

SMALL BUSINESS BANKING

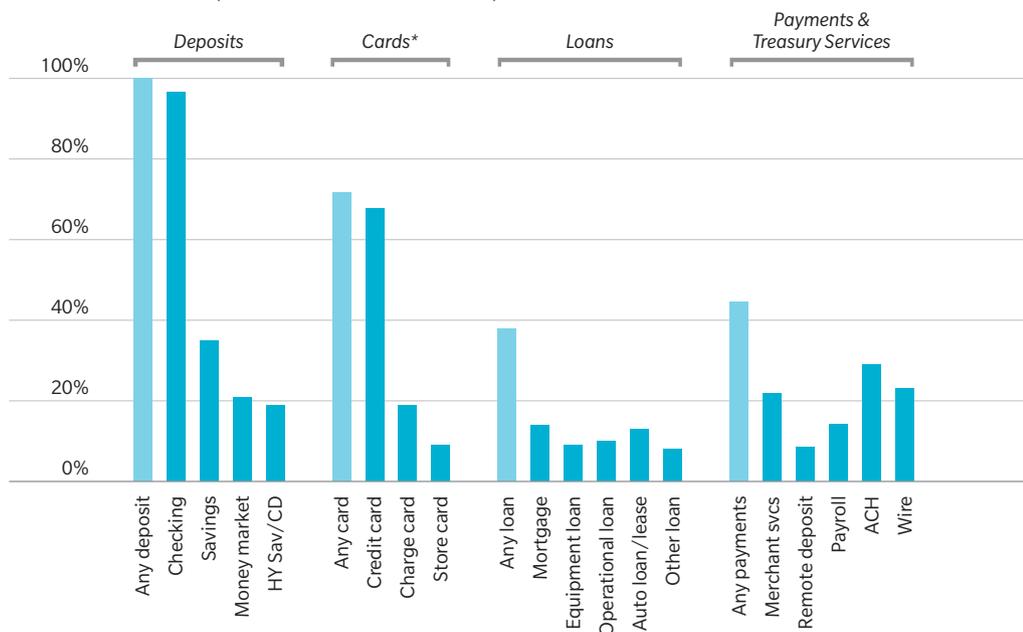
CHALLENGING CONVENTIONAL WISDOM TO ACHIEVE
OUTSIZE GROWTH AND PROFITABILITY

Boasting a base of more than 20 million potential customers¹ with a broad range of financial services needs, the Small Business segment has long presented a significant opportunity for US banks. Recent Oliver Wyman research and analysis² suggest that the SB sector produces \$14 BN of after-tax profit and \$10 BN of after-tax economic profit³, annually – nearly 15% of the total US financial services economic profit pool.

The sector is also resilient: in the face of recent economic turmoil and uncertainty, 73% of business owners told us that their firms were either “very” or “reasonably” profitable, while 75% described them as being in “established” or “growth” mode.

EXHIBIT 1: SMALL BUSINESSES ARE HEAVY USERS OF FINANCIAL SERVICES

PRODUCT USAGE RATE (EMPLOYER SMALL BUSINESSES)



* Card consists of cards used solely for the business; 44% of SBs are also merchants (accept cards)

Source: 2011 Oliver Wyman Small Business banking survey

However, strategies that meet small business needs, create differentiation and maximize potential economic returns have proven elusive. Following the financial crisis disruption, the market has largely settled back into competitive equilibrium, with many banks – and their advisors – allowing a set of conventional wisdoms to constrain their thinking as they craft their strategies. A bank willing to challenge these conventional wisdoms, Oliver Wyman believes, can define a break-out strategy that gains material share from competitors and delivers higher growth and higher profits.

1 ~20% of small businesses in the US have at least one employee in addition to the owner. Source: 2007 Census

2 A 2011 survey of 5,000 small business owners, from which we estimated the profit to banks from these businesses’ product and service usage.

3 ‘Economic profit’ is the profit after tax earned by the bank over-and-above the required rate of return on capital held against the risks of the business; it is worth noting that today, most of this profit comes from high-balance checking accounts and high-volume merchant services accounts – and not from small business loans.

