WHITE PAPER

BANKS! IT'S TIME TO CHANGE YOUR GAME IN SME LENDING WHY AND HOW

Abstract

Small and medium-size business enterprises (SMEs) are vital for the economic growth and competitiveness of any country; hence supporting the SMEs' financial needs is crucial. For banks too, SMEs form a key and loyal customer segment. Unfortunately, in spite of these factors, the recent years have seen significant unbundling in the banks' SME lending business across the globe. Consequently, the historic strong relationship between banks and their SME customers has gradually begun eroding. If banks do not change their approach towards the SME lending business, they risk losing – forever – a major portion of this very important customer segment to the alternative SME lenders. It's therefore the need of the hour for banks to thoroughly review and transform their SME lending business. This white paper provides insights on the market disruptions being rendered by alternative SME lenders, the key challenges faced in banks' SME lending business, and recommendations for banks on ways to transform their SME lending business.

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Overview

Small and medium-size business enterprises (SMEs) are crucial for the economic growth and competitiveness of any country. Consider this – in the USA, small businesses comprise 99% of all companies, employ over 50% of the country's private sector workforce, contribute over 50% of the non-farm GDP, and for the past two decades have created around two-thirds of the net new jobs.

Similarly, in Australia, the nearly 2 million SMEs make up for around 70% of all industry employment. In the UK, the SMEs employ nearly 60% of the private sector workforce. And most of the innovations across all geographies happen through the SMEs.

From the aforementioned, it is obvious that supporting SMEs' financial needs is crucial to a country's growth. Having seen this, it is no wonder that in recent years, policy makers in many countries (for example US, UK, and the EU) have embarked on initiatives to encourage SME lending. For banks as well, SMEs form a key and loyal customer segment. Unfortunately, despite such positive factors, the recent years have actually seen significant unbundling in the banks' SME lending business. SME lending on the banks' balance sheets have decreased significantly, even as their loans to large businesses continue to rise. Consequently, the historic strong relationship between banks and their SME customers has gradually begun to erode. If banks do not change their approach towards SME lending business in earnest, they risk losing – forever – a major portion of this very important customer segment.

Market Disruption by Alternative SME Lenders

Banks are facing increasing competition from the alternative SME lenders such as online peer-to-peer lenders (e.g. Prosper, Lending Club, and Funding Circle), payments companies (e.g. Paypal, Square), online balance sheet lenders (e.g. Kabbage, OnDeck), lender-agnostic marketplaces (e.g. Biz2Credit, Fundera, Lendio), and others. These alternative lenders have been leveraging their multi-year experience and automation investments to originated SME loans in huge volumes, over the past few years. They have also been using technology innovatively to simplify the lending process, enhance speed, provide price transparency, improve customer experience, and reduce SMEs' borrowing cost. Refer Figure 1 for key illustrative capabilities of alternative SME lenders' solutions.

Alternative SME lenders' solutions: Key illustrative capabilities		
Innovative and robust technology platform		
Customer portal; partner API and portal	Access to **databases having millions of SMEs' information; 1000s of data points automatically evaluated**	**Real time risk profile assessment** using a myriad of traditional (e.g. personal credit history) and alternative data (Yelp reviews on business, predictive indexes on current cash flow data from Quick Books entries and bank accounts)
Highly automated pricing and decision engine	**Data collection from numerous sources** (online banking, social data, credit bureaus, payments data)	**Real-time analytics** capabilities; model monitoring and revalidation
Cloud-based credit scoring, backed by big data analytics	Lending decisions using **predictive modelling,** data aggregation	Much **lower operating expenses**
Superlative customer experience		
Quick application with minimal to nil paperwork	**Fast funding** approval	Takes **2 weeks or less for funding** (good number of loans get disbursed within 48 hours)
Less expensive loans as compared to daily payment loans	**Enhanced price transparency**	

Figure 1 – Alternative SME lenders' solutions: Key capabilities

Banks' SME Lending: Key Challenges

Refer Figure 2 for key challenges faced in SME lending from the banks and Figure 3 for key process issues in the banks' SME lending.

