

# Retail Banking Insights

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## Reinventing Small and Medium-Size Business Banking in the U.S.

Small and mid-size businesses (SMBs) are an important segment for U.S. banks, but bank lending to SMBs has been flat in recent years and remains 16 percent below its 2008 peak.<sup>1</sup> Alternative lenders, on the other hand, have seen staggering growth: Kabbage is originating more than \$5 million in SMB loans each day, and originations at OnDeck have surpassed the \$4 billion mark. Marketplaces, such as Fundera and Biz2credit, and peer-to-peer (P2P) lenders, such as Lending Club, are becoming more active in this space.

U.S. banks, in short, have left a gap in the SMB lending experience that fintech disruptors are using to their advantage. According to the McKinsey's Small Business Banking Panel,<sup>2</sup> three out of four SMBs use some form of digital engagement (e.g., online, mobile, remote relationship manager) in their banking relationships, and 80 percent indicate that their research process for securing credit begins online. If banks do not move quickly to engage with SMBs digitally, they risk losing as much as 60 percent of their overall profits to fintech attackers over the next decade,<sup>3</sup> and SMBs could be the low-hanging fruit.

To recapture the initiative, banks need to leverage the advantages they already have and develop capabilities to meet the changing needs of the SMB segment.

### **U.S. banks and SMBs: A beneficial relationship**

A robust banking industry needs a thriving small business community, and vice versa. The U.S. small business segment represents an estimated revenue pool of around \$90 billion to \$100 billion across lending and deposits. Technology innovations (e.g., advanced analytics in underwriting for sub-credit customers) and changing customer behavior (e.g., desire for digital tools to manage business) are opening the market to

<sup>1</sup> FDIC

<sup>2</sup> McKinsey's SMB Banking Panel surveys about 2,000 U.S. businesses with between ~\$100,000 and \$500 million in annual revenues.

<sup>3</sup> *The Fight for the Customer: McKinsey Global Banking Annual Review*, McKinsey & Company, September 2015

new customers and creating opportunities for engagement (e.g., online cash management tools). This expands the SMB opportunity for banks, but also raises the bar. Banks will need to craft tailored propositions for the segment and develop a distinctive small business banking strategy in order to return to profitable growth in the segment.

SMBs have long been a leading driver of the U.S. economy, and despite a troubling long-term stagnation in net start-ups, they continue to be well-positioned for growth. SMBs generate two-thirds of net new U.S. private sector jobs and account for 98 percent of firms exporting goods. Seventy percent anticipate revenue growth in 2017. SMBs in the U.S. have staged a gradual recovery from the financial crisis, and as they rebound, are looking to invest.

Traditionally, however, banks have struggled to serve SMBs in an economically sustainable way and to deliver offerings and experiences that stand out clearly from those of other banks. SMB clients are a diverse group, typically with small levels of income, and with needs that vary by maturity, size and industry. Due to the nature of the segment, there is less reliable data for risk assessment. As a result, many banks have yet to “crack the code” in terms of autoscoring, making the underwriting economics work, and optimizing support levels. Those that can make progress in these particular areas stand to gain outsized share. McKinsey’s recent work in the SMB segment suggests that leading small business banks can capture twice as much revenue per client, and achieve lending product adoption four times greater, than their competitors.

Banks possess a wealth of strategic advantages in the battle against fintechs for SMB business, and they must actively leverage these in order to stay competitive. While McKinsey research indicates that 60 percent of SMBs are receptive to the notion of a remote relationship manager model, banks’ branch networks and high-touch service models remain valuable differentiators—if they can be integrated with alternative service models. Online lenders are adept at driving demand; however, recent challenges in selling off loan portfolios to banks or investors at expected terms have exposed a weakness in their business models. Banks, with their access to reasonably priced funding sources, have the upper hand here. But they need to continue to digitize and reinvent the customer experience, learning from attackers and leveraging their structural advantages.

### **A new model for serving SMBs**

Based on our work with U.S. banks, McKinsey suggests six areas of focus for banks seeking success in the SMB market:

1. Digitizing the onboarding journey
2. Reimagining the credit process
3. Harnessing advanced analytic capabilities
4. Improving sales performance
5. Reinventing the relationship manager role
6. Building a “beyond banking” ecosystem.

## 1. Digitizing the onboarding journey

To compete with online lenders, banks need a seamless, transparent onboarding process for SMBs. McKinsey customer experience research suggests that customer satisfaction in banking services lags in precisely the areas customers care most about: onboarding, transacting and resolving problems. Common problems cited include multiple handoffs across numerous siloed teams, disconnected data sources and tools driving delays, and outdated identity verification practices resulting in longer turn-around times. Addressing these issues can foster a positive consumer experience and build loyalty.

