

PARTNERING WITH MAIN STREET

OPPORTUNITIES FOR GROWTH IN SMALL BUSINESS LENDING



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Before diving into the study results, we hope you will indulge us in a series of acknowledgments.

This study represents the hard work put forward by many people. In particular, we would like to thank Dong Hong, Regulatory Counsel for the CBA, for his assistance in coordinating this project. For those familiar with the consulting business model, you will know that no projects are delivered without a strong team of consultants supporting the Partners. As such, the authors would be remiss in not giving due credit to Gregory Hamill and Andrew Jakubowski who went well beyond the call of duty in seeing this project through.

We would also like to thank the CBA Small Business Banking Committee members for sponsoring this work and providing critical support and guidance. Particular thanks go to the project Steering Committee members.

We are especially grateful to those CBA member institutions that participated directly in the benchmarking study, and the individuals at those organizations who took the considerable time to provide such thoughtful responses.

In addition to the study participants, we thank Ben Cutler of LexisNexis, Michael Stefanick of Equifax, and Noah Breslow of OnDeck for sharing their insightful views on innovations shaping the market.

All that remains to be said is that we sincerely hope that the data, insights and perspectives shared in this study spark healthy debate and motivate continued and ultimately successful pursuit of profitability in the challenging but very important undertaking of small business lending.

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EXECUTIVE SUMMARY

In early 2014, Oliver Wyman, in conjunction with the Consumer Bankers Association (CBA) and its membership, sought to answer the question: *Can banks compete profitably in small business lending?* The short answer is absolutely yes. In fact, some banks are already doing so. However, for many of the banks that aren't profitable in small business lending yet, getting there is going to take leaps in productivity.

Lending is a major element of many US banks' small business strategy and a sizeable minority of banks view lending as a lead product used to acquire new small business customers. We've found that some of our clients are able to attain above-hurdle returns through disciplined management of highly efficient businesses, while others use their lending businesses to support more profitable deposits/card/acquiring businesses.

The major challenges in small business lending are that lending costs are high relative to the revenue potential of a small business loan and credit losses have proven volatile through economic cycles. Pre-crisis attempts to reduce small business lending costs focused on driving automated or score-assisted decisioning to higher and higher limits. While a well-intentioned attempt to improve half of the profit equation, the net result was a modest decline in operating costs and exposure to credit loss rates that exceeded 5% at their peak for some banks.

Post-crisis, automated adjudication levels have been reduced at many banks and eliminated at many others. Beyond the reduction of automated adjudication, banks now perceive greater current regulatory pressure to increase the scrutiny on and thus the cost of their lending processes. This trend, combined with reduced profits from small business deposits given the current low rate environment, puts a lot of pressure on banks to find a solution to their small business lending profitability challenge.

To explore potential solutions, the CBA and Oliver Wyman recruited CBA member banks, mostly from among the top 25 banks along with several large regionals outside of the top 25 for a detailed benchmarking study. The participant banks graciously completed a detailed questionnaire and data request about their small business lending activities (focused on total client exposures < \$1 MM). Additionally, several banks provided sample redacted credit memos.

Not surprisingly, we found that these banks are in the process of tackling a wide range of initiatives to address small business lending profitability. Despite the very high level of activity, we find that there are different levels of maturity in how operating costs associated with lending are identified and accounted for in running the business.

As such, significant changes may be needed to make lending in this space a standalone profitable business for most banks. Based

Exhibit 1: Key takeaways from comparison of highly productive banks and other banks

LEVER	FINDING	IMPLICATIONS
Understanding of costs	Leaders have a substantially better understanding of their aggregate lending costs and costs of sub-processes	As banks improve their lending cost MIS (which many are focusing on), stark cost misalignments will be exposed, enabling them to focus on addressing underlying cost drivers
Approval and booking rates	Leaders have a booking rate of applications that is 400% higher than some of their peers' booking rates; these leaders face no discernible impacts on credit losses	Variation in underwriter productivity is driven almost entirely by variation in approval and booking rates. Banks should focus on improving approval rates by weeding out clear declines early and driving fast turnaround to good clients to reduce competition and increase booking rates.
Process focus	Leaders have a relatively stronger focus on efficiency drivers such as time-to-approve, differentiating annual reviews, and increasing approval rates	Changing processes (vs. the technology on which processes run) will be the main driver in tightening the spread in productivity across banks – technology is often viewed as a panacea, but bad processes can sometimes run on good technology
Technology focus	Leaders report using less automated technology	

on high-level data from a limited sample of banks, we found that the most productive banks generate ~4 times as many loans per underwriter as the least productive AND have lower credit losses.

What can we observe that the highly productive banks are doing that their less productive counterparts are not? Exhibit 1 summarizes our findings across four levers.

