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GREAT EXPECTATIONS

IMPROVING THE LOAN APPLICATION PROCESS FOR SMALL BUSINESS BORROWERS

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EXECUTIVE SUMMARY

The small business segment is a significant source of profit for financial institutions, and lending is an important offering to deepen customer relationships. Oliver Wyman and Fundera surveyed small business owners in late 2016 to better understand the preferences, behaviors and experiences of this segment. Our research identified several areas in which lenders of all types fall short of what borrowers told us they want. Borrowers said that the search[1] and application processes are complicated and time consuming, loan pricing and terms are difficult to understand, and comparison shopping is arduous because it requires multiple applications and comparison of inconsistently presented offers. These largely unaddressed customer needs create opportunities for lenders to differentiate themselves.

In addition, our research confirmed that banks generally lag behind FinTech lenders in creating a satisfying borrowing experience across factors like application length, communication of next steps, and time to approve loan applications. Indeed, borrowers from traditional institutions were about twice as likely to be frustrated by these aspects of the application process as borrowers from alternative lenders. However, alternative lenders' high cost of funds leads to higher pricing that frustrates borrowers. If alternative lenders begin to develop stable, low cost funding sources, banks might need to shore up their relative weakness across most elements of customer experience. Even if this threat does not materialize, banks should want to invest in customer experience improvements to gain an advantage over their peers.

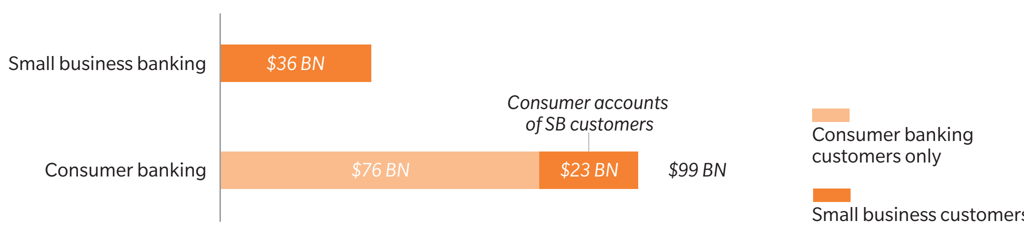
1 The "search" process can include activities like identifying lenders and assessing their reputation, evaluating potential loan products, and so on

INTRODUCTION

The small business segment accounts for about half of GDP in the United States[2] and presents a significant opportunity for financial institutions. In relation to the banking sector, Oliver Wyman estimates that the small business segment represents $36 BN in annual, pre-tax accounting profit.[3] While small business lending is often not a major profit source for banks through the credit cycle, for many small businesses it is an essential offering that complements other basic banking services (e.g., checking, deposits) and highly profitable offerings like credit cards and merchant services. Indeed, two-thirds of small businesses surveyed in 2014 reported that access to credit is important in choosing a primary bank, and half of small businesses reported being likely to switch banks if denied credit.[4]

Exhibit 1: Size of consumer and small business banking profit pools

THROUGH-THE-CYCLE, PRE-TAX ACCOUNTING PROFIT



Note: Profits calculated with Oliver Wyman assumptions for small businesses with <250 employees
Source: Oliver Wyman Survey of Small Business Owners (Q2 2014), Oliver Wyman Survey of Consumer Finances (Q2 2015)

Banks dominate the small business customer base in providing loans and other banking products, but they face increased competition from FinTech online lenders.[5] These relatively new entrants have built a competitive advantage focused on speed and a streamlined application process. The earliest FinTechs in small business lending – most notably CAN Capital – preceded the 2007-2008 financial crisis. OnDeck, Kabbage, Funding Circle and many others emerged in the wake of the crisis, buoyed in part by historically low rates and a pullback in lending by banks and credit unions. These challengers argued not only that they addressed a shortfall in lending to segments of the market but also that they could provide a superior borrower experience. Alternative lenders command only a small fraction of the market, but they have demonstrated the potential for streamlined and digitized application processes, faster underwriting, next-day funding and other customer experience improvements.[6] Meanwhile, banks have been slow to evolve their offerings or exploit their advantages in full.

