Financial Services

FINANCING SMALL BUSINESSES

HOW "NEW-FORM LENDING" WILL RESHAPE BANKS' SMALL BUSINESS STRATEGIES

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A new approach to small business lending is emerging in US banking. We refer to this new approach as "new-form lending". It is based on a simple but powerful insight: the data in a small business's checking account can be a strong real-time indicator of that business's creditworthiness.

We believe that this new approach will rapidly be adopted by all major US banks and become the basis for satisfying what has mostly been an unmet need for short-term cashflow financing for small businesses. Industry-wide, this could be a $2 BN profit opportunity for lenders.

New-form lending will also help improve banks' traditional loan underwriting processes by lowering unit costs and improving risk differentiation.

Finally, new-form lending, by improving the whole approach to SB lending, will strengthen banks' overall value proposition, allowing them to win and retain the most attractive small business relationships.

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WHAT RESEARCH TELLS US ABOUT SB BORROWING NEEDS

Oliver Wyman research reveals many interesting characteristics of small businesses and their owners[1]. One particularly important finding relates to small business funding: while many say they have SB credit cards, car loans or first mortgages, only 15% report having an "operating loan" or "an equipment loan or lease". That is: small businesses don't actually have many "small business loans".

Our research also reveals something else that's curious: although only ~15% of SBs have a "small business loan", 70-80% of business owners say that "access to credit" is an important consideration to them when selecting a bank. The majority of these owners seem not to want a traditional credit line or term loan. Rather, they describe the need for a line of credit that would be available to act as a reserve and buffer against occasional short-term cashflow gaps. We have asked respondents to say roughly how large such a line would need to be. In most cases, their answers translate into an amount equal to between half and one month's revenues. For example, businesses with annual revenues of around $500,000 tended to ask for credit lines of between $20,000 and $40,000.

This is consistent with other Oliver Wyman research findings that show how a small business's average DDA balance is a reflection of the cashflow and cashflow volatility that the business experiences. If two businesses have the same monthly average cashflow but one experiences more volatility, the second one will maintain a higher average DDA balance as protection against coming up short when needing, for example, to meet payroll. Dealing with cashflow volatility is a perpetual worry for small business owners and in the absence of a standby line of credit, they currently resort to various tricks and evasions when faced with a payroll to meet or a large bill to pay, and a downtick in receipts. Banks have been missing the opportunity to meet this need for cashflow volatility protection.

The research suggests that most business owners feel a need for a cashflow protection product driven by the inherent volatility of their businesses' cashflows.

TRADITIONAL SB LENDING DOESN'T SERVE THIS NEED WELL

The traditional small business lending model used by banks does not meet this particular need very well. We have known for some years now that banks' small business loan portfolios are not particularly profitable. The banking industry's use of economic capital and risk-based measures of return led to the realization that small business loan portfolios typically show positive accounting profits but negative economic profits "through the cycle". Further analysis revealed the root cause of the profitability problem: the factors that drive SB loan economics are unit cost, cost of funds, loan losses, economic capital, and loan

1 In 2011 Oliver Wyman surveyed ~5,000 SBs including their profitability to banks; SBs were defined as "in business at least a year" and "have fewer than 100 employees"; please contact us to obtain a summary.

pricing (gross yield). Among these, unit cost is undoubtedly the main culprit. High capital and inadequate loan pricing also contribute.

Faced with these economics, banks have experimented over the last 10 or more years with approaches to small business lending that are more "consumer-like". These semi-automated methods, using credit scores on the business or its owner – or both – as key inputs, promised to reduce those troublesome unit costs but largely did not. Why? Partly because banks deployed automated underwriting only for the easy cases (very good and very bad applicants) and kept the traditional process in place for applicants in the so-called "grey area". In the end, relatively few loan applications ended up being decided only via the "automated" path; and so unit costs didn't shrink as much as planned. Even the use of credit scores proved troublesome, in part because the available data on small businesses are simply not as robust and predictive as in the consumer sphere.