What are the conventional wisdoms restricting banks' strategic thinking? We see five:

1. SEGMENTATION: "The size of the business is the best indicator of needs, profit potential, and sales and service approach"
2. RELATIONSHIP COVERAGE: "Assigning relationship managers is an effective means to attract new businesses, deepen relationships and decrease attrition"
3. CHECKING: "Offering 'free checking' is a table-stakes competitive requirement"
4. SMALL BUSINESS LENDING: "Credit process streamlining is the key to improving profitability and expanding SB lending"
5. NEW REVENUES: "Expanding into new service areas is the best path to increasing fee revenue"

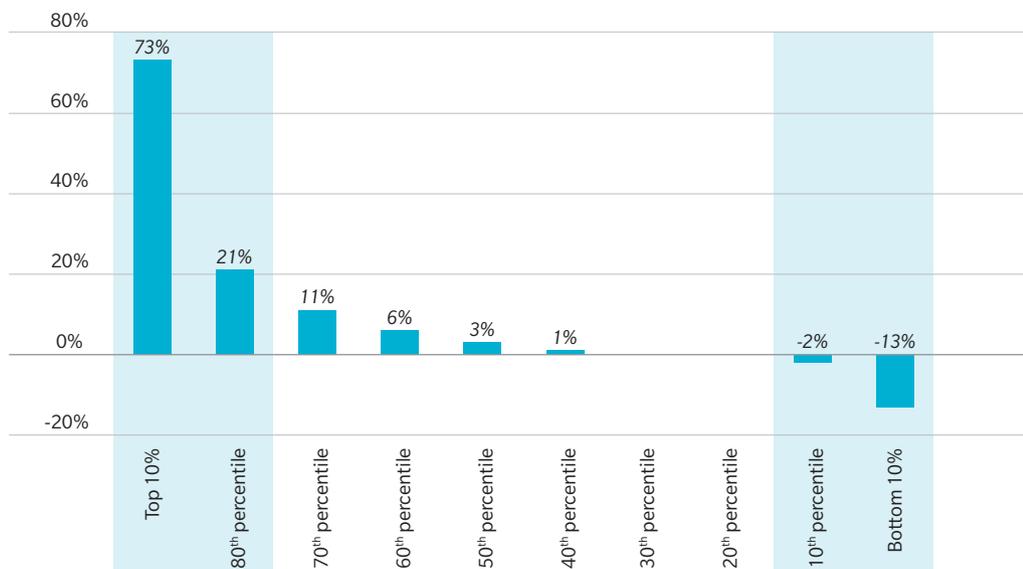
Oliver Wyman research and analysis suggest that some of these conventional wisdoms are wrong, and others only half-right. Worse, they disguise powerful new insights that banks can leverage to upgrade performance substantially. Let us examine them one-by-one.

1. SEGMENTATION: IS REVENUE SIZE ALL WE NEED?

Conventional wisdom places a great deal of weight on business size. For example, most banks use it to dictate how they organize, what prospects they target, and what products and delivery models they employ. Businesses that are larger, the rationale follows, will carry higher deposit balances, have greater credit appetites, and need more complex payments solutions, thus making them more profitable relationships.