Despite their innovative approaches, alternative lenders have struggled to gain major traction in this customer segment – in large part because their costs of funds are

2 US Small Business Administration

3 This segment represents $59.1 BN in annual, through-the-cycle, pre-tax accounting profit including the consumer accounts of small business banking customers

4 Oliver Wyman Survey of small business Owners (Q2 2014), Oliver Wyman Consumer Profit Pools. Through-the-cycle profits calculated with Oliver Wyman assumptions for Small Businesses with <250 employees

5 Though our survey used the term "online lender", we use the terms "FinTech lender", "alternative lender", and "online lender" interchangeably in this paper

6 Innovative approaches to underwriting have helped to drive many of these customer experience improvements

substantially higher than those of deposit-taking institutions. To the extent that alternative lenders develop stable and low cost sources of capital, they will be able to price loans more competitively and reduce the advantage currently held by banks. We therefore anticipate that banks will need to compete more energetically on customer experience. Banks will retain some powerful advantages – including a larger existing customer base, broader name recognition (at least for regional and national players) and a physical distribution network that many customers value. However, we anticipate that they will face more pressure to modernize the customer experience than they have to date.

Against this backdrop, Oliver Wyman and Fundera surveyed nearly 400 small business owners in late 2016 to better understand the preferences, behaviors and experiences of this important segment. Our survey focused specifically on the lending experience and included small business owners both from the Fundera customer base and the broader population (via a market research company).

Our research confirmed that banks generally lag behind FinTech lenders in creating a satisfying borrowing experience. More interestingly, we identified several areas in which all lenders fall short of what borrowers told us they want. These unmet needs are opportunities for differentiation.

A HIGH FRICTION EXPERIENCE

Only one quarter of respondents said they were dissatisfied with their recent borrowing experience. However, they did not seem to be unduly impressed either. Just 22% said that their loan application experience "exceeded expectations". In particular, respondents suggested that traditional lenders have lagged in creating a strong customer experience. Borrowers expressed three related types of complaints:

1. Obtaining a loan takes too long
2. Lenders have not digitized the process sufficiently
3. The process remains high friction

1. OBTAINING A LOAN TAKES TOO LONG

Many borrowers said the process of obtaining a loan was lengthy. They reported spending a lot of time on loan search, application and documentation compilation processes.

Small business lenders have proliferated, so borrowers must choose from a wide range of products. Perhaps as a result, over two-thirds of business owners reported spending at least three hours searching for information on their most recent business loan, and over one-third spent more than six hours. This includes simply the time spent to find a reputable provider and compare loan products, not any part of the application process itself.

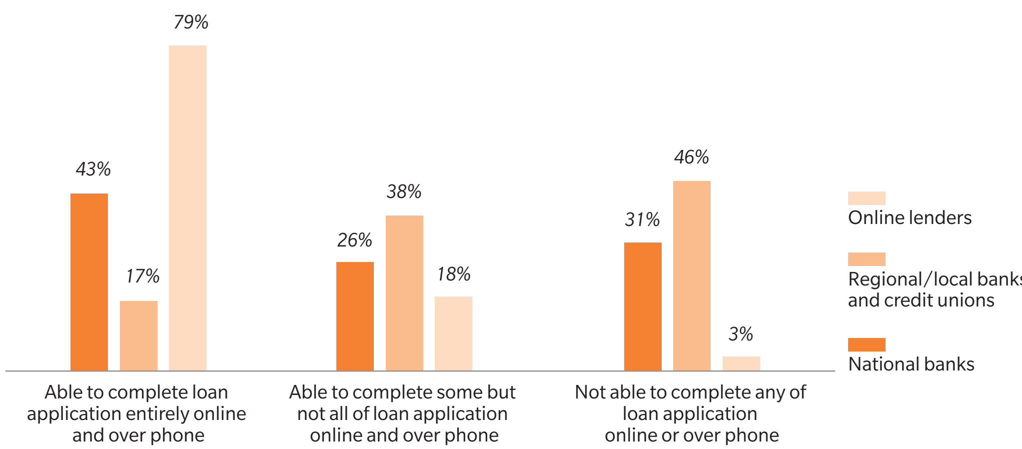
Borrowers also reported that applying was time consuming. Close to a quarter of borrowers from traditional lenders called the application length "frustrating" or "very frustrating". In addition, borrowers spent a large amount of time collecting documentation: half of borrowers reported that it took over two hours just to collect the necessary documents, and one-third said it took at least five hours. We observe that many institutions have not streamlined their application processes to request only the information and documentation they truly need, resulting in onerous documentation gathering requirements.