These and other findings indicate ample room to improve small business lending productivity via a range of levers. Said another way, leaders aren't doing one single thing better than the rest. Winning isn't about revolution; it's about changing a number of process levers with a large aggregate impact. That said, we are under no illusion that this report is necessary to stimulate change. The range of initiatives either recently launched or soon-to-be launched is encouraging, and this space will look very different in 5 years than it does now. The question is whether banks will focus on the greatest drivers of efficiency in the right combination and staging in

order to get the greatest return on their sizable investments.

An area that remains a question for the industry is the role of alternative small business lenders such as OnDeck and CAN Capital. Banks generally do not view these alternatives as a threat to their existing business – instead, they're looking at potential partnerships with these companies to take advantage of their technology, analytics, and process discipline in order to grow the total market and to drive greater efficiency in the existing business. Our view is that this is the right way to think about market evolution. Banks should have an active strategy for the alternative lending space and determine how such products and technologies might fit into the existing capabilities portfolio.

I. SMALL BUSINESS LENDING IN THE US

In this section, we provide context on the US small business lending market from both the demand and supply sides.

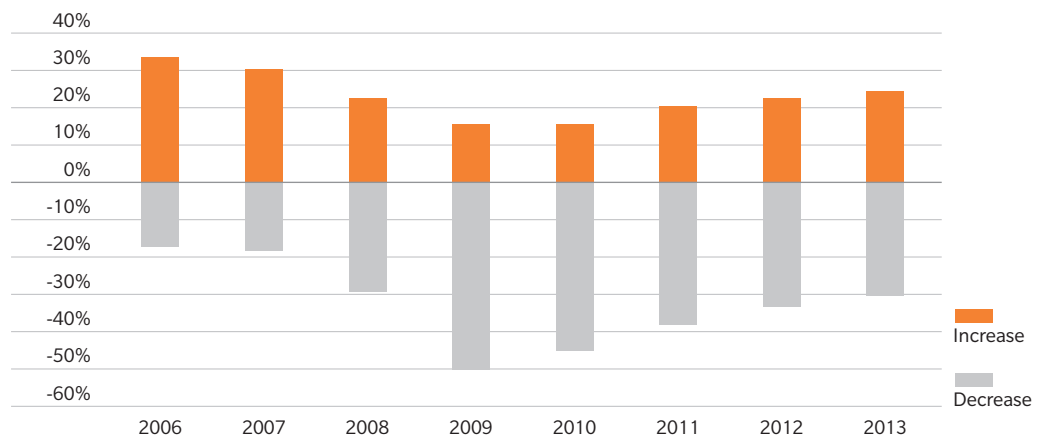
DEMAND SIDE

In the United States, small businesses are big contributors to the national economy. Companies with fewer than 100 employees represent nearly 30% of annual payroll, and these businesses have generated approximately 40% of net job creation (and destruction) annually during the past ten years.^{4,5}

Small businesses have been slow to recover from the financial crisis and the following recession; however we are now seeing a material (but cautious) improvement on a number of indicators. As Exhibit 2 shows, 25% of small businesses report increasing their capital spending over the last 12 months – nearly double the lows of the crisis although not on par with pre-crisis levels.⁶

Similarly, the NFIB Small Business Optimism Index in Exhibit 3 shows an optimistic trend.⁷ In a similar survey conducted by Gallup, small

Exhibit 2: Percent of businesses reporting increased versus decreased capital spending^{*1} 2006-2013



Source Wells Fargo/Gallup Small Business Index Poll, January 2014

*1 Survey taken in Q3 of each year and involve ~600 small businesses with revenues up to \$20 MM

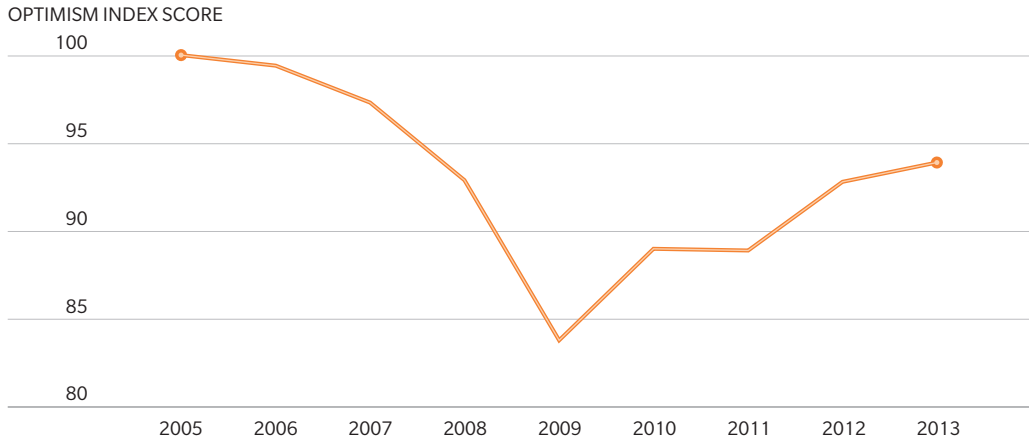
4 US Census, Bureau of Statistics, 2014.