EXHIBIT 2: PROFIT CONTRIBUTION OF SMALL BUSINESS CUSTOMERS RANKED BY RELATIONSHIP PROFIT

CONTRIBUTION TO TOTAL SB PROFIT

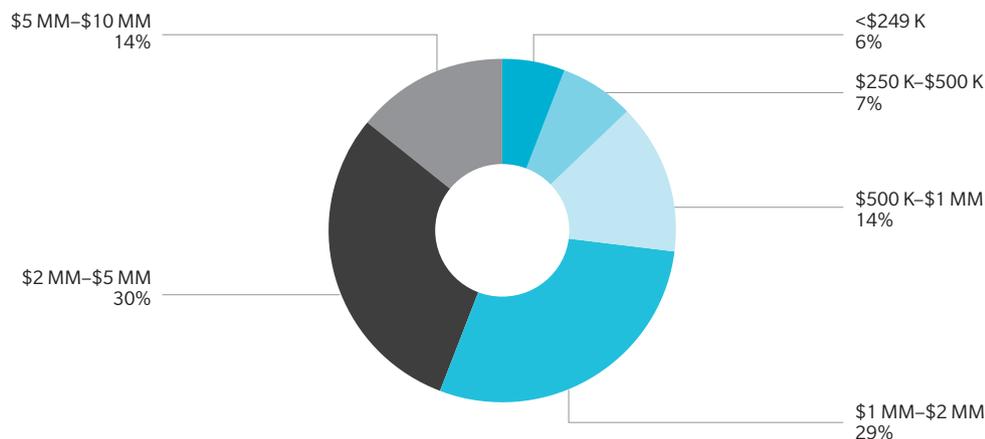


Source: 2011 Oliver Wyman Small Business banking survey

Oliver Wyman research validates the notion that larger businesses are more likely to be profitable. However, it also reveals two interesting findings that averages disguise. Firstly, 20% of businesses (the high value group) generate 95% of total segment profit. More surprisingly, more than half of the high value group have annual revenues less than \$1 MM.

EXHIBIT 3: ANNUAL REVENUES OF THE MOST PROFITABLE SMALL BUSINESS RELATIONSHIPS

TOP 20% OF ALL SMALL BUSINESSES, BY PROFIT CONTRIBUTION



* Payroll businesses only

Source: 2011 Oliver Wyman Small Business banking survey

These small, but high-value customers – who “fly under the radar” of purely revenue-based segmentation – present a significant untapped opportunity. Banks that embrace a profit-centric view and develop the supporting analytics could re-focus their new customer acquisition efforts to target only the most profitable prospects. And, because the average profitability of the high-value group is 3-4 times the market average, these banks could spend much more on the sales process and account-opening offers to entice the high-value group to switch. Similarly, the profit-centric view could be employed to re-focus cross-selling and relationship retention efforts (fee waivers, priority service) within the existing customer base.

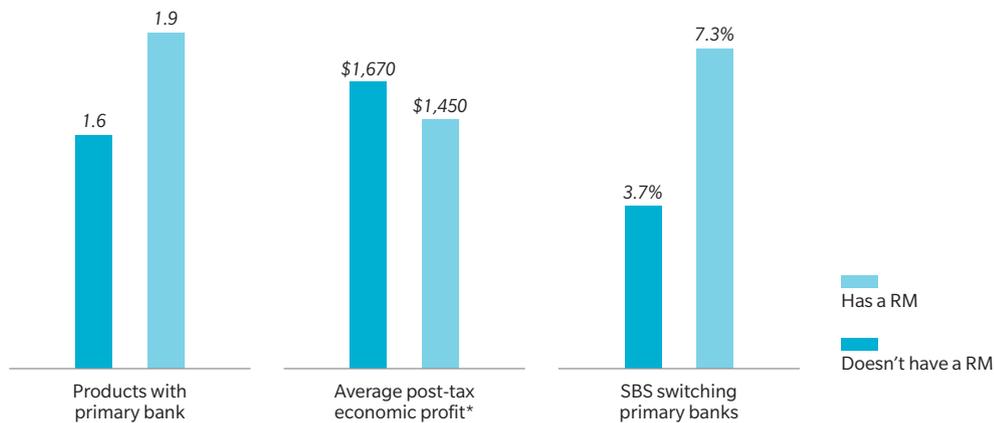
2. RELATIONSHIP COVERAGE: HOW DOES IT ADD VALUE?

Conventional wisdom dictates that banks should assign dedicated relationship managers to increase growth and profitability of their small business customer base. Most banks deploy dedicated SB bankers or specially-trained branch managers in high-opportunity trade areas in an attempt to achieve these gains, asking them to manage a “book” of 75-150 relationships. The logic is that these individuals can build industry and local-market expertise and provide the superior service necessary to attract, deepen and extend small business relationships.

Oliver Wyman research and client experiences suggest the current model is not delivering. As illustrated below, while businesses with RMs have slightly deeper relationships, the added breadth does not compensate the bank for the significant added expense. Further, customers with RMs exhibit higher, not lower attrition rates.

