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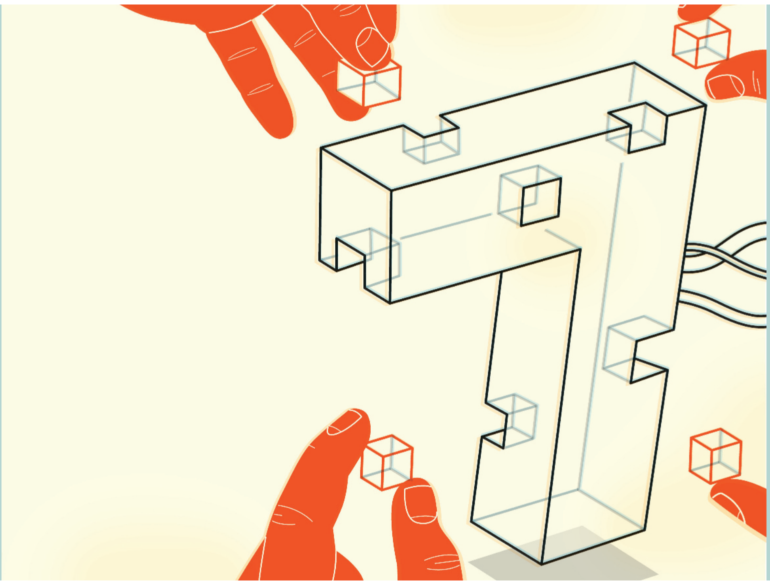
Financial Services Practice



Digital Models for a Digital Age: Transition and Opportunity in Small Business Banking

Introduction

Small businesses are a critical driver of economic growth in the United States, generating about half of the nation's GDP and providing more than 40 percent of jobs. The financial crisis hit the sector hard, but as the U.S. economy recovers and GDP growth improves, so too should the fortunes of small businesses and the banks that serve them.

However, being a great small business bank is getting harder. Advances in technology have opened up the field to attackers, who target some of the most lucrative areas in small business financial services, such as payments and lending. Because these attackers are deploying the latest technology and solving more focused problems, they often provide a much better customer experience – seen, for example, in lending processes that take between a few minutes to a couple of days, rather than a matter of weeks, to complete. And as small business owners and their employees get more comfortable with consumer technology such as iPhones, there is increasing variance among small businesses in how they want to connect with their banks (e.g., differing views on the importance and purpose of a local relationship manager, sensitivity to slower service or more paper-intensive applications).

Succeeding in this new environment will require a fundamental shift for banks — from a traditional set of banking tools to a *digital* skill-set. In recent years, retail banks – particularly small business banking operations – have increased efficiency by automating, simplifying and applying lean principles to core processes. But this focus on systematizing operations often results in a narrow set of products and servicing options on the front end. The result is that banks have difficulty satisfying the needs of small businesses that fall outside of their core target market. So, for example, a newer small business with a short credit history has a hard time getting a loan; another small business struggles to justify the costs of a point-of-sale device for payments processing. This lack of flexibility is not the way to gain small business customers.

At the same time, the emergence of digital technology – multichannel options, big data analytics, high-speed processing and broad adaptability – is enabling attackers in payments (e.g., Square) and lending (e.g., On Deck Capital) to show what can be achieved with a new, clean-sheet, digitally enabled approach to small business financial services. Mass *production* in small business banking is giving way to mass *customization*.

Established small business banking operations cannot turn on a dime, or respond to every threat. But they must find a way to stay ahead of the competition where it matters most: *in lending, relationship management and products and services that reinforce and defend the primary focus* on deposits and lending (e.g., cash flow management tools). To do so, they should take a play from attackers' books, adopting technology to protect their core businesses and grow market share.

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Customers Worth Fighting For

The U.S. small business sector – comprising firms with 500 or fewer employees – employs approximately 60 million Americans, or 40 percent of the work force. According to recent Small Business Administration statistics, small businesses also account for 45 to 50 percent of U.S. GDP. The combined revenues banks receive from both small businesses and their owners' personal banking activities is also significant – representing 20 to 30 percent of banks' financial service revenues (Exhibit 1, page 4). In 2011, this combined stream totaled approximately $160 billion to $230 billion for small businesses with annual revenues of more than $500,000.