Key challenges faced by SMEs		
Banking consolidation	**Lack of support from banks**	**Stricter collateral needs and covenants**
Large scale banks' consolidation resulting in significant reduction in SME lending (e.g. No. of community banks in the US have dropped to less than 7,000 today from over 14,000 in 1984)	SMEs believe that **banks don't understand their needs or support them well** (only 1 out of 5 SME loans get approved by banks)	In many countries (e.g. Australia), in addition to usual financial covenants like leverage ratio, minimum interest coverage or current ratio, **lenders apply many other non-financial covenants** (e.g. restrictions on business mergers and acquisition, any considerable changes in the SME's business, etc.)
Community banks, which form a major source of SME lending, **have been getting absorbed by large banks**	Banks still **focus on traditional service and sales models,** and which are unaligned with today's SME needs	In recent years, **the value of real estate, which make up the majority of the SMEs' assets and collaterals, have reduced immensely. Many banks today prefer liquid collateral over real estate**
	Many banks **refuse to lend to certain SME categories** (e.g. restaurants, or SMEs with less than $2 million in revenue)	**Many SMEs lack the credit score, cash flow, or collaterals that banks are asking for** – e.g. requirement for proven track record for many years, owner having high (>680) personal FICO score, etc.
	Many big banks **simply refer their SME customers to their costly small business credit card products** for low-value loan requests	
	SMEs **spend over 25 hours simply on their loan request paperwork,** and have to approach numerous banks with their application	
	Successful loan applicants have to wait for weeks, or even months for the funds to get approved by the bank	
Key challenges faced by banks		
Dynamic SME sector	**Fast-evolving SME needs**	**Regulatory**
SMEs are highly sensitive to changes in economic environment, usually operate in risky markets, and have higher rate of failure	SMEs' **needs are evolving fast;** loan is no longer their sole expectation	In many countries, in addition to myriad new regulations, **banks are also uncertain on the implications these regulations have on their lending businesses.** Consequently, banks are averse to lend based upon "softer" underwriting criteria like long standing relationship with borrower, etc.
Are amongst the most **challenging customer segments to acquire**	They **expect banks to provide innovative and personalized services, and sound advice on banking products and on their wider business issues**	**Regulations like Basel III, with their increased capital requirements, have reduced the banks' available funds for lending** – with SMEs getting the most adversely impacted
Are **heterogeneous, active in large number of sectors, and difficult to segment using the conventional banking models**	Expect **superlative multichannel delivery**	**Banks have to hire additional staff for focusing on regulatory enforcement** – this has adversely impacted the banks' ROA
Banks face **difficulty in specializing in, and targeting, a particular SME market segment**		
Owing to SMEs' heterogeneity, banks have been **unable to develop optimal general standards for assessing the loan application**		

Credit assessment	Process
Conventionally, **banks' SME lending has been strongly relation-based** (e.g. borrower's management skills, business acumen, and attitude towards indebtedness have been considered)	Many **banks' SME lending processes are paper-intensive, manual, and cumbersome**
However, in recent times, with the move towards algorithmic and sophisticated credit assessment models, **banks are facing shortage of skilled staff to assess the borrower's credit-worthiness**	Many **lack online application feature, automated approval process, or the automated pricing capability**
Many SMEs lack documentation on income statements, balance sheet, operating performance, etc. Also, **none or very limited public information on their performance is available** - as SMEs rarely issue debt securities or publicly trade equity	Lack of process and workflow automation, and lack of an online platform are **key reasons for many of the SME lending process issues**

Figure 2 – Key challenges faced in SME lending from the banks

Banks' SME lending process issues	Adverse impact on SMEs
• **Failure in following established policies and procedures** - in desperation to gain new SME customers • **Origination** – inordinate focus on **manual data collection and entry** • **Credit analysis / sanctioning – multiple and redundant credit decision levels;** long lead time in communicating lending decision to borrower • **Monitoring - long reaction time** for deteriorating credit quality • **Portfolio management - problematic data usability / availability at firm-wide aggregate level** • **Workout / recoveries** – long reaction time due to **fragmented and inconsistent documentation (e.g., on collateral)** • **Loss data management usually happens through Excel sheets, access databases, etc.** Approach is reactive – data collection happens post-default • **Document management solutions are not always integrated with the loan origination or other processing system,** leading to manual and redundant entry of loan information	• **High underwriting, transaction, and search cost** • Prospective borrowers **asked to provide much more documentation than is necessary** for judicious underwriting • Many banks **enforce the same application and the underwriting processes for all of the loans** – irrespective of the complexity and size of the requests, or the borrower's risk profile. Consequently, **the transaction cost to process a $2 million loan is the same as for a $100,000 loan** • It is **difficult and time-consuming for qualified SME borrowers to find a willing bank lender,** and vice versa • Process inefficiencies lead to **high TAT, lack of predictability and transparency for borrowers**