EXHIBIT 4: BEHAVIOR AND PROFITABILITY OF SBS WITH AND WITHOUT RM COVERAGE

CUSTOMERS WITH RMS
 MAINTAIN SLIGHTLY
 DEEPER RELATIONSHIPS... ..BUT ARE LESS PROFITABLE... ..AND ARE MORE LIKELY TO SWITCH



* Payroll businesses only

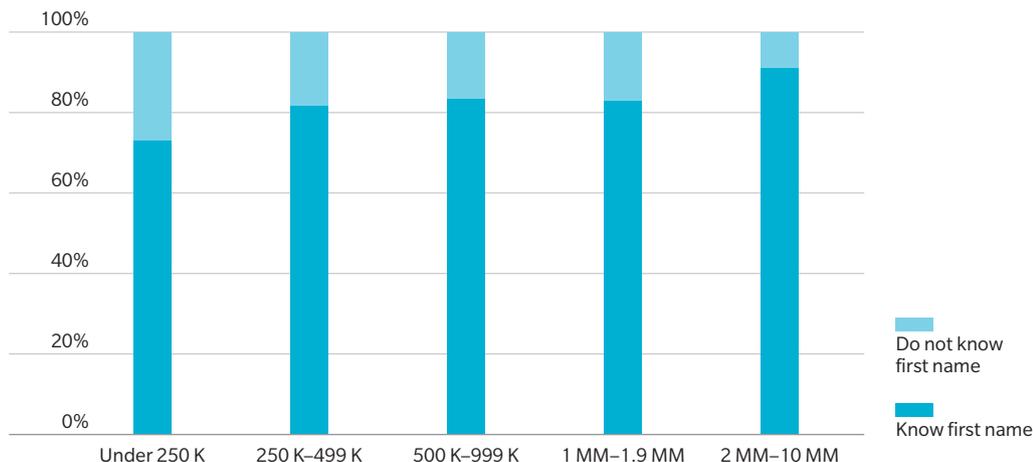
Source: 2011 Oliver Wyman Small Business banking survey

There are several factors that may contribute to these unexpected outcomes:

- First, many banks expect branch management to provide SB relationship management, but it receives low priority in the context of other responsibilities
- Second, some RMs do not develop much of a relationship with business owners: in our survey roughly one in five SBs with an assigned RM could not remember the RM's name
- Third, we have found that even successful dedicated SB bankers can lower the retention rate for SBs, in this case due to their own turnover. SB bankers change jobs more frequently than the 'natural' rate of SB attrition, and, in doing so, these bankers take their best relationships with them. Hence, high RM turnover actually accelerates SB attrition
- Finally, RMs are expensive; with a typical 'loading' of 100 businesses, each RM will probably have only two or three hours a year of client 'face-time' but must add at least \$1,000 of pre-tax contribution per business just to cover his/her fully-loaded cost

EXHIBIT 5: “DO YOU KNOW THE NAME OF YOUR RELATIONSHIP MANAGER?”

ALL SMALL BUSINESSES WITH AN ASSIGNED RM (US\$)



* Payroll businesses only

Source: 2011 Oliver Wyman Small Business banking survey

To improve the returns from relationship management assignments, banks could:

- Assign local RMs to high-profit accounts or prospects only; measure and compensate RM performance based on the incremental value they create
- Redesign RM job responsibilities to focus on skills and activities that make a material difference to clients, eliminating fulfillment-related activities that could be handled less expensively and with lower opportunity cost in the back office; increase account loading accordingly
- Experiment with a team-based or “virtual RM” model to serve less valuable or lower-opportunity small business clients
- Invest in building stronger institutional ties with the business owner, to mitigate the risk that he/she would follow the RM to a different bank