Small business banking returns were hit hard by the economic crisis, with revenues from the sector declining by roughly 25 to 30 percent between 2007 and 2010. However, the outlook for the next three to five years is encouraging, with modest revenue-per-customer growth driven by expected rebounds in lending (e.g., secured, unsecured, credit cards), cash management and other treasury and transaction services, and merchant acceptance, as more small businesses accept card-based payments.

Competition is increasing

For banks, maintaining their stronghold in deposits and lending is an economic imperative. But both product categories are open to attack from new players and approaches. Deposits are vulnerable because more small business owners view them as a commodity service and are increasingly willing to move their deposit relationships in exchange for improvements in other parts of their banking relationships (e.g., access to and cost of credit, quality of service). Lending is vulnerable because banks are already starting to cede ground to start-ups and other competitors drawing on big data-enabled approaches, especially for smaller, unsecured loans. These trends represent the leading edge of a broader assault on lucrative small business lending by lightly regulated and more nimble institutions.

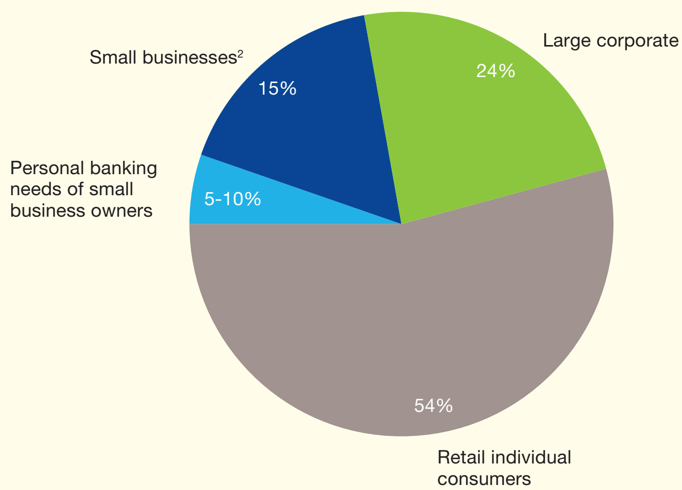
The movement can be understood by looking at current innovations that threaten banks' standing in deposits and lending. For example, American Express and Chase have taken the lead in using credit and charge cards as relationship-building tools: creating communities for small-business cardholders (e.g., American Express' OPEN Forum), linking cards to technology-enabled cash management and reporting services, and offering a host of additional services (e.g., procurement, discounts, payroll) through partner providers. The data these players gather also provides a foundation for a more granular understanding of their customers, from both risk and sales perspectives. Banks should consider the threat these "extras" pose to ownership of primary deposit relationships. (See next page for examples of threats to the core deposits and lending businesses.)

Exhibit 1

Small businesses represent a meaningful portion of overall banking revenue pools

Revenue (fees and interest) after risk cost from U.S. credit[1] and deposits, 2011

100% = $780 billion



[1] Net of charge-offs

[2] Defined as businesses with less than $20 million in annual revenues

Source: McKinsey Global Banking Profit Pools; U.S. Small Business Association

One area of innovation generating significant attention among small business bankers is mobile-based merchant acceptance. Square, PayPal Here, Groupon and other firms are making it possible for anyone to accept credit card payments through a dongle and smart phone or tablet. The direct implications for banks are unclear, but it appears unlikely that dongle-based smartphone acceptance poses a threat.