Finally, most respondents said it took days to receive approval after submitting an application and then to receive funds after approval.[7] Online lenders tend to complete these steps much more quickly with more automated underwriting processes.[8]

2. LENDERS HAVE NOT DIGITIZED THE PROCESS SUFFICIENTLY

While most banks and credit unions allow small businesses to complete some of the loan application process online or over the phone, they lag behind online lenders in offering these capabilities. The majority of borrowers from national banks reported that they were unable to complete the entire application process online (i.e., they needed to visit a branch or mail physical documents). Borrowers from smaller banks and credit unions reported that those institutions were even less likely to have developed these processes.

Exhibit 2: Reported ability for borrowers to complete loan application online or by phone



Source: Oliver Wyman and Fundera Small Business Borrowing Experience Survey

This is an important shortcoming in the borrower experience with traditional lenders. While some borrowers prefer to use the branch to apply, we saw a strong preference for digital channels across many aspects of the application process. Unsurprisingly, younger borrowers were the most likely to prefer these digital solutions. For example, nearly all borrowers under the age of 35 expressed a preference for submitting documents online,[9] rather than by mail or at a branch.

Given these borrower preferences, lenders should enable customers to use these channels. In addition, lenders that have digitized parts of the application process should continue to improve the experience by allowing customers to do even more online.

7 Oliver Wyman has found that the end-to-end process can take weeks, even for smaller and less complex loans

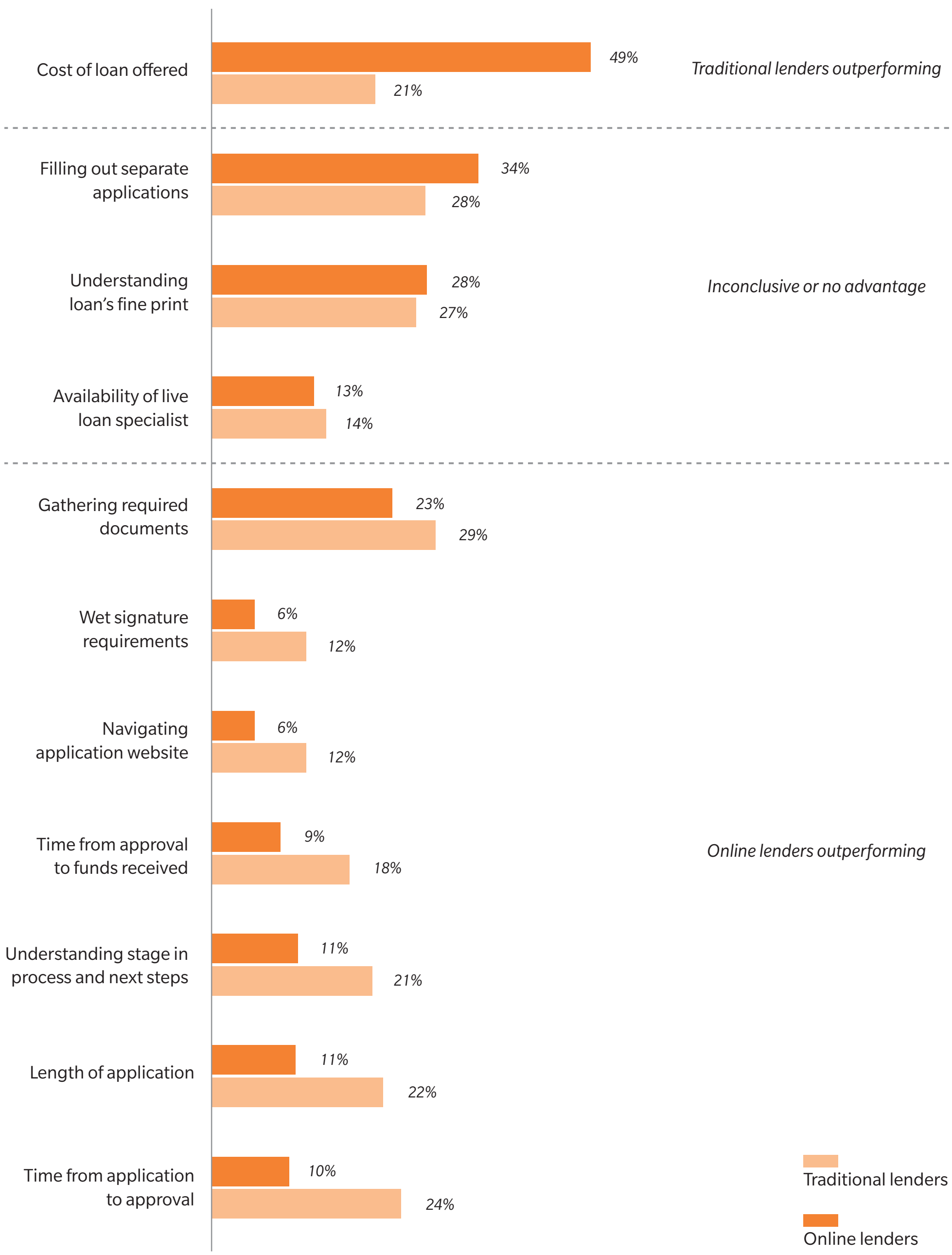
8 The Federal Reserve likewise has found that the loan application process is time consuming. Firms spend an average of 24 total hours applying for credit, according to the 2014 *Joint Small Business Credit Report* produced by the Federal Reserve Banks of New York, Atlanta, Cleveland, and Philadelphia