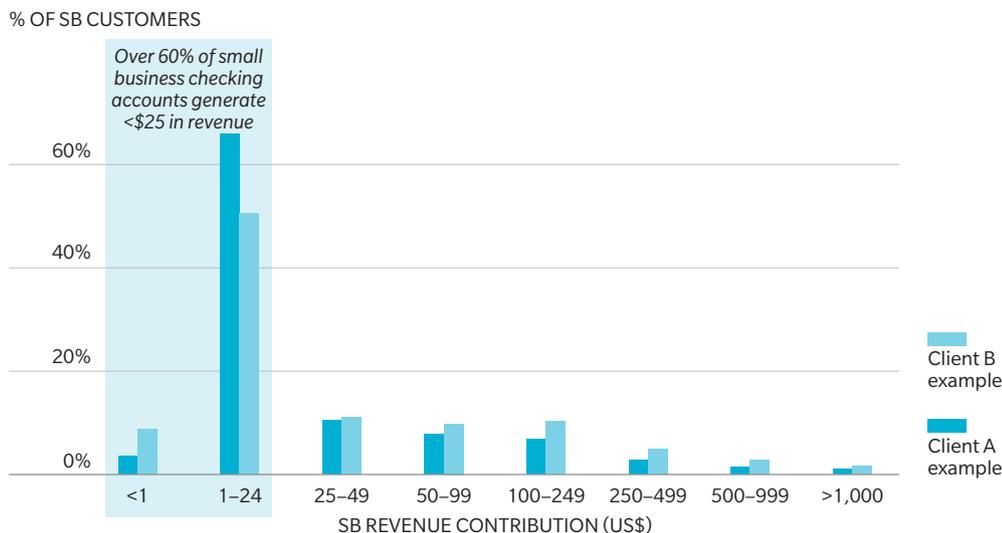
3. SMALL BUSINESS CHECKING: TO FEE OR NOT TO FEE?

Conventional wisdom holds that if even one bank in a given trade area offers free checking, all banks will be forced to follow suit. Although “totally free” has given way to “easily free”⁴ for many institutions, the working assumption remains unchanged: attract the relationship with no monthly maintenance fee and generate revenue through upselling, cross-selling and/or item fees for activity in excess of the included transactions and/or cash deposits.

4 “Easily free” connotes accounts whose fees are waived through simple, easy-to-qualify means that the vast majority of small businesses would meet. Examples would include very low minimum balance requirements and waivers for opening one or two additional products where debit card, online statements and/or other no/low revenue options.

Our recent research and client work suggest banks should not compete on price, regardless of what competitors choose to do. The connection between market share and revenue production is tenuous. As Exhibit 6 shows, the majority of small business free checking relationships generate minimal revenue and a significant portion of those will be loss-making on a marginal cost basis.

EXHIBIT 6: SMALL BUSINESS CHECKING REVENUE CONCENTRATION



Source: Oliver Wyman client work

Three factors explain why banks are generating so little revenue from such a significant percentage of the customer base:

1. In our experience, more than half of SB free checking accounts will contain an average balance less than \$5,000, providing limited interest margin
2. Very few clients generate transaction-or cash deposit-based incidence fees. For most banks, 90-95% of small business clients will not exceed the established transaction caps, monthly, and less than 5% will order a wire or other fee-generating transaction
3. Despite ongoing efforts, most banks have yet to crack the code on cross-selling savings accounts, merchant services, cards and other products that generate real revenue streams

Additionally, checking does not need to be free to attract and retain customers. Our research suggests that small business owners spend very little time worrying about optimizing their financial services costs, and that the hassle associated with switching banks greatly outweighs the potential savings. In fact, more than 80% would stay with their current bank if a \$10 fee was imposed on their account.

More importantly, small business owners will pay for value where they see it. Having tested dozens of potential account attributes, add-ons and service benefits, three areas emerge:

1. **Simplicity and cost certainty:** Business owners prefer a single, bundled fee structure over more prevalent per-transaction pricing models. For example, the average business owner in our research would pay \$8/month more to have unlimited transactions, versus an account with 100 included transactions, despite the fact that more than 90% of businesses never exceed the 100 transaction limit
2. **Working capital access and protection:** Accelerated funds availability and small stand-by credit lines resonate very strongly. In fact, these register as the most powerful motivators of switching and carry incremental values of \$5-15/month. Check payment guarantees and fraud protection are also appealing
3. **Relationship benefits:** The presence of relationship benefits, whether rewards programs, discounts on loans, savings interest rate bonuses and higher service levels (e.g. 24/7 phone support, dedicated business banker) all are accorded quantifiable values. Interestingly, business owners appear to consider the presence of these benefits to be more important than the actual economic value conveyed

Banks can capitalize on these insights by redesigning their core small business checking offerings, building each product around the preferences of distinct sub-segments and pricing for the value they deliver. Some may also choose to convert a subset or all of their existing free checking portfolios as a means to generating an immediate revenue lift. While this approach may result in more modest account acquisition and retention rates, it will materially improve the overall economics of the business and increase the focus on more valuable relationships.