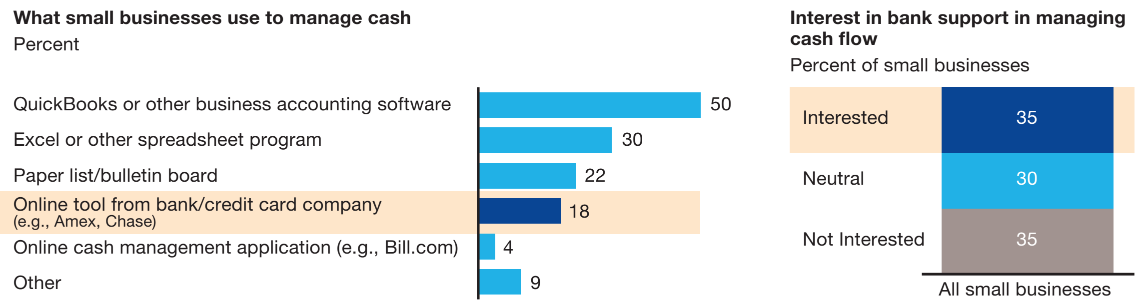
Small business banking innovators

Big data-enabled online lenders: Lenders such as Kabbage, which targets eBay and Amazon marketplace sellers, and On Deck Capital, which targets offline businesses, are creating a niche by underwriting based on businesses' cash flow, and focusing on customers that are too small or too new to get loans from traditional banks. Both lenders have brief application processes and fast turnaround times, enabled by pulling data from online sources (e.g., merchant gateways, bank accounts, social networks). They also leverage the data for risk assessment. These online lenders have not yet encroached on the core of small business lending (e.g., bigger loans, secured lending, credit lines and credit cards); however, an increasing number of small businesses appear willing to pay a bit more for the benefits they offer.

Technology-enabled cash flow management services: Intuit, Bill.com and others are developing intuitive interfaces and software that integrate payments, receivables and online banking data to provide reporting and cash flow management tools. These tools matter to small business owners because they provide guidance on when credit may be needed and when there is excess cash that could be moved to a higher-return account (exhibit). As dashboard-type solutions become the primary financial decision-making platform for some small business owners, the risk grows that banks' deposit and lending products will become commodities on someone else's platform.

Advisory services: Some banks provide training and advice on non-financial business topics, hoping to reduce churn by helping existing customers reduce failures and grow revenues. A variety of models address the needs of small businesses of every size, ranging from low-cost online tools for micro-business owners to on-site visits from industry experts to offer guidance on topics such as marketing and sales, operations and strategic planning for larger small businesses.

Examples of small-business banking innovations



[1] Question: Would you be excited about a primary bank offering that had few branches and emphasized helping you manage your cash flow?

Source: McKinsey Small Business Payments & Financial Services Panel, June 2012

Bank of America's recent announcement of a dongle-based payments solution makes it likely that other banks will follow suit, just as they quickly caught up with market leaders on remote check capture. Additionally, micro-merchants using dongles account for a limited portion of total small business banking revenue pools. Nor do the dongles offer a significant cost advantage – interchange on the products is the same or higher than for many traditional merchant-acquiring options.

On the other hand, easy-to-deploy tablet point-of-sale solutions are beginning to offer a diverse set of small business services. In this case, the implications for banks are more serious because these new players are forging relationships with somewhat larger small business customers that may – at the expense of banks – establish a beachhead for other financial services such as merchant advances, payroll and lending.

The Three Keys to Small Business Banking

Evolving customer needs, new financial services competitors and rapidly evolving technology are creating opportunities and challenges in small business banking. Banks should prioritize their responses in three areas: lending, relationship management and new products and services that help defend the core deposit and lending businesses:

1. Take the pain out of the lending process

Small business loan originations are well below pre-crisis levels and are not recovering as quickly as the underlying creditworthiness of the borrowers. Partly this is due to a decline in applications, but recent research McKinsey conducted with Equifax shows that decreased lending is a two-sided problem. Banks have pulled back on small business lending marketing efforts (e.g., direct mailing for credit cards) and are now competing more intensely for the highest-rated businesses. This shift in focus away from large swaths of the small business market depresses applications, as do exhaustive requirements, which frustrate owners worried about putting a lot of time into applications that may be declined. Thirty to forty percent of small businesses surveyed recently by McKinsey expressed willingness to consolidate their banking relationships (i.e., move deposits) to a provider that could lend without such time-consuming applications and with more certainty around the approval process. To jump-start lending in a risk-appropriate way, banks can take several steps (some of which may seem obvious, but are frequently lacking in many banks):

- Simplify applications by asking only for information that will affect the underwriting decision; limiting wherever possible the number of pages and attachments businesses have to submit; and pulling data in an automated way from online banking sites.

