An EMI Industry
Intelligence Report

The Transformation of Small Business Banking

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There's great outcry in the national media that because of the continuing credit freeze, small businesses are unable to get urgently needed loans and lines from TARP-rich banks.

EMI set out to learn the truth:

- Are creditworthy small businesses being denied lines and loans?
- Are trade terms not being extended and are businesses being asked to put up more collateral?
- Are decision criteria so much more rigorous than in the past?

And based on what we learned, we've assessed the impact of the lending environment on the role of the business banker and on bank profitability.

EMI Strategic Marketing

No Longer Business As Usual

It's important to look beyond lending to what today's financial environment means for business bankers.

In today's uncertain financial environment, there's a great deal of conflicting information on the extent to which banks are lending to small businesses and what the government's actions are likely to achieve.

- The Obama administration is working hard to revitalize SBA lending programs, while pushing the TARP-funded banks (which they earlier accused of reckless lending practices) to now lend more.
- Small businesses claim they can't get the funding they need and are laying off staff in their failing businesses — and screaming about it to the media.
- CEOs of banks large and small claim they're still lending to the creditworthy and protesting loudly against the public backlash through the financial press, as well as on their websites.
- At the same time, the Federal Reserve and National Federation of Independent Businesses (NFIB) tell us that while loan demand is down, most of the small businesses that need loans are getting them.

This white paper provides insight into what's really going on in lending practices today. We look beyond lending to what this means for the role of business bankers, and provide recommendations on the direction banks should be taking to help their small business customers ride out this storm.

Getting at the Truth behind Lending Denials

On March 16, the Obama administration reported that it had authorized the SBA to support $28BN in lending guarantees. They are also financing the purchase of highly rated SBA loans and working on a small business and community bank lending initiative. This is in addition to the previously announced liquidity to be provided through TARP and TALF funding (Term Asset-Backed Securities Loan Facility).[1]

Even more important, the American Recovery and Reinvestment Act, signed into law February 17, 2009, also contains a range of incentives and enhancements:

- Loan fee waivers;
- Higher guarantees (now up to 90%);
- New programs such as the Business Stabilization Loan, a deferred-payment loan of up to $35,000 to small businesses that need to make payments on an existing, qualifying loan for up to six months; and
- Secondary market incentives.

Since its passage, SBA average weekly loan volume has risen 21.7%, to $146MM.

But simply providing funds to the marketplace doesn't mean the end of the credit freeze — or that the banks will make enough loans to significantly impact small business stability or growth.

Customers of the largest banks, including the regionals, report that they are nearly twice as likely to be denied credit as those patronizing local or community banks.

According to Federal Reserve statistics, banks are lending at record levels, with Commercial and Industrial (C&I) loans at $1.6 trillion in early November, up 15% from a year earlier and growing at a 25% annual rate over the previous three months. However, most of this new lending was against credit lines opened before the economic crisis was full-blown.[2]

At the same time, small businesses' contention that it is more difficult to obtain credit is supported by industry data: the Federal Reserve's latest Senior Loan Officer Opinion Survey on Bank Lending Practices reported that 69% had tightened standards for approving applications for C&I loans or credit lines to small firms over the past three months.[3] 88% had widened spreads of loan rates over the cost of funds for C&I loans. And in the same survey, 65% of loan officers reported that demand for C&I loans from small firms was moderately or substantially weaker. In addition to lowered demand, the lack of a market for securitized small business loans further reduced banks' appetite for lending.

So what are small businesses themselves reporting through the National Federation of Independent Businesses?[4]

- **Demand for loans is down:** 30% of small employers applied for credit between early September and mid-November, with over half applying more than once. Of the 70% who did not seek credit, 8% said they didn't apply because they expected to be turned down.
- **Credit is available for qualified applicants:** 49% of the applicants obtained all or most of the credit they wanted; another 14% obtained some of the credit. Only 34% could not obtain credit — *or approximately 10% of the population were denied.*
- **Credit card lending has tightened and is getting worse:** 8% of the NFIB small businesses applied for a credit card. Of the 45% approved, 38% received satisfactory credit limits and terms.
- **New originations for lines of credit are even tighter:** 9% of NFIB small businesses applied for a line of credit. 21% received the amount they needed and favorable terms, and 9% received less than favorable terms.