4. LOANS: A NEW PROCESS OR A DIFFERENT NEED?

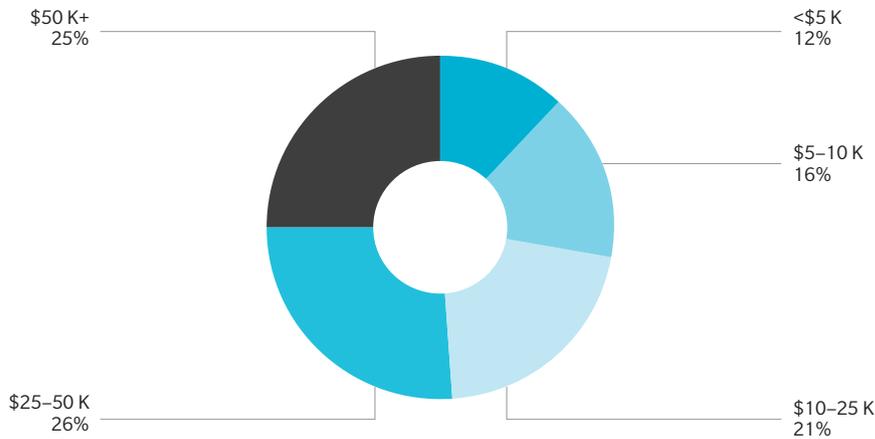
Small business owners have long considered access to working capital their most important unmet need. In fact, in recent Oliver Wyman research, 70-80% of small business owners indicated it to be an important consideration in selecting a bank. And yet, while many have small business credit cards, auto loans or first mortgages, only 15% have an open operational loan or equipment loan/lease.

Conventional wisdom dictates that if banks make the credit process less painful – whether by streamlining the application process, requesting less information, or making faster decisions – more small businesses will respond, increasing origination volumes and, by extension, profits.

Our research and experience suggest otherwise – that most SB owners who value access to credit need something other than a traditional credit line or term-loan. Rather, they describe a substantially smaller facility designed to address short-term gaps in cash flow (in effect, a payables-receivables duration mismatch), generally in the amount of half- to one-month's revenues.

EXHIBIT 7: DESIRED AMOUNT OF CREDIT AVAILABILITY

ALL SBS WHO VALUE ACCESS TO CREDIT



Source: Client Small Business banking survey, March 2012

Under the traditional credit process, even performing loans originated to address this need would fail to produce an accounting profit. To illustrate the point, consider a request for a \$75,000 one-year term loan. Assuming a 3% interest margin over funding cost, such a loan would produce ~\$1,225 in revenue over its term. The all-in origination cost per funded loan ranges from \$900 to \$1,800 for most banks, alone, without taking into account sales force compensation, credit risk and capital consumption costs. Clearly, even a streamlined credit process isn't a solution.

Instead, banks should create an entirely new small business working capital loan product category, akin to (but not entirely the same as) offerings pioneered over the past 5-7 years by firms like Capital Access Network, OnDeck Capital and Amerimerchant. This new product would be distinct in three ways:

1. Origination: The new loan would be sold to existing customers, primarily via a web-based interface, using existing data from other bank accounts or which could be sourced electronically from third parties and underwritten primarily on an automated basis, with limited manual intervention
2. Underwriting: The bank would utilize direct observation of real, recent cash-flows from the business checking or merchant services account to predict future cash flows and, by extension, to determine the ability of a firm to take on credit
3. Repayment: Payments would be remitted in small increments via an automated, daily remittance cycle, as a means of identifying at-risk loans more quickly and smoothing cash flow impact of the new loan on the business

Oliver Wyman research suggests this new category could produce billions in new outstandings and pre-tax profits. Seeing this potential, American Express and Amazon.com have recently entered the market by making a portion of expected future receipts – Amex card receivables and Amazon Marketplace sales volumes, respectively – available to their merchants in the form of an advance. However, banks should possess an advantage over both, due to insight afforded to them as holders of the primary checking account, thus enabling them to see the full breadth of a small business' cash flows as opposed to just one slice.