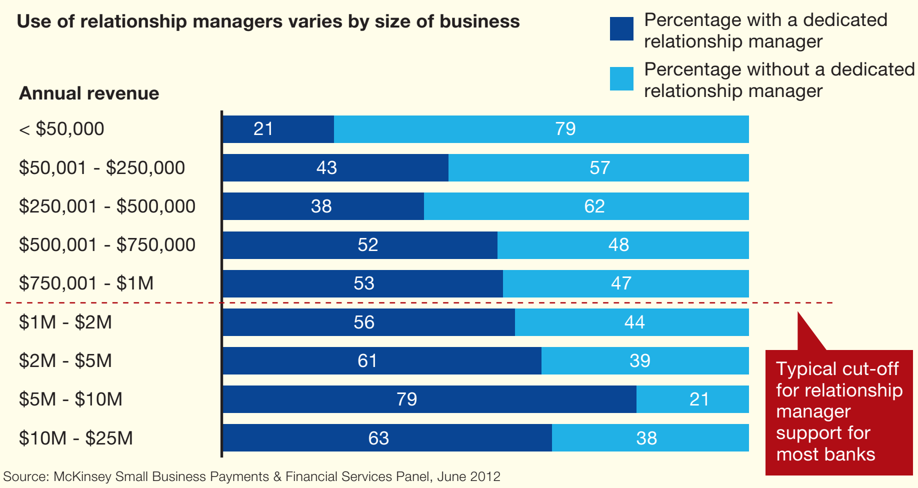
- **Approve easier-to-underwrite loans more quickly.** For instance, develop "flight paths" for different loan types; that is, process lower-risk loans automatically, and give higher-risk loans more in-depth treatment.
- **Allow relationship managers to focus on sales and customer support** by shifting more of the administrative burden of processing loan applications to centralized teams.
- **Make use of all of the data already available.** As an example, banks can use the checking account, merchant acceptance or credit card data they have on their small business clients to identify high-potential customers, give tentative pre-approval, reduce the hassle of applications and lower the amount of time required to underwrite.

2. Practice value-based relationship management

Relationship management drives acquisition and sales and can be a deciding factor for customers considering switching banks. The challenge for banks is that relationship management often represents the single biggest line item in the cost of serving small businesses. Many banks struggle to align their limited relationship management capacity against the relative value and needs of small businesses (Exhibit 2).

Exhibit 2

Banks struggle to find the right alignment of relationship management capacity and customer size



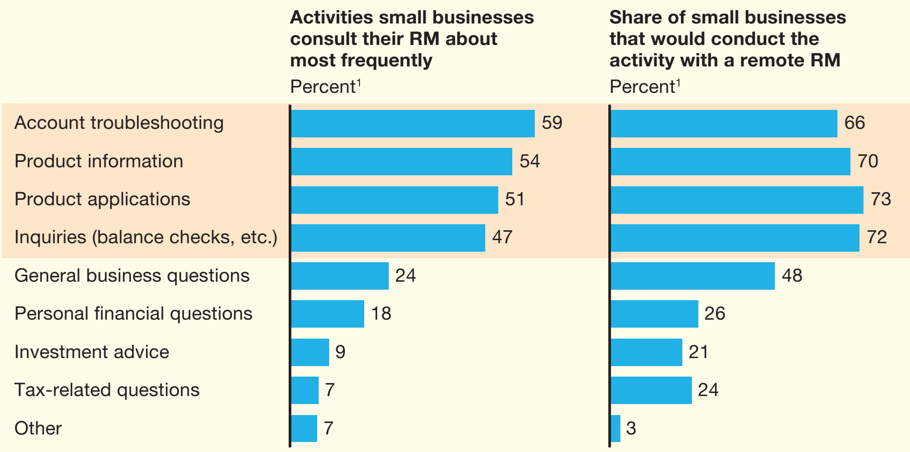
Source: McKinsey Small Business Payments & Financial Services Panel, June 2012

Banks can reduce relationship management expenses without unduly impairing service. Videoconferencing can provide small businesses with consistent levels of attention with fewer relationship managers (RMs) – time once spent traveling from one customer to another can now be dedicated to serving more customers remotely. Nearly half of Europe's leading banks have implemented or are testing remote RM approaches, among them Spain's Bankinter, which won awards for its innovative service model, Netherlands-based ABN AMRO and Britain's HSBC. In the U.S., there is evidence that some top banks are moving to a remote banker approach for small business customers in the lower end of the market who are better served by a remote expert. Remote bankers play a role in deepening existing customer relationships and also in acquiring new clients identified through referrals and leads from branches.

