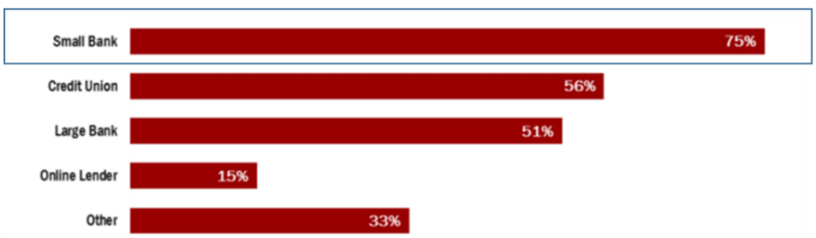
"The State of Small Business Lending," Working Paper 17-042, Harvard Business School, 2016.

Community institutions have many competitive advantages over large banks and non-banks in serving small businesses, including funding costs as low as one-fifth of the cost of non-banks. Further, they have strong customer relationships, customer trust and established, if expensive, regulatory compliance and regularly ~~They~~ outperform large institutions in trust and relationship skills. Community institutions are well positioned to continue their competitive dominance in small business lending *if they embrace and incorporate the technological advances available today*.

"Small business loans under $100k are over half of all loans, but unprofitable for community banks today."

Community Banks Rank High in Overall Lending Satisfaction

Figure 15: Borrower Satisfaction by Institution Type
Lender Satisfaction Score (Percent Satisfied Minus Percent Dissatisfied)



Source: "2015 Small Business Credit Survey," Federal Reserve, March 2016.

"The State of Small Business Lending," Working Paper 17-042, Harvard Business School, 2016.

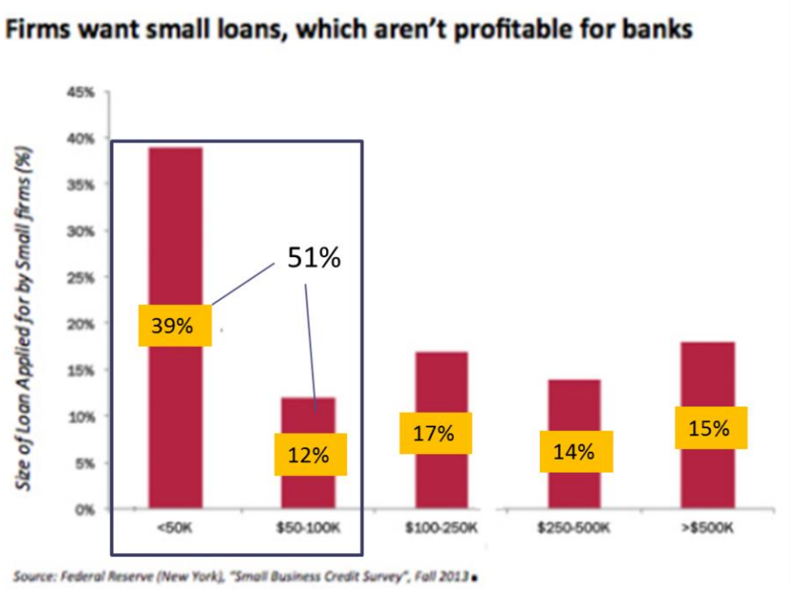
Further, despite community institution strength in small business loans, they are extremely weak in the segment of small business loans under $100,000, holding less than 15% of the market segment according to FDIC data. In fact, community institutions held more dollars in loans under $100,000 to businesses in 2005 than they do today. This is particularly significant since two-thirds of all businesses are non-employer business wanting smaller credit, as reflected in sole proprietors being the majority of bank business checking relationships.

While business loans under $100,000 represent over half of all small business loans and average $20,000, bank costs are over $1,000 to underwrite and deliver such loans, and over $1,000 to maintain annually. Costs averaging 5% of the loan value make these loans unprofitable.

Of course, community institutions want lending officers to focus on profitable volume, and often define small business as business loans under $1 million, or maybe as low as under $250,000. As the chart above illustrates, the segmentation may make sense from a perspective of profitability of a loan, but the largest part of the market is clearly loans under $100,000, with small segment opportunities between $100,000 and $1,000,000.

"Digital technology can fully automate small business loans under $100,000."

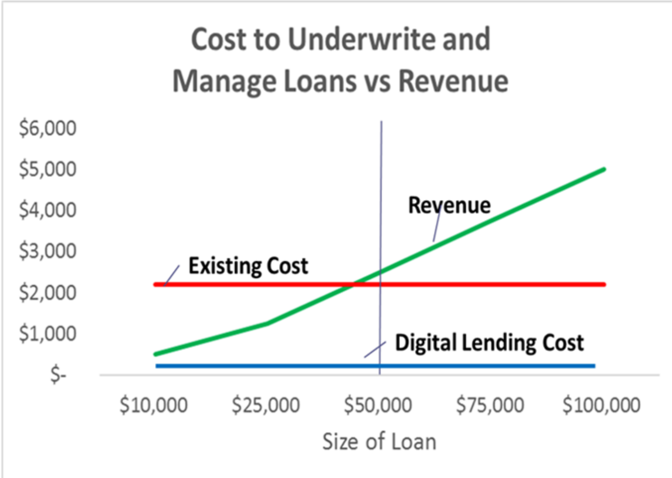
Most Small Business Loans Are Under $100,0000



"The State of Small Business Lending," Working Paper 17-042, Harvard Business School, 2016.