9 This included options for transmission through the lender's website, via email or by granting one-time permission to the lender to retrieve information directly

3. THE PROCESS REMAINS HIGH FRICTION

Even for minor aspects of the borrowing experience, online lenders tended to outperform traditional lenders. For example, borrowers from online lenders were half as likely to report being frustrated by not understanding next steps in the loan application process, navigating the application website or completing signature requirements.

Exhibit 3: Borrowers reporting aspect of obtaining a small business loan was frustrating or very frustrating



Note: "Filling out separate applications" refers to completing a new loan application, either for each lender or for each loan product from the same lender

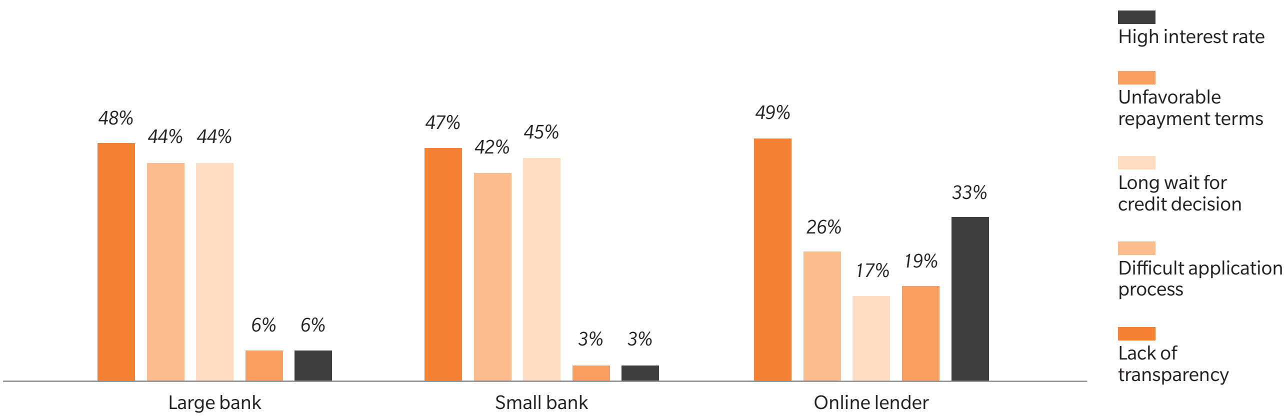
Source: Oliver Wyman and Fundera Small Business Borrowing Experience Survey

However, several opportunities clearly remain for FinTechs and bank lenders alike to improve their customer experience: completing separate applications is a common source of frustration for customers of both online and traditional lenders, loan specialists are not always available when borrowers want to speak with them and understanding the loan offer is a challenge across lenders. Many of these relate to improving transparency and openness, which we discuss in the following section.