Figure 3 – Banks' SME lending – Key process issues

Recommendation for banks

So what should banks do to raise the game in their SME Lending business? The following are our key recommendations.

- **Engage SMEs early and use judicious segmentation:** As SMEs usually do not switch easily from a bank with which they already have established relationship, banks' focus should be on acquiring them at an early business stage. Implementing needs and value-based SMEs segmentation is crucial, as investments needed by each of the segments is quite different. For effective segmentation, customer size, business profile, desired products and services, credit rating information, and depth of client's existing relationship with the bank, are some of the crucial parameters to be considered. Judicious segmentation would help banks design granular processes for the specific segments. Instead of trying to focus equally on all SME segments, banks should identify some of the key segments that they could profitably target.

- **Prudentially differentiated rating process:** Considering SME loan sizes are relatively small and that there is intense competition from alternative lenders, banks should innovate and optimize the huge efforts spent by their skilled rating analysts. They should not have their rating analysts thoroughly review all of the lending applications. Rather, the loan review and approval process can be tailored, making it a function of the borrower's risk profile, loan value, and other available relevant information on the borrower. The banks' loan processing costs can be significantly reduced if application routing is prudently done through a differentiated, streamlined, and automated decision-making process, which is in turn based on risk-adjusted decision-making and pricing model. The banks' existing lengthy loan review and approval process that is used commonly for both the SMEs and larger corporates must be abandoned and a simplified process should be put in place instead. In the new simplified process, a fully automated lending system (similar to those used in retail lending) for credit evaluation and decision-making should be enabled for some of the SME segments and loan types. Low-value lending products for the SMEs that have strong credit history could be routed through this fully automated lending process. Similarly, SMEs that have good credit rating, and long-standing profitable relationship with the bank, could be provided with pre-approved credit limits. This will help forgo the need for running expensive, new loan evaluation and approval processes each time. Also, for complex and risky loan requests that also need human analysis and judgment, appropriate levels of decentralized and localized decision-making should be enabled.

- **Advice and support:** To gain traction from early-stage SMEs, and also to increase their fee income, banks need to provide the SMEs more than just funding. The additional value-added services from banks could include bespoke business advice and guidance, practical business support, and more. Offering a tiered range of value-added services is recommended – from providing elementary credit control templates and guidelines, to enabling online business management newsletters and tools, and from HR and legal advice tools, to enabling working capital advice platform. Banks could leverage their online channels not just for marketing their own services and products, but also those of their key SME customers. Additionally, banks can leverage their online platforms to enable virtual communities for the SMEs to connect with each other and with prospective customers and promote their products. Such initiatives can help enhance the SMEs' trust in, and stickiness with, their banks. A bank's endeavor should be to become the 'main provider' for an SME, as SMEs have proven to stick with their main bank for their other financial needs (e.g. deposits, revolving credit etc.).

- **Digitalization:** Banks should provide SMEs and their own staff with multi-channel self-service capabilities. For example, they should enable online dashboards to aid performance visibility and stakeholders' management. Similarly, enabling an online portal would strengthen the SMEs' self-service capabilities. Digitalization focus should be on enhancing the SMEs' experience – through features like user-configurable and graphical dashboards, and workflow management tools. Designing flexible digital platforms that provide end–to-end services and offer a range of choices to SMEs is crucial. Banks' omni- / multi-channel lending life cycle capabilities should provide for easy online application, low documentation requirements, document imaging capabilities, expedient underwriting, and funding, digital exchange of documents across the life cycle, graphically enriched cross-selling and what-if scenarios generation, online credit assessment and monitoring, intuitive wizard-driven interface, GUI-based parameterization, and more.