In fact, data quality has been a perennial problem for banks when it comes to small businesses. The traditional underwriting process for small business loans frequently calls for the business owner to provide the bank with at least two years of audited or unaudited financial statements, and/or 2-3 years of tax returns. Either way, these data are essentially out of date by the time the bank reviews them – and may not have been that accurate to begin with.

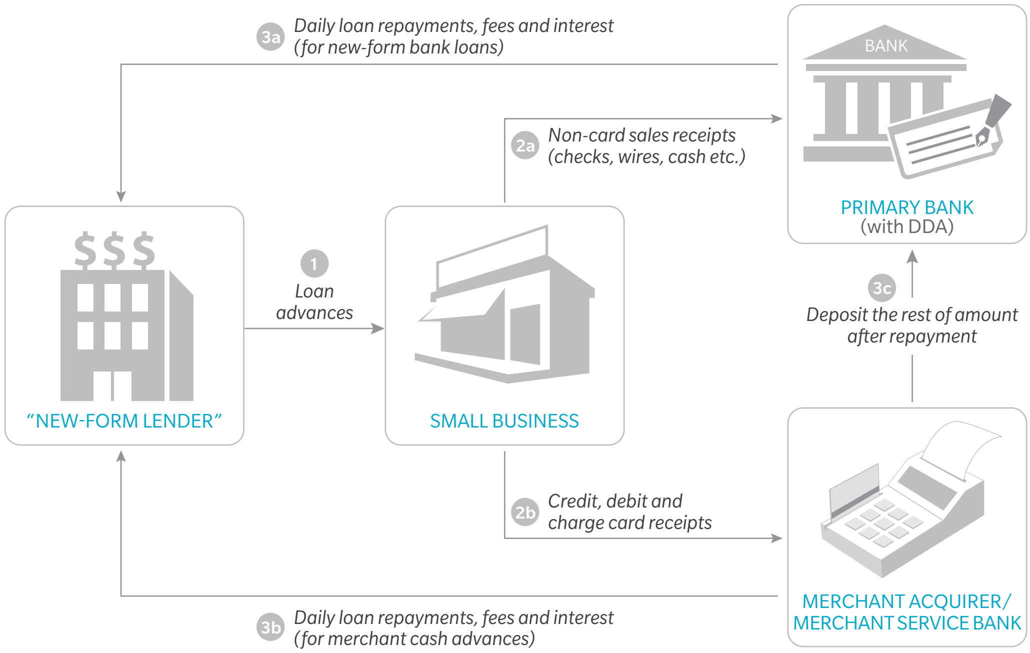
NEW-FORM LENDING TO THE RESCUE?

We see a new approach to small business lending emerging in US banking that we refer to as "new-form lending". It is based on the simple but powerful insight that the data describing a business's cashflows can be a strong real-time indicator of that business's creditworthiness. One source of data on a small business's cashflows can be its merchant services account (if the business accepts credit cards for payment). Another source is the business's primary checking account (whether the business is, or is not, a merchant).

We believe this new approach will rapidly be adopted by all major US banks and become the basis for meeting the hitherto unmet need for short-term cashflow financing described briefly above. It will also provide a key underwriting input to banks' *traditional* loan underwriting processes and thereby help to lower unit cost and improve risk differentiation (and hence pricing).

The idea of examining a small business's near-real-time cashflows to derive risk insights seems to have originated in the world of merchant receivables financing. Starting 10-15 years ago, firms like Capital Access Network and AmeriMerchant emerged to advance funds to card-accepting merchants based on an analysis of the patterns in their monthly charge volumes. Extending that logic, firms like On Deck Capital now use a combination of merchant-account and/or DDA cashflow patterns to assess a business's creditworthiness. The wider view is rapidly becoming the standard template for "new-form lending" and makes this approach work for both merchants and non-merchants.

THE RELATIONSHIP BETWEEN BANK, SMALL BUSINESS, MERCHANT ACQUIRER AND INDEPENDENT NEW-FORM LENDER



As the merchant receivables financing market evolved, lenders needed new analytical methods to automate the interpretation of recent cashflow patterns and make predictions about future receipts. In recent years, lenders have expanded their models to incorporate DDA cashflow patterns in addition to – or instead of – the merchant account in order to assess a business's creditworthiness. This wider view takes a more complete cashflow picture than merchant receipts alone and more-than-doubles the total market by making financing available for both merchants and non-merchants.