THE NEED FOR TRANSPARENCY

Borrowers wanted not only a better process but also clearer and more accessible information. These findings are consistent with those of the Federal Reserve's Small Business Credit Survey, which found that lack of transparency was a leading reason for dissatisfaction even among successful applicants.

Exhibit 4: Reasons for dissatisfaction among employer firms dissatisfied with lender



Note: Large banks were characterized as those with at least $10 BN in total deposits, and online lenders were defined as nonbank alternative and marketplace lenders, such as Lending Club, OnDeck, CAN Capital and PayPal Working Capital. Note that this survey analyzed employer firms only, so the population is not directly comparable to that which we surveyed

Source: Federal Reserve Small Business Credit Survey 2016 (April 2017)

There were two themes to the transparency challenge. First, customers sometimes struggled to understand the terms of individual offers. Second, they encountered friction when trying to obtain and compare offers from multiple lenders.

READING THE FINE PRINT

Many borrowers reported that it was difficult to understand the terms of an offer of credit. For example, understanding the total cost of a loan can be challenging, given the many drivers of cost: interest rate, origination fees, guaranty fees,[10] and prepayment penalties, to name a few examples. As a result, respondents strongly favored (85%) a standardized disclosure to help them understand a given loan's cost and terms, and also help them compare multiple offers.

10 For loans backed by the Small Business Administration. Lenders may choose to pass this cost onto the borrower

The availability of knowledgeable loan specialists improved the experience. 90% of borrowers reported interacting with a loan specialist during the application process, and only 15% would have preferred a loan process that did not require interacting with a human loan specialist. Younger borrowers were more likely than others to prefer a process that did not require such interaction, but even they were divided. It seems that while many borrowers prefer online options for much of the application process, access to human specialists remains valuable.

SHOP 'TIL YOU DROP

Across lenders and age groups, borrowers shopped for multiple offers. More than 60% of borrowers from traditional financial institutions and 79% of those borrowing from online lenders said that they considered at least two loan offers.[11] Many seemed to do so because it was difficult to compare lenders during the search process. Four in ten respondents said it was "difficult" or "very difficult" to find a lender that offered the best terms.

Yet searching and completing multiple applications were time consuming activities. Nearly half of those who applied for multiple loans spent over six hours searching for information alone, and over one-third spent more than five hours applying for loans. Borrowers then struggled to compare offers, since lenders present terms differently.[12] Inconsistency in offer presentation may contribute to respondents' broadly positive perception of brokers, who can help customers interpret loan offers.

As a result of these challenges, nearly all borrowers who applied for multiple loans said that standardized applications and offer presentations would be valuable.

PRICING AS A COMPETITIVE LYNCHPIN

Although alternative lenders are widely perceived to offer a superior customer experience, they fall short in pricing. Several factors may contribute to the higher costs of alternative lenders:

- Most importantly, alternative lenders have a higher cost of capital because they lack access to the stable, low cost deposits that banks and credit unions can use to fund their loans. The average cost of funds for a bank is around 0.06%,[13] while OnDeck reported a 5.9% cost of funds rate in the company's Q1 2017 financial results.[14]
- Alternative lenders serve many borrowers who struggle to access credit through banks (e.g., based on industry). These borrowers may find only higher cost loan options (no matter the lender) but borrow more frequently from alternative lenders.
- Businesses that apply for credit from the still-new, FinTech lenders may be higher risk borrowers than those who apply for credit from other lenders or through other channels (consistent with the experience of credit card issuers in the early years of allowing online applications). Alternative lenders would need to price this risk into loans they originated.

11 This is consistent with research by the Federal Reserve (Federal Reserve Small Business Credit Survey 2016) that indicated that 61% of employer firms submitted at least two applications, and over one-third submitted three or more