- **Virtual Relationship Managers (RMs) and Social Media:** Enabling remote virtual RMs would help banks enhance their responsiveness to SMEs' needs and also aid in lower cost-to-serve achievement. Virtual RMs can be made available through online messaging tools and through telephone. An online feature to book appointments with RMs for face-to-face discussion should also be provided. Further, SMEs periodically look for new ideas and answers to their pressing challenges. Hence, banks can enable a social platform-based community tool where the SMEs and their customers could connect and share insights.
- **Mobile:** Robust mobile channel capabilities should be made available to SME customers and to the banks' own support staff. Banks' RMs can be provided with mobile devices to help them effectively manage client relationships, loan marketing, origination, and more. Similarly, bank's senior treasury personnel should have access to mobile features like advanced alerts, transaction approvals, payments initiation, cash management, FX services, exception management, and other relevant features. Transaction approvals, balance checking, flexible account management, payments, calendars and scheduling, FX services, alerts, and basic reporting are some of the key features expected by SMEs and banks' staff. Evangelizing the SME customers and banks' staff on the benefits of the mobile channel, are important. In addition to the smartphones' capabilities, banks must also enable robust tablet channel capabilities. For example, banks can provide their field staff full-capability lending tablets comprising tablet-specific lending applications, online dashboard for viewing the SMEs' cash flow and accounts, create what-if scenarios, and more. Having tablet specific applications with video functionality can also allow banks to co-create their product and services by engaging virtual focus groups and customers in ideating for and testing of the new services and products.
- **Analytics:** Banks can improve their lending decision by using advanced and next-generation analytics, BI, and big data tools. Investment in a borrowers' data consolidation solution is needed, to allow for effective portfolio analytics capabilities such as proactive identification of loan covenant noncompliance, credit-quality-deterioration prediction, risk assessment of payment default, etc. The solution should have scalable, flexible, and standardized data management architecture. Banks, especially the larger ones, have information on millions of SME customers' activities within the business' accounts. This information goldmine should be leveraged for predictive model creation. For developing the credit-scoring algorithms, banks should leverage big data solutions on the internal and external structured data, as well as the external unstructured customer data (e.g. from blogs, tweets, product, and business reviews).
- **Automation and cloud:** Automating and optimizing the end-to-end lending process is important for banks. They can consider implementing consolidated lending platform (having well-integrated origination, underwriting, and servicing capabilities). Such a platform would enhance information visibility, improve data management, enrich client-experience, enable collaboration, provide automated workflow based on deal value, and support STP capabilities. It would also enable easy business-rules configurability, provide integrated customer view (including profitability across product holding), augment effective relationship life cycle management, support self-service productivity tools implementation, and more. For lending systems integration, balanced and intelligent integration rather than "full integration" should be the way to go. Focus should be on optimizing the manual tasks and minimizing the repetitive manual data entry across applications. Refer Figure 4 for key expectations from the SME lending automation. Banks can also consider leveraging vendors' advanced cloud-based solutions, as appropriate. For example, quite a few banks have a case for sun-setting their unwieldy and complex legacy LOS systems and replacing these with robust cloud-based solutions. Using SaaS-based solutions can especially be considered by banks for fraud checks, regulatory compliance, document preparation, automated underwriting, and real-time sanctions screening. Today, credit scoring is also being enabled through a new generation of cloud-based organizations like Skyscorer.

SME lending automation – Key expectations			
Single source system for collateral management	Loan management system **integration with eBAM capabilities**	**Automated servicing platform** supporting customer service, loan setup, default management	**Automated underwriting** based upon the loan / product sizes
Integration with external databases and tools (social tools, credit rating agencies, etc.) **and with bank's core systems** (using open architecture)	**Workflow system having automated data feeds;** minimal need for manual data-entry	**Holistic decision engine** backed by predefined algorithms	**Automated data collection tools** for feeding into risk models
Robust portfolio monitoring system	**Automatic customer data synchronization;** improved Universal Customer Identifier (UCI) and obligor data management	**Central capturing and indexing of documents;** centralized document repositories with role-based access across organization	**Centralized loan monitoring system;** advanced automated reporting capabilities