The following initiatives can help banks meet customer demands for the onboarding:

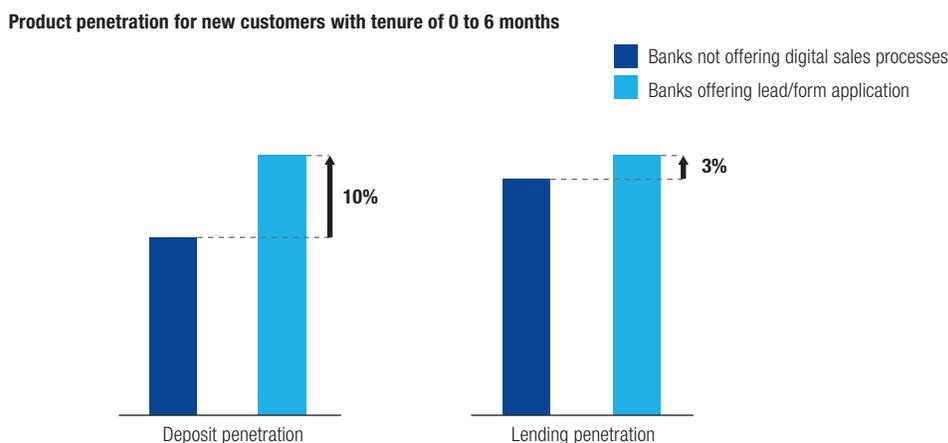
- *A dedicated onboarding hub for SMBs.* Typically, successful banks create a dedicated hub for SMBs, often including online product applications, document upload functionality, status-tracking and banker appointment-scheduling. Banks should incorporate best practices pioneered by non-traditional lending innovators to create brief online applications to optimize data collection. The emphasis should be on making the process easy for the customer—for example, a straightforward one-page online information form. Banks should consider leveraging third-party data where applicable and pre-filling information, including both business and personal information, using existing customer data. Kabbage, for example, extends loans to online sellers (e.g., on eBay and Amazon) based on their transaction patterns, UPS shipping data, and social network data such as number of Twitter followers.
- *Real-time decision-making and fulfillment:* Instant decisions and actions—for example, providing instant approval for a credit card based on customer's credit history, or instantly sending a welcome kit/debit card for a new checking account—can make a difference to customers. Several leading banks have set up integrated support teams to guide SMBs through this onboarding journey, replace multiple operational handoffs, and ensure end-to-end accountability of the onboarding process. Functionality that validates customers remotely and opens accounts digitally, leveraging a mix of e-signature, retina authentication and other customer validation tools (e.g., picture of driver's license), can meaningfully enhance the customer experience. Banks that have successfully digitized the onboarding journey have reduced the end-to-end onboarding time from two weeks to as little as two hours. And according to data from McKinsey's Finalta, banks offering digital sales processes achieve higher penetration rates with new deposit and lending customers (Exhibit 1).

## 2. Reimagining the credit process

The SMB credit process at banks today usually involves a multitude of actors without clear responsibilities, resulting in frequent transfers and significant duplication of work. Teams are often assigned to ad hoc tasks without visibility into the overall process. This makes it difficult for banks to compete with attackers, who are using technology and analytics to approve and disburse loans within hours. Banks need to quickly raise their game in using data to make better and more informed credit decisions. Westpac, for example, launched their Live Online Lending Application (LOLA), a much faster credit application process for SMBs that conditionally approved over \$30 billion of lending for existing customers within one year of launch.

Exhibit 1

Digital sales processes improve penetration rates with new customers



Source: McKinsey & Company analysis; Finalta

A cutting-edge SMB lending process leverages a combination of digital and operational levers to transform the end-to-end process and deliver faster approvals and fulfillment with greater efficiency in the back-office. A successful process includes the following steps:

- The first step is to create a *streamlined application process* based on several key design principles. There should be a common digital interface for both the online and relationship manager channels, so customers can start and complete their applications seamlessly across channels. The interface should facilitate needs-based conversations and guide customers to the most relevant lending products. Finally, the interface should require as little data entry as possible, with pre-populated data whenever possible (e.g., if the applicant is an existing customer). Customers should be able to upload documents, as opposed to submitting them manually.
- The next step is to *transform the adjudication portion of the process*, using external data (e.g., deposit accounts, partnerships with companies like Yodlee) to create more sophisticated credit models. The aspiration should be to develop auto-adjudication capabilities for as much of the loan portfolio as possible. Instant approval for simple loans will free up the adjudicators in the middle office to focus on more complex loans—leading to a multi-hour process for moderately complex cases and a multi-day process for highly complex loans. This approach to leveraging data and more sophisticated models can also be extended to pricing and credit monitoring. For example, banks could use transaction data to determine pricing and automate credit monitoring for larger, more complex loans.
- Post approval, banks can *dramatically streamline the fulfillment process*. At this point in the process, customers crave transparency about when their loan will be disbursed and want to jump through the fewest hoops possible—none, if possible. The use of technologies like e-signatures and document upload, combined with simple terms and conditions, will go a long way toward meeting these customer needs. On the back-end, the bank should also ensure that fulfillment processes are aligned to the new credit process, with straight-through-processing for simple loans and higher

documentation requirements only for higher-value or more complex loans. The goal should be to disburse funds into the customer's account within four hours for simple loans.

- Across the entire process, *banks should leverage intelligent workflow management tools* to maximize transparency into the status of each credit application. Systems like Pega can help banks develop an end-to-end view of how each application is processed, allowing the banks to troubleshoot problematic files and spotlight areas for improvement. Banks need this comprehensive view to truly deliver step-change and compete with fintech lenders. A number of banks have made significant moves in this space, fulfilling loans of \$500,000 in under five days.

### 3. Harnessing advanced analytics capabilities

While non-bank disruptors have established an early lead in using advanced analytics to manage risk and increase revenues, banks do have an advantage: access to more robust data. Big data, to be clear, is not a magic bullet. The payoff can be large, but results from incremental improvements in thousands of decisions. The few banks that have made progress in the use of advanced analytics, in McKinsey's experience, tend to frame their thinking around sophisticated underwriting, developing efficient pricing models, improving customer acquisition/retention, and suggesting relevant products to customers.

Banks can significantly improve the predictive powers of their credit models and the resulting underwriting decisions by leveraging non-traditional data sources (e.g. social media, ATM and credit card transactions) and advanced modeling techniques. Improved models should incorporate data in real time, allowing for more sophisticated monitoring techniques and decreased losses. Advanced analytics can also generate significant value through efficient pricing models that increase profitability and margins, while minimizing impact on loan volumes. Banks can make highly informed data-driven marketing and pricing decisions by adopting analytical best practices, including propensity-to-buy models and relationship underwriting and banking, which can be developed in-house or adapted from existing marketing techniques.

The combination of advanced analytics and non-traditional data can facilitate targeted conversations with prospective customers. Algorithm-driven triggers can be used to establish product leads and product recommendations by identifying common customer product needs and linking customer and prospect characteristics to solutions. Automation allows relationship managers to focus on leads with the highest value and likelihood of converting. At one institution, the impact of a simple Amazon-like recommendation model in small business, combined with a set of scripts and tools for robust customer dialogue about lending, resulted in a three-fold improvement in conversion.

### 4. Improving sales performance

Improving sales efficiency will be a key to unlocking the value of relationships in SMB banking. Done right, it can yield sustained and substantial impact: for example, increases in product penetration of 15 to 25 percent and in revenues of 5 to 10 percent. In the past, banks have typically captured only a fraction of the potential for improved sales performance, due to an over-emphasis on "hard" levers such as sales processes, technology tools, metrics and compensation. They can realize greater savings

by applying a comprehensive set of levers, including capability-building and improved front-line sales productivity; optimized coverage models focused on high-opportunity pockets; refined customer segments with targeted value propositions.

To increase the sales productivity of the front line, banks can provide coaching and job aids, and run capability-building programs. They should also transform the execution of lead outreach by establishing best practices for calling, setting appointments and converting sales. This process should start with interviews with top-performing relationship managers to identify best practices, and sessions with area managers to codify new coaching practices, performance management models and reinforcement of leads. A digital relationship manager workbench provides one-stop access to the tools (e.g., product pitch libraries, video conferencing capabilities, sales support tools) needed to manage the day-to-day business. Enhanced lead models, which deliver “smart leads” to relationship managers (e.g., known product ownership and propensities for prospects; cross-sell for existing customers) can also help increase sales productivity. McKinsey’s experience suggests that these initiatives can drive a four-fold increase in lead calling discipline, 3.5 additional appointments per week per relationship manager, and a 170 bps increase in appointment-to-sale conversion rates.