For a $250,000 loan, for example, both the borrower and the lender have needs for more extensive evaluation of one another, and the time and effort are profitable of a loan of such size even with historical underwriting processes. For the large segment of loans under $100,000, partial digital lending automation does not generate a profitable loan. Community institutions in the last 20 years have referred this segment to credit card lending, which is dominated by a handful of financial institutions, and other alternatives.

Loans Under $50,000 Not Profitable



Digital technology, particularly among non-banks, has focused first on this lending gap left by community institutions and others. Competitors ranging from Kabbage to PayPal target the small business marketplace for loans under $100,000. Digital technologies, including online and mobile application processes, automated data management and underwriting, and e-sign can automate in a single cell the assembly line process of small business lending up to $1 million.

"Many lending platforms are only partially digital."

The Technology Opportunity

Community institutions have well-developed lending processes that historically proceed on an assembly line, beginning with a relationship with the customer or prospect. This has served the industry well as two-thirds of the variation in ROA among community institutions can be explained by one number: loan losses. The importance of relationship knowledge and careful underwriting processes have served the industry well in assuring loan losses are small.

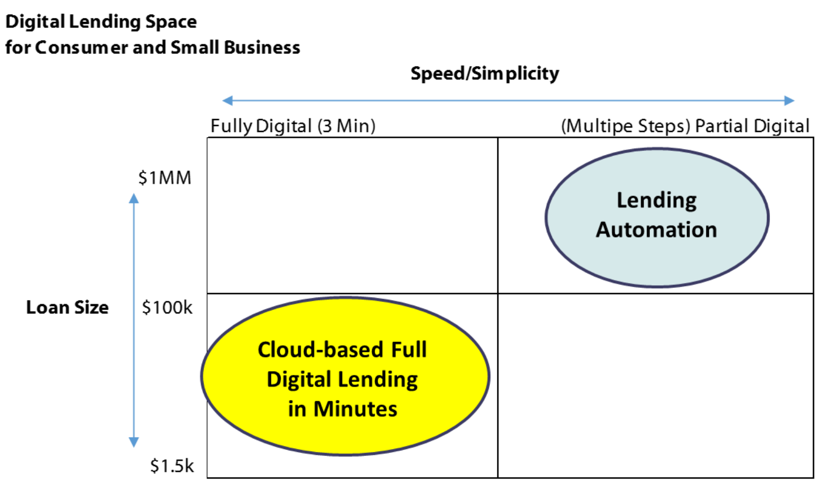
Existing loan platforms such as those available from D+H LaserPro, Wolters Kluwer, CRIF, Baker Hill, core providers and others enhance this process with online and mobile applications, automated decision and underwriting tools, document preparation and e-sign. Many institutions are reviewing their small business lending processes to leverage automation tools and new mobile technology. The chart below illustrates this process with lending automation that is not fully digital.

Assembly Line Lending Automation Not Fully Digital

"Digital functionality can be segmented by need for speed and simplicity."

Competitive technologies in the marketplace today can be segmented by their *digital functionality* for speed and simplicity, the key service factor gap for community institutions. Fully cloud-based digital technology allows delivering loans in three minutes online and smart device for loans under $100,000 because of the differences in loan needs for speed and simplicity by segment.

Digital Lending Segmentation by Speed and Simplicity



Digital technology allows new efficiency in speed and simplicity that can put community institutions back into this market particularly with their checking customer relationships. The Harvard Business School study points out, "Banks could have formidable advantages if they better tap the DDA data available to them." Under available technology, a small business loan under $100,000 can be completely done in minutes, with underwriting using credit reports and cash flow documentation from areas such as the institution deposit volume of the business. Losses are documented as higher approaching credit card levels, but with risk-adjusted pricing and the highly efficient digital processes available delivering and maintaining loans for less than $200, the business strategy is highly profitable and sound. The charge below illustrates the segmented technology strategies.

"Banks could have formidable advantages if they better tap the DDA data available to them."

Historically, we have embraced as community financial institutions the efficiency of a single loan platform with focus on a single technology on our servers, focused training for our team members and a single source for data management. However, digital cloud-based technology is a sea change in economics, as documented by McKinsey. With this digital technology, nothing is installed on your servers, self-service by customers allow branch team members to only have to know "it looks like you click here next," and all data and documents are e-sign in minutes and still reside on your core.

Digital technology changes the nature of products it delivers by breaking it into more options and delivery choices. With music and video, digital technology allows me not just to rely on picking up a CD or DVD at or store, but also search very precisely a specific song or movie, and download it in minutes online, or stream it in seconds. Similar, for some businesses loans, I can search my specific needs with the long tail of the internet, find what I want and close in minutes. Over 80% of music is now bought and enjoyed digitally in minutes, and financial institutions should plan to provide small business loans under $100,000 in minutes with digital technology in the future.