Figure 4 – Key expectations from the SME lending automation

SME lending initiatives by proactive banks: Examples

Refer Figure 5 for examples on SME lending innovations and initiatives by proactive banks

SME Lending: Examples of initiatives and innovations by proactive banks	
Barclays / HSBC	Barclays **launched 'MyBusinessWorks' - a fee-based service for the business start-up customers**
	HSBC **opened its e-Masterclass-Global Knowledge Center for the SMEs' learning.** The Center also comprises free learning modules
RBS	**Refers its SME clients, who have been turned down by it for loans, to P2P lenders – Assetz Capital and Funding Circle**
Wells Fargo	Has been **offering business owners an online financial education portal (Business Insight Resource Center)** – comprising relevant award-winning articles, videos, podcasts, and other resources. SME owners can access the Business Credit Center on the Business Insight Resource Center
BankInter	Its **SME customers can use its virtual channels to interact with the bank's staff via the online video conferencing**
	It also **launched its 'Mobile Virtual Network'** in partnership with the Dutch telecom operator KPN, to reduce the customer's data transfer cost
Leumi Bank	Israel's leading commercial bank had launched **'Leumi V' application that delivers face-to-face contact for the customers** at their desktop and through mobile devices
Jack Henry and Associates	Had introduced the **"Commercial Lending Center" - a hosted portal to allow community financial institutions to attract more business borrowers by enabling a more convenient loan application and management cycle.** Using the Center, community institutions can accept commercial loan applications 24/7, online, and better manage the workflow process – thereby enabling faster response times
	The center **enables financial institutions to compete with alternative lenders and also expand their relationships with businesses** that do not generally qualify for the traditional loans
HSBC	Is **increasing its lending to UK SMEs by more than 25% in 2015**
	It would also be **waiving certain fees on the SME loans**
PNC	**Developed an SME version of its popular PNC Virtual Wallet online tool** to help the SMEs better manage their finances
SunTrust	Through its **"Business Class Banking" program offers its SME customers business advice, enables better understanding of the industry-based cash flow cycles and debt management programs**
RBC	**Uses Nomis Price Optimizer 3.3 across its multiple lines of business to better execute its customer-centric approach** and quickly identify opportunities to grow its SME business

Figure 5 – Banks' SME lending innovations and initiatives

Conclusion

It's the need of the hour for banks to thoroughly review and transform their SME lending business with the leading goal of delivering superlative services that the SME customers have begun to expect. For banks, being complacent in this business is no longer an option with the irreversible onward galloping of alternative SME lenders. Banks should work towards innovating and growing organically in their SME lending business; and also, wherever appropriate, can look at entering into joint ventures with some of these leading alternative lenders as a strategic tool.

About the Authors

Anjani Kumar

Principal Consultant, Consumer & Commercial Banking group, Infosys

Anjani Kumar has over 17 years of comprehensive IT, domain and process consulting experience. Currently, he manages several strategic initiatives including the Competency Development Program and Thought Leadership showcasing efforts. Over the years, he has provided consulting services and managed many large and critical IT engagements for numerous key clients. He was also recognized as the lead process auditor for the IT division of a major global bank. He has extensive techno-functional skills and an in-depth understanding of quality and process models – CMMI, Six Sigma, ITIL, etc. Anjani holds a Bachelor of Engineering degree from IIT Roorkee and, over the years, has earned many reputed and industry-recognized domain and process certifications.

He can be contacted at anjani_kumar@infosys.com

Chetna Kothari

Senior Consultant, Commercial Banking group, Infosys

Chetna Kothari has over ten years of combined experience as IT Domain Consultant and Portfolio Manager, specializing in Commercial Banking and Wealth Management operations. Over the years, Chetna has consistently participated in the successful delivery of complex programs for large organizations spanning geographies. Her engagements span a major banking organization that operates across Australia, New Zealand, and the Pacific region; a leading U.S. bank; and one of the biggest banks in Switzerland that is also the amongst the world's largest private wealth managers.

She can be contacted at chetna_kothari@infosys.com