Getting to the Heart of the Matter

There's clearly confusion in the media — especially in TV and newsprint — about loan availability and denial. Too many journalists are making blanket statements about banking industry behavior without considering that its constituent parts behave very differently — from national and regional banks to smaller local and community banks, to credit unions, non-profits and even private, alternative sources of funding.

Customers of the largest banks, including the regionals, report that they are nearly twice as likely to be denied credit as those patronizing local or community banks. And the large banks are not as easily renewing prior revolving lines of credit.[5] Looking at their financials, one can easily understand why.

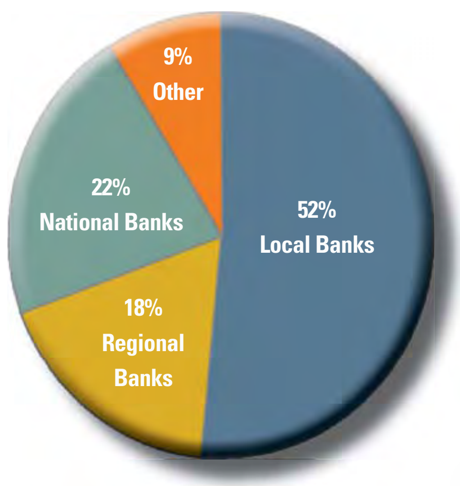
More than 50% of small businesses have their primary lending relationship with a local bank.

Loan Losses Are Significantly Impacting Profitability
Bank of America: From October through December 2008, Bank of America took permanent losses on about 2.9% of its outstanding small business loans — an annual loss rate of almost 12%[6] — nearly double its past year's performance. Approximately 60% of its small business loan portfolio is credit card based, and cards represented 75% of its charge-offs for the year. In addition, other losses occurred as the result of its decision in August 2006 to offer unsecured lines of up to $100,000 to start-ups. It has now discontinued that offer to that segment.
Chase: When reporting higher than anticipated business banking losses, Chase reported that loan origination volume was $0.8BN in 4Q08, compared to $1.2BN in 3Q08 and $1.7BN in 4Q07.
Advanta Bank: Credit card losses continue to increase. Advanta's managed net charge-off rate on its small business credit card portfolio grew to 11.99% in 4Q08. As a result, it recently announced a "return to basics," with a focus on current profitable customers and a slowdown of prospect acquisition.
SBA Programs: The SBA reported that losses from loans through its own lending programs more than doubled in 2008, reaching nearly $1.3BN.

Banks Are Making Loans

Banks are still lending — although the smaller banks, which have suffered fewer losses than larger banks, appear to be a more likely source of funds for small businesses. And while Congress and the American public are questioning what the large banks are doing with TARP funds, the 288 small- and mid-sized banks that received $78.8BN are clearly using TARP funds for their intended purpose.[7]

That smaller and regional banks are lending portends well for loan applicants.



A recent Small Business Research Board study reports that 52% of small business owners or managers said that their primary lending relationship was with a local bank, while only 22% named a national institution.[8]

However, it is important to point out that the larger banks have not stopped lending — but they have tightened underwriting criteria and loan terms to offset risk.

Banks large and small are still making small businesses loans, and they're reporting on their continuing lending to local and national media.