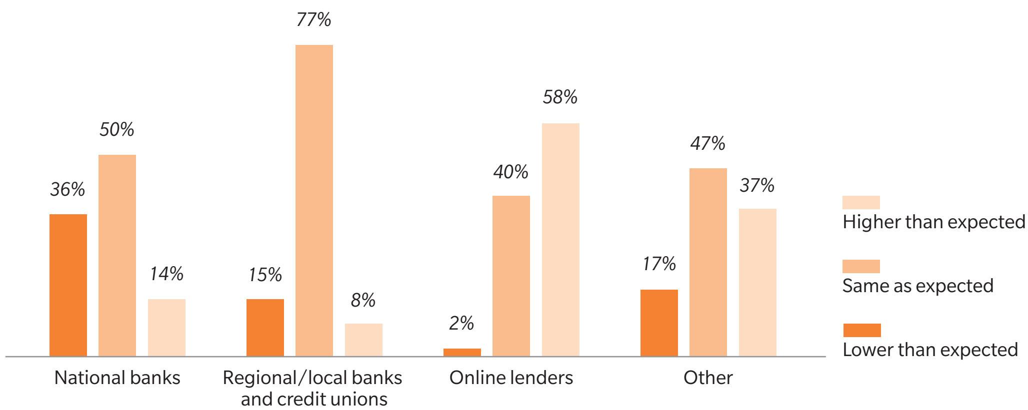
12 These include the factor rate, simple interest rate, annual percentage rate, total or monthly interest payments, total loan cost (including interest costs but also origination fees and closing fees) and other terms and conditions

13 Based on the FDIC's simple average of rates paid on savings by depository institutions

14 "OnDeck Reports First Quarter 2017 Financial Results." OnDeck Capital (May 8, 2017)

The results of our survey reflect the large disparity in loan pricing. Only 11% of borrowers from a bank or credit union reported that the rate was higher than expected, and twice as many said it was lower than anticipated. By contrast, 58% of those who borrowed from online lenders said that the cost of borrowing was higher than expected. Those who borrowed from an online lender were far more likely to describe the cost of the loan offered as "frustrating" or "very frustrating," and cost was by far the most frequent source of complaint for these consumers (see Exhibit 3).

Exhibit 5: Respondents' perceptions of loan cost relative to expectations



Source: Oliver Wyman and Fundera Small Business Borrowing Experience Survey

Many borrowers nonetheless borrow from FinTech lenders. Alternative lenders often provide credit more quickly than banks or credit unions, lend to businesses that would be unable to access credit through the banks[15] and provide a more pleasant customer experience. However, alternative lenders' high cost of funds impedes their ability to compete with incumbents and is a major driver of customer frustration.[16] If alternative lenders begin to develop stable, low cost funding sources, banks might need to shore up their relative weakness in customer experience.[17]

IMPROVING THE LENDING EXPERIENCE

Although the challenges faced by banks and FinTechs vary, some of the root causes of poor customer experience are common across many types of lenders. We have identified several key areas for financial institutions to improve the borrower experience, ranging from features and products to back-end processes.

15 For example, the Federal Reserve's 2016 Small Business Credit Survey (April 2017) found that smaller-revenue employer firms had higher approvals at smaller banks (60% success) and online lenders (59% success) than at large banks (45% success)

16 In addition, Oliver Wyman has observed some alternative lenders charge significantly higher rates than can be explained just by cost of funding. However, this survey focused on borrower perceptions, rather than addressing actual differences in pricing

17 This compares banks and alternative lenders as categories. Even if this threat does not materialize, banks may need to invest in customer experience improvements to keep up with their peers

CREATE TRUST THROUGH TRANSPARENCY

Borrowers want greater transparency in the form of lower barriers to comparison shopping and clearer information about loan offers. Opportunities for lenders span the products, application process and the offer presentation. We suggest to:

1. Disclose loan terms clearly and consistently
2. Simplify the product suite
3. Streamline and standardize the application process

1. DISCLOSE LOAN TERMS CLEARLY AND CONSISTENTLY

The simplest and most obvious way to improve transparency is to ensure customers understand the terms of their loan offers. Nearly one-third of borrowers indicated that understanding their loan's fine print and terms is "frustrating" or "very frustrating." As noted earlier, 85% of respondents said that a standardized disclosure for the cost of loans (i.e., lenders showing repayment terms and charges in a consistent manner) would help them better understand and compare loans.