Banks that optimize their coverage model to focus on high-opportunity pockets are likely to see material impact on their lead conversations and revenues. However, this requires a granular understanding of market opportunity by industry and geography to optimize coverage. Banks should be able to determine which micro-markets contain SMBs with the highest revenue/profit potential, and the characteristics of these micro-markets (e.g., socio-demographic, economic, competitors, customers). Additionally, banks should adapt coverage models to enable multiple touchpoints, aligning expertise with client value. This will in turn demand a redefinition of roles, responsibilities and processes for employees in various channels (e.g., telemarketing, branch manager, small business specialist, small business call center), in order to deliver service based on business size and industry type.

Strategic customer segmentation is crucial to developing consistent and appropriate customer service for each segment. Banks should focus on two or three distinct sub-segments that offer the highest revenue/profit potential and adapt coverage accordingly. Banks can extract more value from each segment through:

- *Targeted customer marketing*: Highlighting lending capabilities for industries with greater financing needs
- *Specialized service models*: Dedicated relationship managers for high-priority industries, industry-specific forums and training for customers and prospects
- *Tailored underwriting*: Specialized underwriting groups for specific industries

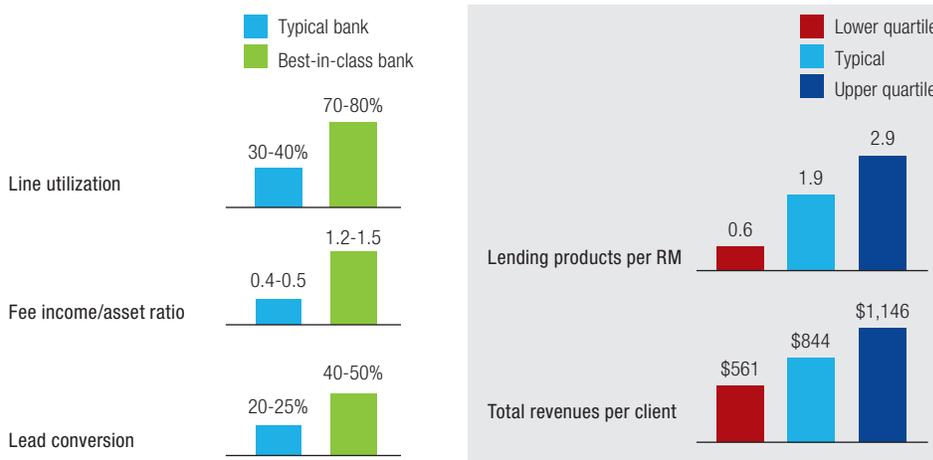
According to McKinsey’s 2016 Finalta benchmarking, improvements in sales efficiency can drive superior performance in a number of key banking metrics (Exhibit 2).

## **5. Reinventing the relationship manager role**

Nearly half of the SMBs in McKinsey’s research were receptive to a remote relationship manager model. This fact opens the window for the realization of significant operating efficiencies. The remote model can reduce cost-to-serve by more than

Exhibit 2

Improvements in sales efficiency unlock relationship value



Source: McKinsey & Company analysis; Finalta

50 percent, double customer experience scores, and triple sales per relationship manager. Forty percent of banks in the U.S. are either piloting or have started to successfully deploy a remote relationship manager model, according to McKinsey’s 2016 Finalta benchmarking. However, relationship manager performance is highly variable and driven by the initiative and skillset of the individual, with limited “support from the system.” Successful implementation therefore requires effective tools for both parties to the relationship.

According to the McKinsey SMB panel research, about 60 percent of SMBs find the remote relationship manager model very appealing, and around 15 percent are willing to switch to this model from their local relationship manager. It is important to note that the remote model is not a one-size-fits-all proposition. Banks should target those sub-segments that are most favorably disposed to the model. It can be a good fit for mid-value customers or for companies in certain industries (e.g., real estate, manufacturing, nonprofit) that value cost-efficiency and proactive sales campaigns. Banks should target SMB clients that are already comfortable with remote channels and simplify products to align with client needs (e.g., entertainment lending for entertainment companies). A well-designed remote model should be capable of servicing a portfolio of 500 to 1,000 clients using a “proactive sales/reactive service” approach. Importantly, banks should empower relationship managers in this model to avoid excessive back-and-forth on matters such as pricing.

**6. Building a “beyond banking” ecosystem**

SMBs are increasingly looking for a single provider that can connect them with other services they need to run their businesses. Financial services providers in Asia are already starting to move in this direction. Ping An Insurance, for example, provides a range of services to both personal and small business customers, such as a rewards program to connect SMBs with their customers. Banks are in a unique position to build these “beyond banking” ecosystems—and in doing so they can truly differentiate their offerings from fintech competitors. Banks can leverage the data on their existing

SMB customers to orchestrate this “ecosystem” of business services.