5 US Bureau of Labor Statistics, 2014.

6 Wells Fargo/Gallup Small Business Index Poll, January 2014.

7 NFIB Small Business Optimism Index, February 2014.

Exhibit 3: NFIB small business optimism index
2005-2013



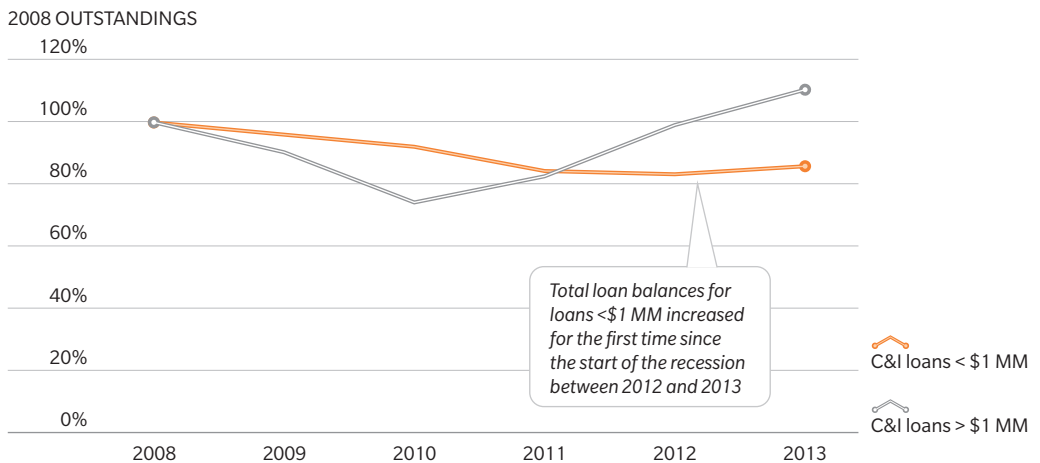
Source NFIB Small Business Optimism Index, February 2014

business optimism reached its most positive score since October 2008 but remains below pre-crisis levels.⁸

Despite the positive signals, small business C&I borrowing from banks (loans <1 MM) is

14%, or about \$50 BN, lower than pre-crisis levels. This is illustrated in Exhibit 4. It's also worrisome that there have been only limited signs of a rebound while borrowing of larger businesses has increased steadily since 2010, now exceeding pre-crisis levels.⁹

Exhibit 4: Bank C&I loan outstandings based on loan size indexed to 2008
2008-2013



Source SNL Financial, Oliver Wyman analysis

⁸ Wells Fargo/Gallup Small Business Index Poll, January 2014.

⁹ SNL Financial, Oliver Wyman analysis.

It is worth noting that the depressed levels of borrowing illustrated above is in fact even more severe than these numbers illustrate. A large proportion of small business borrowing pre-crisis was in the form of personal home equity loans and lines, which were at the time widely available (due mostly to rapidly appreciating home values) and are now a shadow of their former selves (due to more stagnant home prices and dramatically tighter credit standards in this space).

SUPPLY-SIDE PERSPECTIVE

Small businesses represent a large revenue pool for banks.¹⁰

Given this, it is little surprise that most banks report small business lending as crucial to their strategy. The exact role of small business lending varies from bank to bank, with some viewing it as a mechanism to generate asset growth in the medium-term and others viewing it as the primary means to source clients.

As banks transform their branch networks, small businesses have become a focal point as a profitable customer segment served largely out of the branch, though actions taken in the network vary widely. This level of strategic divergence is much wider than in other consumer banking businesses (e.g. card, mortgage) and reflects the fact that banks do not yet have strong information on and thus an understanding of small business lending profit drivers. This makes this business truly unique and suggests more opportunity to evolve the business model and our understanding of it than in many other core retail banking businesses. As a result, the opportunity for winners to emerge

from the pack is significantly higher than in other businesses.

Exploring the dynamics of supply and demand in the small business lending space, Oliver Wyman's Small Business New Form Lending Study in 2013 revealed that existing small businesses (i.e. those that have operated for more than 1 year) reported being declined for credit 15% of the time. This finding is summarized in Exhibit 5. While the decline rates on an individual loan application are certainly much higher, by shopping around, small businesses are able to get credit 85% of the time when they need it.