A Snapshot of Lending Leaders	
Local	*MidSouth Bank,* based in Louisiana, increased its total loans 6.9% to $609MM in 2008. The bank expects to continue to increase lending in 2009 by 3% to 4%.[9] *Pacific Continental Bank* renewed or originated 1,500 loans totaling more than $580MM in 2008, growing its total loan portfolio by 16.2%. Its CEO is calling for more lending, stating that "It's time we fire up our community economic recovery engines by giving credit where credit is due."[10] *Valley National Bank* in New Jersey is aggressively lending but is requiring more collateral for secured loans and a larger down payment (20% rather than 15%) for commercial real estate-related loans.
Regional	*Capital One Bank* is taking advantage of larger banks' exiting or slowing down lending to expand its market presence.[11] Its National Sales Manager for small business banking reported that while the bank has seen some drop-off in loan requests, it's seeking new business opportunities and has dollars "available for small-business lending consistent with past lending levels."[12] *Comerica's* small business loan portfolio increased 5% in 2008, to $4.24BN, although there was a decline between 3Q and 4Q. *M&T Bank* grew its C&I loans 13% in 2008.[13] Its annual report also states that TARP has brought with it pressure to lend, but at a time when loan demand is limited and the small businesses most in need of credit are those least able to repay. *Zions* is aggressively lending in Utah and Idaho, combining its $1.4BN TARP funding with its savings from cutting its dividend 26%, plus $300MM from securities sales.[14]
National	*Bank of America* continues to support small businesses as "a critical driver of the U.S. economy," reporting on its website that in 2008 the bank extended almost $4.8BN in new credit to nearly 250,000 small business customers (those with <$2.5MM in revenue and <$250,000 in credit exposure). On March 9th, CEO Ken Lewis' Op-Ed in the *Wall Street Journal* stated that according to the Federal Reserve, business lending is "trending up modestly so far" in 2009.[15] *Wells Fargo* reports it hasn't changed its approval processes, nor its availability of funds for business loans, claiming that its underwriting processes are the same today as 5 to 10 years ago. It looks at three years of tax returns and financial statements, corporate and personal, and may also review inventory and accounts receivables reports. In addition to personal assets and credit scores above mid-600s, Wells Fargo expects a level of industry experience in the guarantors. But it will also lend to start-ups and early-stage businesses in certain industries.[16] And it made 2,775 SBA loans nationwide last year (totaling $659MM), often with a focus on women-owned and other minority-owned businesses.

Credit unions are seeing a rise in business lending — from $28BN in 2007 to $33BN in 2008.[18]

Changing Times Call for Changing Terms

There is funding out there for creditworthy applicants. But key issues for the banks still lending are their nonperforming asset and charge-off rates. As a result, banks are changing the terms of such loans in order to generate significant net interest income to offset risk, with small banks charging higher rates than their larger counterparts.

Loan Rates Offset Risk
Average Domestic C&I Loan Rates, February 2-6, 2009[17]

Loan Size	Small Banks	Large Banks	All Banks
$7.5K - $99K	5.36%	3.41%	4.19%
$100K - $999K	4.99%	3.20%	3.68%
$1MM - $9.99MM	4.73%	2.69%	3.02%
$10MM and up	–	2.85%	2.88%

And changes to terms are particularly evident in small business credit card portfolios:

- **Business credit card pricing:** CreditCard.com reported that business card offers had an APR of 16.74% at the start of February 2009, compared to 10.46% at the start of August 2008, and this rise occurred during a period where banks' cost of funds fell sharply, to practically zero.
- **Revolving credit terms:** Numerous press stories and blogs have appeared in which cardholders with large balances or large lines of credit are being asked to pay down their balances faster, agree to higher APRs on those balances, or have had their available revolving lines reduced or eliminated.

Small Businesses Are Turning to Alternative Financing

With national banks wary of extending credit, many small businesses are turning away from their primary banks and looking at a broad range of alternative sources.

- **Credit unions:** Approximately 27% of U.S. credit unions offer business loans, and the amount of their business loans rose from $28BN in 2007 to $33BN in 2008.[18] The credit union industry is putting pressure on the government to raise its cap on small business lending. (Since 1998, the amount of business loans a credit union can offer is capped at 12.25% of assets.) The industry argues that raising this cap could lead to $10BN in additional business lending in the next 12 months.
- **Non-bank lenders:** There are hundreds of local organizations like Acción USA, the country's largest microlender, which has local state operations that offer small credit lines (often up to $10K) primarily to minority-owned businesses. In addition, factoring organizations and other asset-backed lenders, such as AdvanceMe and Amerisource Funding, have sprung up to provide merchants with cash advances against receivables or other collateral.