The central premise underpinning this approach is that direct observation of real, recent cashflows provides a reliable guide to predict future cash flows – at least in near term – and, by extension, to determine the ability of a firm to take on credit.

A second innovation of new-form lending is the use of a daily remittance cycle to administer the loans. A key early feature of this type of financing was the idea that advances would be repaid directly from the merchant services account. This led to the deployment of daily remittance platforms that could connect directly to a merchant services account (or, later, to a DDA account), and process small loan principal and interest payments on a daily, as opposed to the more traditional monthly, basis.

In a daily remittance cycle, the borrower accepts a commitment to repay interest and a slice of principal in small increments each day over the term of the loan, rather than the standard monthly remittance cycle of almost all other bank lending. The daily remittance cycle offers two benefits. First, by monitoring the advances and payments on a daily cycle, the lender is more on top of things and in a better position to respond to late payments – as well as to adjust and potentially increase or decrease the loan or line size. This makes intuitive sense: if a lender is reviewing monthly, weekly and daily cashflows as a basis from which to infer creditworthiness, i.e. to *underwrite* a loan, then he would also *administer* the loan on a daily remittance cycle.

Second, compared with monthly remittance, the use of a daily remittance model helps smooth the cash flow impact of the new loan for the SB; after all, monthly remittance introduces yet another source of cashflow "lumpiness" – and cashflow volatility was the issue the business owner needed the loan to address in the first place.

Recognizing the market opportunity, over the last year, several other lenders have taken innovative steps in this new financing arena. Amex launched American Express Merchant Financing, a commercial lending option for medium-to-large merchants who accept Amex cards that, in effect, provides receivables financing. Amazon also introduced a financing option for merchants who sell over its web platform; and Amazon has excellent risk analytics that it can deploy against these merchants, observing first-hand the ebb and flow of purchase volume and merchant conduct.

Despite the origins of new-form lending as a merchant financing device, and despite recent innovations that extend the device within the merchant space, we believe that banks, with their extensive small business deposit bases, have a significant information and relationship advantage in this interesting new arena. Whereas Amex, Amazon and other merchant receivables financing firms see only the component of cash flow which flows over their platform, the primary checking bank sees essentially all sales receipts as well as all outgoing payments. Banks, in other words, have a more complete perspective and are not limited to the merchant segment (a little less than half of all SBs accept cards). They also already "own" all of the primary DDA relationships with SBs.

GETTING STARTED WITH NEW-FORM LENDING

How can banks interpret their SB customers' daily cashflow data to assess credit-worthiness? Our recent client experience suggests that various metrics derived from 4-6 months of checking account and payments activity prove to be a reliable guide to a firm's ability to handle a given loan amount. What kind of metrics? Things like: daily average balance, balance volatility, cashflow volume (in relation to average balance), cashflow "lumpiness", mean and variance of daily receipts, mean and variance of daily outgoing payments, the "decay rate" of balance after a large deposit, and customer mix/revenue concentration. Of course, while these metrics may apply to some degree in any SB sector, their significance varies according to the specific industry in which the firm operates; the metrics that matter most are different for a restaurant than for a manufacturer.

As with other types of lending, the ability to generate the most accurate and reliable models is partly a function of expertise but also a function of data. Only after accumulating some "bad" outcomes can one develop significantly better predictive models. This is a factor that gives a temporary competitive advantage to the larger, more experienced players in new-form lending.

New-form lending can be a profitable new financing product that banks can offer their SB customers and drive significant improvements in banks' traditional lending processes and associated economics. It can:

PROVIDE BUSINESS OWNERS WITH ACCESS TO A NEW KIND OF SHORT-TERM CREDIT THEY SAY THEY WANT

New-form lending can allow the bank that provides a business with its primary DDA to pre-approve it for a standby line of credit suitable for covering episodic and short-term cashflow balancing. The amount of such a line or loan could be dynamically adjusted to growth or other changes in the business's financial status, as continuously revealed through the "pulse" of its DDA cash balances and cashflows. The cost of marketing, underwriting and administering this new product category can be a very small fraction of the current costs of a traditional line of credit.