Banks can offer services in two broad categories:

- *Business support services:* These would include collection management, administrative support (accounting, business tax filing, payroll support), legal support (contract management, document management), and core business support (inventory management).
- *Beyond-banking marketplace/community.* This could include an online lending platform to connect SMBs with investors to raise capital, an eBay-like virtual marketplace to connect retail and SMB customers, and business community platforms for exchanging professional services, ratings and benchmarking solutions.

A first-mover advantage is critical for banks seeking to build an SMB ecosystem. The first step is to identify priority SMB segments and the most important services for those segments. This gives banks a list of potential partners for initial conversations. Then banks need to align on the right ecosystem approach. They can open up their existing online platform to integrate third-party offerings from tech providers and fintechs (UBS and Commerzbank have started down this path), plug into a third-party platform or form strategic alliances.

### The SMB model of the future

As they proceed on the foregoing initiatives, banks seeking to build profitable share in the SMB market must put the following building blocks in place:

- *Set up a “digital factory.”* Banks will need a permanent cross-functional team to build the capabilities required to provide digital solutions for SMBs. Roles typically include product owners, business analysts, functional reps, project managers with specialized skills (e.g., agile coaches), and development specialists, such as digital solution architects, infrastructure engineers and product designers. Scotiabank, for example, brought together 350 employees in a digital factory in downtown Toronto. The factory will serve as an incubator where interdisciplinary teams innovate and collaborate with fintech providers and start-ups.
- *Establish a data analytics unit.* The unit should combine technical data expertise and analytic talent (data scientists), led by a chief analytics officer providing market perspective. Wells Fargo’s Big Data Lab aims at “pioneering the use of emerging technology and data science to drive customer experience, prevent fraud and develop customer insights.” The data analytics unit should develop use cases that can deliver value for the SMB segment (e.g., underwriting, lead generation) and identify the internal and external data that will support these use cases. For example, banks could use daily transaction data from existing customers to generate a list of potential leads and pre-approved loans.
- *Explore fintech partnerships for scale.* As banks look to close gaps in digital expertise with non-bank disruptors, partnerships may be an important piece of the puzzle. Partnerships will entail critical design choices in the use of underwriting solutions, branding (white label versus referral) and balance-sheet decisions for the loan. Approaches thus far in the space have ranged from white-labelling to basic referral agreements. JPMorgan Chase, for example, is collaborating with OnDeck Capital to speed up the

loan delivery process for its four million SMB customers. Regions Bank integrated Foundation Group's online application into its SMB web site to support its loan offering. Fifth Third recently announced a partnership with merchant payments solution provider GreenSky, whereby the bank will originate loans through Greensky's merchant network. Fifth Third also plans to integrate GreenSky's technology platform into its own banking channels, speeding up loan approvals. Finally, Golden Pacific Bank teamed with the fintech firm Better Finance to establish a fully automated loan platform designed to sharply reduce SMB loan approval and processing times. Banks will need to assess their make-versus-buy alternatives on this front and act accordingly.



McKinsey expects digital channels to be an increasingly important means of engagement between banks and SMBs in the next three to five years. The aspiration is relatively straightforward—offer SMB customers the products they want and the omnichannel connection they prefer. But the “how” is more complex. Banks will need to take a comprehensive, yet fine-tuned, approach to creating a truly differentiated SMB offering. Bank executives should ask the following high-level questions to help frame constructive strategic discussions:

- Have we set an aspirational target for our SMB unit? What economic benefits will it deliver, and over what timeframe? Does this target account for competitive dynamics and industry evolution?
- Are we positioned to capture growth across all critical dimensions of the SMB segment?
- What investments are we making today to innovate along these dimensions?
- Which capabilities should be built in-house, and which should be developed with partners?
- Where do we see our SMB unit five years from now?

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### **Further insights**

McKinsey's Consumer & Small Business Banking Practice publishes on issues of interest to industry executives. Our recent reports include:

*Retail Banking Insights, Number 9: The Winning Formula for Omnichannel Banking in North America*

**January 2017**

*Retail Banking Insights, Number 8: Radically Simplifying the Retail Bank*

**September 2016**

*Retail Banking Insights, Number 7: A Mortgage Operating Model for the Digital Age*

**February 2016**

*Retail Banking Insights, Number 6: Driving Revenue Growth in Retail Banking*

**March 2015**