Many alternative lenders have taken steps in that direction, developing and submitting themselves to standards designed to protect borrowers. In late 2015, a network of lenders, brokers and advocates formed the Responsible Business Lending Coalition with a "Small Business Borrowers' Bill of Rights" to combat abusive practices in small business lending. Signatories attested that they would comply with (or in the case of non-lenders, endorse) the requirements of the bill of rights, which range from pricing transparency to fair collections.[18]

In 2016, lenders focused more specifically on pricing disclosure. Fundera launched a disclosure box initiative to promote pricing transparency.[19] Then the Innovative Lending Platform Association (which began with the three largest US online small business lending platforms: OnDeck, Kabbage and CAN Capital) and Association for Enterprise Opportunity introduced a "pricing disclosure and comparison tool focused on empowering small businesses to better assess and compare finance options."[20] Their SMART Box ("Straightforward Metrics Around Rate and Total cost") is a supplemental disclosure to create standards around pricing metrics.

Small business lending lacks many of the disclosure requirements that exist for consumer credit. The Truth in Lending Act does not impose disclosure requirements on credit extended to businesses, and small business lending lacks the required disclosures of some forms of consumer credit like credit cards (i.e., the "Schumer box"). Absent these requirements, lenders can build trust by helping borrowers better understand their loan terms voluntarily.

18 Small Business Borrowers' Bill of Rights website, produced by the Responsible Business Lending Coalition
19 Peter Renton, "Fundera Disclosure Box Initiative Promotes Responsible Small Business Lending." *Lend Academy* (September 13, 2016)
20 "Nation's Top Online Small Business Lending Platforms Unveil SMART Box™." OnDeck (October 24, 2016)

2. SIMPLIFY THE PRODUCT SUITE

Small business owners face a plethora of credit and financing options, including term loans, SBA loans,[21] lines of credit, invoice financing, equipment loans and personal loans used for a business purpose. The proliferation of products creates optionality, and lenders and financing companies often try to help match borrowers to appropriate products. However, product proliferation comes with certain costs from borrower friction (it can be challenging for borrowers to evaluate so many different credit and financing options, particularly when lenders and financing companies use different names to describe the same products) to reduced secondary market activity, so it requires justification.

We contend that small business credit and financing (excluding real estate) typically falls into one of three basic forms, so much of the product proliferation may be only incrementally valuable to borrowers:

1. **Term loans** in which businesses borrow a lump sum, receive the principal at once and pay it back over a specific period of time. Some of these loans are asset-based (such as equipment loans), while others are unsecured.
2. **Lines of credit** that allow borrowers to utilize and pay only for the amount of credit that is needed. Credit automatically renews as debts are paid off, and lines of credit can be asset-based (as in the case of inventory financing) or not.
3. **Merchant cash advances** that solve for temporary liquidity shortages by allowing business owners to sell a portion of their future card transactions. Merchant cash advances differ from secured lines of credit in several key respects: they tend to be small dollar and high APR, are repaid daily and require a distinct financing administration platform.

As a result, we believe that lenders can standardize product types and terms to make it easier for borrowers to understand and compare their small business credit and financing options, just as lenders increasingly have standardized terms for residential mortgages over time.

3. STREAMLINE AND STANDARDIZE THE APPLICATION PROCESS

Finally, many borrowers reported that comparing offers is important, but not all complete multiple applications. This may be because varying application forms and documentation requirements make applying for credit at multiple financial institutions difficult.

Platforms like Fundera and Credit Karma help to address this challenge by prequalifying customers for offers from a range of lenders. In addition, lenders should standardize the application process to make it easier for borrowers to apply. For example, Fannie Mae and Freddie Mac produced the Uniform Residential Loan Application (known as Form 1003 by Fannie Mae and Form 65 by Freddie Mac). Mortgage lenders have widely adopted the 1003 as a standard application form.

Though there is less impetus to standardize small business credit, this example demonstrates how the industry can converge around standards that can create transparency for borrowers, secondary market participants and more. And while standardization

21 The Small Business Administration participates in a number of loan programs designed for business owners who may have trouble qualifying for a traditional bank loan

requires coordination among lenders, lenders also can unilaterally simplify their own loan applications to lower the costs of applying.