Despite the much lower unit costs, banks will need to design this product carefully as it will, by its nature, generate limited volumes of revolving balances and spreads. For example, if a business with revenues of $500,000 and a line size of $20,000 took advantage of it every single month for an average of two weeks, then it would generate the equivalent of a standing $10,000 loan. In practice, some businesses might take advantage of the line even less than this.

A key part of the product design, therefore, is to get the fee and rate structures right, with a line commitment fee, as well as possible draw-down fees, in addition to any interest on outstanding balances. Of course, if possible, the design also needs to avoid a countervailing sense of "nickel-and-diming" the customer.

We estimate the US market for this type of standby line-of-credit very roughly as follows:

Potential number of standby lines	~8 MM
Potential "equivalent" revolving balances	$80-120 BN
Potential additional after-tax profit	$1.5-2.5 BN[2]

IMPROVE THE ECONOMICS OF TRADITIONAL LENDING

The two central principles of new-form lending – the use of near-real-time, accurate cashflow data, and daily remittance – can also be used to improve traditional lending procedures. All three of the key cost components flagged earlier as problem areas for traditional lending can be improved by adopting (and adapting) these principles in the way traditional lines & loans are handled.

The *marketing cost* of attracting qualified loan applicants will be significantly reduced through the likely mechanism whereby many small business customers will be pre-approved for a "new-form loan" and later "upgraded" when they qualify for a more traditional line that does not need to be "cleaned up" on a monthly basis. And from there, successful, growing businesses may further qualify for multi-year term loans.

2 This represents an increase in total bank profits from small businesses of approximately 15-25%.

The *cost of underwriting and approval* for traditional lines and loans, even when the target SB has not been a bank customer before, should be significantly reduced. Using recent merchant account and/or DDA data, a bank can generate a more accurate assessment of creditworthiness than it could the old-fashioned way, and get to this point much quicker and more cheaply. Of course, the underwriting process will likely use additional inputs besides the new-form lending emphasis on recent DDA cashflow patterns. But for smaller lines or loans, an adequate assessment of risk can be made at low cost, through a combination of new-form principles and selected use of traditional credit scores and tax returns.

The *cost of loan administration* can also be reduced by placing traditional lines on a daily remittance basis and adopting new-form lending's more systemic approach to portfolio monitoring and early warning delinquency triggers.

WHERE DO I GET A DAILY REMITTANCE PLATFORM?

Getting started in new-form lending has some practical challenges for banks. One of the biggest is that banks do not have daily remittance loan systems, with relatively few options for obtaining one. One option would be to create such a system from scratch, but we see few banks with the appetite for this. Instead, our bank clients have opted to negotiate an arrangement with one of the handful of firms that does have a viable daily remittance platform. This allows them to get started on the other challenges. These arrangements have typically also allowed for a way to share SB applicants between the bank and the platform provider; since these firms are also lenders, the banks often approve and book loans to the higher credit quality applicants while their turndowns are re-underwritten by the independent firm.

THE BROADER IMPACT OF NEW-FORM LENDING

We have already outlined two important ways in which new-form lending will improve bank lending to small businesses. But more lending options with better economics could turn out to be only part of the overall impact of new-form lending.

Recent Oliver Wyman research determined that the majority of Small Business Banking profit currently derives from high-balance checking accounts, merchant services accounts and credit cards[3]. The growth of new-form lending will certainly add to that profit pool. The biggest positive impact of new-form lending for an individual bank, however, may not be the profit that it adds directly, but the role it can play in crafting a winning value proposition that is used to "win over" high-value prospects in the sales process and protect existing high-value customer relationships against competitive inroads.

3 See the Oliver Wyman "Point of View" titled "*A Profit Growth Strategy for Small Business Banking*".

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