What This Means for Banks Large and Small

Community banks and credit unions are approving twice as many loans as the larger banks.

Today's uncertainty has led to somewhat diminished small business loan demand, especially as businesses attempt to ensure stability but are not looking to grow their businesses or build inventories. Further, borrowers are less creditworthy than in previous years, just as lenders are tightening credit standards. In addition, many lenders, concerned about liquidity, are raising their cash reserves instead of lending for now, with some even slowing SBA-backed lending because of the disruption in securitization for those loans.

Yet community banks and credit unions are approving twice as many loans as the larger banks. With a few regional exceptions, smaller community banks and credit unions did not engage in much subprime or large commercial real estate lending, and therefore have lower charge-off rates than their national counterparts. Today they have available funds and are aggressively seeking loan applicants.

But they don't want to merely be lenders. They want the whole small business "relationship," just as do the larger banks. Every bank is seeking deposits — whether DDAs or business money market accounts — and are beefing up their servicing capabilities to better advise and win over small business owners.

Business Bankers Are Not Just Loan Officers Any More

Business bankers used to be called "loan officers" for good reason — that was the primary role expected of them by their customers, and loan volume was the foundation of their compensation. Today's small business bankers have a much broader charter, with a mandate to be more of a "trusted advisor" than a "lender."

Business owners always want personal attention, and they will switch to find it. In fact, a recent survey found that the top two reasons small business owners switch banks are that the former bank was not responsive enough (24%) and that they were treated better by the new bank (also 24%).[19]

Worried that a growing number of business owners and managers now expect inattention and loan rejection, some of the larger national and regional banks have committed to outreach to small businesses. Whether or not they're likely to approve the loans and lines applied for, more banks are aggressively inviting small businesses into their branches for free consultations and to better compete with community banks that traditionally have greater customer interaction and higher satisfaction rates. To motivate reluctant prospects to start a dialogue, some even offer financial incentives:

- **Wells Fargo,** prospecting locally, offers $100 to businesses that come to a branch and open a small business "bundle," including a DDA with debit and ATM cards.
- **Chase** is offering up to $150 for branch visits and qualifying activities: $25 for an in-branch account review; $25 each for opening a savings, debit or credit card account; $25 for a deposit of $10,000 or greater; and $25 for doing at least two of those activities.

Today, satisfaction is highest at the local banks — even though those banks don't always offer all the services the small business needs.

- **PNC** offers $300 if it can't beat the merchant's current payment processing costs. To encourage a branch visit, it also offers $300 if the business customer opens both a business checking account and merchant services.

Going beyond Lending

While not every small business needs a loan today, they certainly have other operational needs which business bankers are actively addressing. With business bankers now only occasionally acting as "loan officers," they must be trained as financial counselors — supplementing accountants and attorneys that owners rely on heavily. Business owners expect their bankers to know enough about their individual business requirements to direct them to the right bundle of services.

Many banks today are focused on selling a suite of cash management services, built upon their checking and online banking platform. The technologically sophisticated banks offer an array of products that can improve a business' operational efficiency. Most of these services center around cash management:

- **Collection services** for achieving faster funds inflows: remote deposit capture, lockbox, wire services, sweeps, ACH
- **Disbursement services** for better timing of funds outflows: payment cards, payroll, bill pay, wire services, controlled disbursement, ACH
- **Account management** for tracking daily cash positions, fraud detection and prevention, internet banking, account analysis with downloadable data, positive pay, check reconciliation, mobile banking
- **Investment and borrowing services** for maximizing idle funds or borrowing on an "as needed" basis with products such as investment and loan sweeps

The dilemma: Large commercial banks traditionally have "treasury officers" or "relationship managers" working in a hub-and-spoke team of specialists to provide counsel and the right product to middle market and larger customers. They have years of expertise in delivering complex cash management functionality to larger commercial customers. The challenge is in the economics of selling and supporting small businesses on these advanced products. Success in keeping the small business customer satisfied requires not only offering the products, but also being able to support them well, both in person and online. For smaller banks that are introducing cash management tools, the challenge is greater.