McKinsey research reveals that half of small business owners are receptive to working in this fashion. The data showed no meaningful impact on the satisfaction levels of small businesses already using remote relationship management tools. Most owners would use RMs for the same services regardless of location (Exhibit 3). Some businesses, such as retailers, prefer in-person meetings, so banks will need to balance the benefits of remote RM staffing with evolving customer preferences.

Exhibit 3

Most small businesses are open to the use of remote services for their most frequent banking activities



[1] Percent of small businesses surveyed that currently have a dedicated relationship manager and are comfortable moving to a remote model

Source: McKinsey Small Business Banking Survey, 2011

Remote models may provide a further benefit. Today, there is limited room for growth for an employee who becomes the lead small business RM in a branch. Typically, most of the branch's business will be on the consumer side, so promotion to branch manager is less likely for small business specialists in many banks. As banks move to remote channels, creating centers of competence and more leveraged models, growth opportunities and career options for small business RMs should increase.

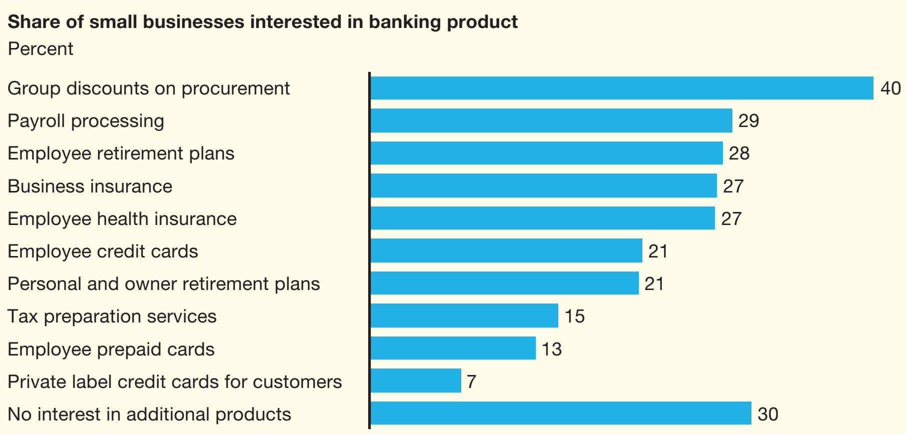
3. Go beyond core products and services

McKinsey research shows that small businesses are increasingly interested in non-core banking services such as procurement discounts, payroll and employee retirement plans (Exhibit 4). For banks, offering additional products and services can deepen relationships, increase access to data and grow revenues; but not all such opportunities are worth pursuing. To prioritize, banks should focus on products and services that meet at least two of the following criteria:

- Provide meaningful revenue pools (e.g., employee benefits)
- Are easy to offer, especially through partners (e.g., payroll)
- Help defend core deposits or lending business (e.g., cash flow management tools)

Exhibit 4

Small businesses express interest in a range of non-core banking products and services



Source: McKinsey Small Business Banking Survey, 2011

A number of banks in Europe and the U.S. are already experimenting with products and services tailored to the needs and preferences of small business customers. Those that can test innovations quickly will have a valuable head start (e.g., American Express and Chase with small business credit cards).

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The U.S. small business sector is vast and diverse, presenting a substantial revenue and profit opportunity for a range of financial services providers. The needs of these millions of small businesses continue to evolve, and more and more of these needs are being met by more nimble attackers. To protect their core businesses, banks must deliver meaningful value to customers without adding unnecessary complexity and cost, and they should embrace the use of technology to bring differentiated experiences to these important clients.

The McKinsey Small Business Payments & Financial Services Panel

Conducted in June 2012, the McKinsey Small Business Payments & Financial Services Panel includes responses from more than 1,000 small business owners. Topics covered include banking preferences and market innovations (e.g., remote relationship management, credit and lending, cash management, business-to-business payments), financial product penetration (e.g., demand deposit account balances, loan utilization), assessment of provider services, outlook on economy and business growth, and outlook on mobile commerce adoption.

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