DIGITIZE THE PROCESS – BUT WITH CARE

Digitization presents opportunities for banks and FinTech lenders alike to improve the customer experience and lower costs (e.g., through lower customer service utilization and the reduction of manual loan fulfillment processes). Though digitization opportunities in lending could be the subject of an entire separate paper, we identify a few basic opportunities:

- **Invest in customer-facing digital solutions that reduce friction** – Individually incremental additions like remote document capture or clearer updates as to the status of an application can significantly improve the experience in the aggregate.
- **Automate the underwriting of lower risk loans** – Banks can underwrite low-risk loans automatically to provide businesses with quicker access to capital and free up resources to evaluate higher risk loans. The use of merchant account and/or DDA (demand deposit account) cash flow patterns to derive risk insights can facilitate this, and alternative lenders like OnDeck Capital now use this data in their underwriting process.[22]
- **Recognize when digitization is not the solution** – In updating their approach to the small business segment, lenders should resist the temptation to treat every business owner like a "digital native." For example, a minority of borrowers preferred an application process that eliminated interaction with a human loan specialist entirely.[23]

ADDRESS THE LESS OBVIOUS DRIVERS OF CUSTOMER EXPERIENCE

Lenders addressing customer experience issues might focus on the parts of the process that are most visible to customers. However, cosmetic changes alone are insufficient and may mask the root causes of a poor borrower experience. New FinTech players can define the customer experience upfront and develop a supporting infrastructure that accommodates this vision. Banks and credit unions often face legacy infrastructure, processes and cultures that impede this execution. Though the specific challenges vary by lender, some of these hidden barriers to better customer experience include:

- **Technical entropy** – Traditional financial institutions often struggle to adapt because of legacy technology that is ill equipped to meet new business needs. Banks' back-end systems are encumbered by disparate "spaghetti" systems, incongruent processes and poor scaling to growth and demand, all of which generate friction and inhibit innovation.
- **Legacy processes** – Many institutions' processes are inefficient and result in worse service provided to borrowers. Challenges can include exacting documentation requirements (sometimes coupled with manual collection), lack of automation or too frequent manual reviews and time consuming underwriting approaches.
- **Limited dedicated resources** – Within banks, the small business organization tends to lack the dedicated staff and other resources that the Consumer or Commercial businesses maintain. For example, banks sometimes leverage product development or

22 Peter Carroll and Ben Hoffman, "Financing Small Businesses: How 'New-Form Lending' Will Reshape Banks' Small Business Strategies." Oliver Wyman (2013)

23 Nearly all borrowers over the age of 45 had no preference or preferred to speak with a human loan specialist. Those under 45 were about evenly split between those who would have or would not have preferred a process where they avoided speaking with a human loan specialist. Lenders will need to adapt to evolving preferences as this segment becomes an increasing share of the small business lending market. However, even that borrower group is by no means homogenous

other resources from other businesses, rather than maintain their own small business capabilities. This can contribute to small business borrowing excessively from the Consumer and Commercial businesses, even when that is not appropriate.

Lenders first must recognize where they fall short in the customer experience they create. But equally importantly, they should understand the barriers to change, many of which the borrower never sees. Although these issues are most pronounced at banks and credit unions, some FinTech lenders are susceptible to these challenges, as well.

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The small business lending experience represents an important opportunity for lenders from banks to FinTech companies. For retail banks, lending is a relationship anchor for acquiring and retaining small business customers. Although many retail banks struggle to profit from small business loans, these offerings can attract higher profit card, merchant services, checking and deposits opportunities. While banks benefit greatly from their lower cost of capital, their pricing moat will become less durable if alternative lenders acquire more stable funding sources, so customer experience will become a more important part of their value propositions.[24]

For lenders in the FinTech space, delighting the customer is necessary to overcome the advantages of traditional lenders. Incumbent financial institutions count among their advantages cost, brand recognition, physical distribution networks and existing customer relationships. True differentiation in customer experience is essentially a prerequisite for FinTech lenders to overcome these advantages and compete effectively with one another. Since some borrowers' needs remain unmet by any lender, these opportunities clearly exist.

24 Recent applications by SoFi and Square to become industrial loan companies represent early efforts by FinTech companies to develop such funding sources

ABOUT OLIVER WYMAN

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.

ABOUT FUNDERA

Fundera is an online marketplace for small business loans that allows small business owners to apply to 30 lenders with one easy common application. Small business owners can come to Fundera for any of their financing needs, from credit cards to SBA loans and everything in between.

Fundera replaces small business loan brokers with software and algorithms, making the process faster and easier to navigate. Since launching in 2014, Fundera has raised $20 MM in equity financing. To date, Fundera has helped over 5,500 small business owners secure over $350 MM in financing on its platform.

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