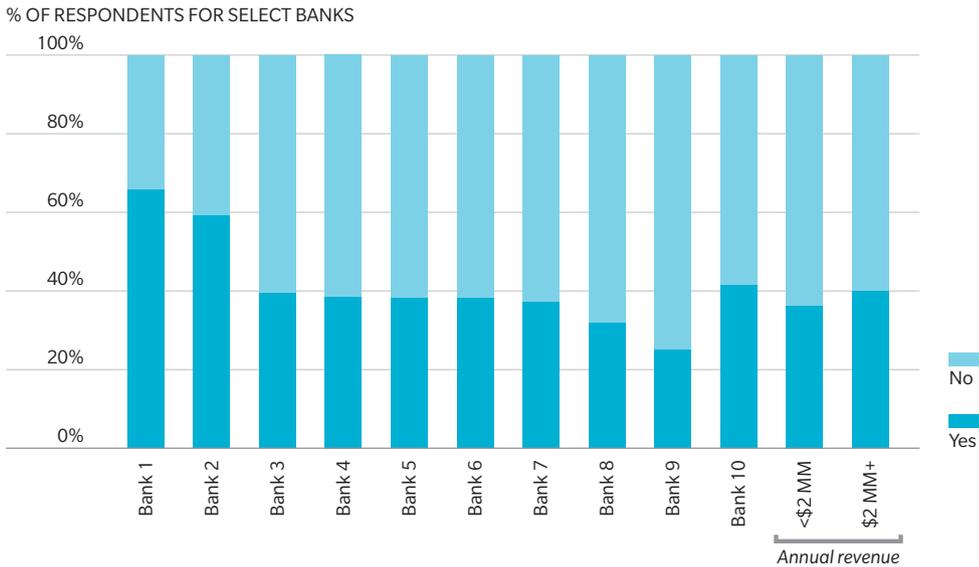
5. NEW REVENUES: NEW OFFERINGS OR NEW PACKAGING?

In the face of the declining profitability of core product categories, generating new revenue streams has become a top priority for the banking industry. To this end, some banks have even begun to explore opportunities to expand the scope of services they provide to small businesses into other professional services areas, including aggregated procurement discounts, marketing services, business transfer services and employee health benefits administration. While one or more of these may emerge as a new, previously untapped wellspring, Oliver Wyman research suggests that more immediate (and much more certain) returns are available via a renewed focus on the fee-based payables and receivables services that most banks already offer.

Remote deposit capture provides a useful case example. It meets a clear need for a significant share of small businesses – check payments make up 50-70% of receivables in non-retail sectors – and yet fewer than one in four SBs make use of it. The issues are two-fold:

- Awareness remains low. In a recent survey of small business customers at the ten largest banks showed that, depending on the institution, 35-75% of clients erroneously believed RDC was not offered by their bank
- Product configuration and pricing depress adoption. Banks who exhibit the lowest penetration rates tend merely to have repurposed their Commercial RDC product structures to SB customers, as opposed to tailoring specific offerings that reflect their needs and business characteristics

EXHIBIT 8: DOES YOUR PRIMARY BANK OFFER REMOTE DEPOSIT CAPTURE CAPABILITY?



Source: 2011 Oliver Wyman Small Business banking survey

Payroll, e-invoicing and electronic payments – all of which provide rich fee income streams – all face similar challenges. Targeted marketing campaigns, and refreshed product/pricing plans would help in each case, but banks should also develop service packages that incorporate the right mix of these services with the checking account. Our experience suggests more than 40% of new customers would opt for a correctly designed package over a stand-alone checking account, without any incremental incentive.

* * * * *

Small business remains a big opportunity for US retail banks. However, as competition continues to increase for the best relationships within the segment, those who abide by conventional wisdom will achieve suboptimal returns. Those who challenge it will enjoy outsize growth and profitability.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

AMERICAS

+1 212 541 8100

EMEA

+44 20 7333 8333

ASIA PACIFIC

+65 6510 9700

AUTHORS

Tim Spence, Partner

Anna Epshteyn, Senior Manager

CONTRIBUTORS

Peter Carroll, Partner

Ben Hoffman, Partner

Julian Lewis, Senior Consultant

Kirk Saari, Partner

www.oliverwyman.com

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