There's a real cost to keeping small business customers away from the competition. Local banks — both community and CUs — are starting to offer many of these advanced services, so growing the ranks of knowledgeable business bankers is a must. At the same time, to make this work, banks need to reduce some of their support costs by motivating customers to online services, which must have user-friendly navigation and both online and on-phone help functionality.

As businesses grow, those that are most successful and profitable — and are the banks' most desirable customers — will continue to migrate to those banks that offer the right services and proactive relationship servicing.

Today, satisfaction is highest at the local banks — even though those banks don't always offer all the services the small business needs. That's why 38% use two banks, 19% use three, 11% use four or more, and only 30% use one bank exclusively.[20] Those statistics will undoubtedly change. As cash management services achieve greater penetration and become increasingly integrated with a bank's online platforms, it's likely that the banks with the best technology — and the best service — will eventually win most of their customers' business.

Banks can move beyond the “no” to a loan. The relationship is more important than ever, and it takes targeting, tools, training and high touch to retain and grow small business.

Sales Development Strategies Essential to Driving Relationships and Profit

Ultimately, the strongest profitability weapon in the small business battlefield is an efficient sales channel. While product offers and promotions may attract clients, it’s bankers who keep them and manage them to profitability.

Banks are transforming lending officers and business bankers into relationship managers, supported by branch-based and call center teams who are needed to improve the economics of a high-touch small business channel. What’s more, you need channel efficiency to address the needs of the heavily branch-wed small business market. Best practice banks make their sales and service a small business competitive advantage by following these maxims:

- **Choose your targets wisely:** We all talk about small business as if it is one monolithic market, when it is really comprised of a jigsaw of segments — industry, size, age, and location are just a few of the factors that can change how a business looks at banking. Done well, a vertical go-to-market approach improves both your marketing ROI and sales effectiveness.
- **Ensure 360° understanding of the customer:** Business sales teams need to ask smart questions more than they need to recite product features. Create marketing programs, training and tools that build in the signals, savvy and skills to deepen discovery of customer needs and buying triggers.
- **Hire well, train better:** Business bankers, branch managers and platform teams should be able to talk needs with small business owners and decision-makers. Hire for confidence in small business conversation, and train for competence in diagnosing requirements and ability to match these to products. Ensure that your sales and service professionals become proactive advisors rather than just order-takers.
- **Make marketing about the customer experience, not the ads:** Small businesses don’t have time to read fancy ads and brochures. The best small business marketers invest first in making the products, the process, and the people deliver a better small business mousetrap. Merchandising is an important part of the mix too, since more than a third of small businesses prefer to work with their banks right in the branch.
- **Add tools and team support to drive productivity:** Not every business banker can be conversant in every product. Use automated marketing tools, collateral customization engines, and expert overlays of technical specialists to improve the consistency of the customer experience … and the quality of your cross-sell results. Simplify what your professionals need to do to match the right product and pricing to the prospect.
- **Collaborate for continuity:** Team business bankers with branch managers, especially when business bankers have to travel among branches. When a banker travels — or moves on to another position — the branch can be the glue.
- **Design compensation to motivate relationship development:** Old-world comp plans focus on selling product silos — starting with lending, or less frequently, deposits. Pay your sales and service channels to sell to the total business need, and focus on cash management, payroll, and online banking — all products with high retention value. Leave room for rolling incentives to support product launches and seasonal campaigns that can drive execution of specific objectives.

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About EMI

EMI has been working with Fortune 500 companies and financial services leaders to drive results through our clients' sales and service channels. For more than 20 years, our strategic programs, combined with our industry expertise, have helped companies achieve greater growth and increased customer loyalty.

To learn more about what EMI can do for your company, call 617-224-1101 or visit us on the web at emiboston.com.

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