Further, standards and terms for all loans appear to be easing, allowing small business owners to more readily access the supply of credit. According to the SBA 2012 Annual Report, bankers reported easing their standards and terms on C&I loans to businesses of all sizes throughout 2012.¹¹ Similarly, according to the OCC's 2012 Survey of Credit Underwriting Practices Report, bankers described a slowdown in tightening of underwriting standards for small business loans.¹² For domestic banks, the decision to ease standards and terms was driven by increased competition, as reported in the Federal Reserve's January 2014 Senior Loan Officer Opinion Survey on Bank Lending Practices.¹³

While the US economy has started to recover, some banks are still reeling from high peak credit losses like those experienced during the financial crisis. Even though peak net charge-off rates have come down, as illustrated in Exhibit 6, the sluggish rate of growth in the US suggests the macroeconomic environment is still frail and

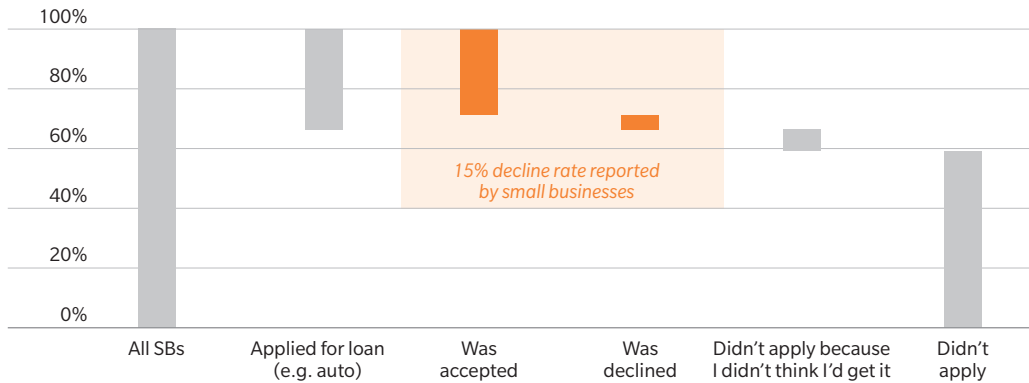
¹⁰ Oliver Wyman Small Business Study, 2011.

¹¹ US Small Business Administration, 2013.

¹² US Office of the Comptroller of the Currency, 2013.

¹³ Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices, January 2014.

Exhibit 5: Oliver Wyman small business lending study findings on small business loan application frequency and outcomes



Source: Oliver Wyman Small Business New Form Lending Survey, 2013

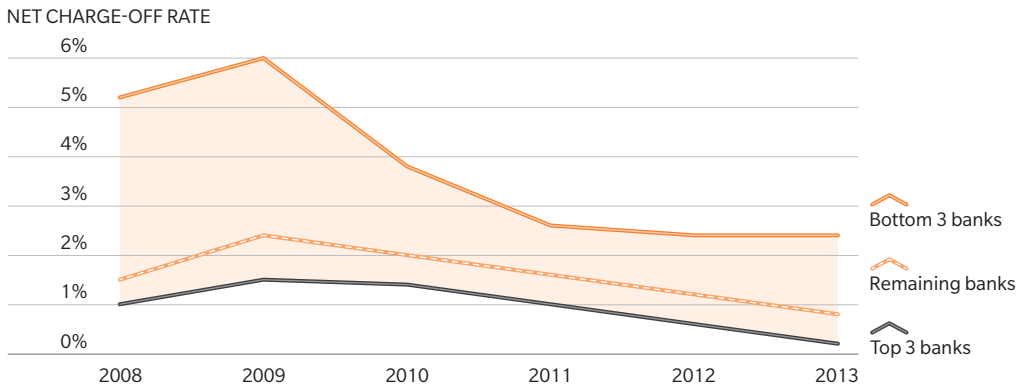
banks could be exposed to future losses. The implied advice: proceed with caution.

We suspect that concerns about the past as well as future regulatory uncertainty have slowed or even reversed progress at resuscitating the profitability of small business lending. We will explore this further in later sections but continue to be optimistic that there are many opportunities to reduce cost-to-lend without a negative impact on credit risk management effectiveness.

Despite the fact that they have not fully recovered from the crisis, small businesses and the lenders that support them remain an integral part of the national economy. As market conditions continue to improve, small businesses will be presented with an increasing number of opportunities for growth. The same holds true for small business lenders.

Now, we turn our attention to those lenders and the main question at hand: "Can banks compete profitably in small business lending?"

Exhibit 6: Average net charge-off rate by bank cohort 2008-2013



Note: Top 3 banks reported the lowest net charge-off rates for the year. Bottom 3 banks reported the highest net charge-offs for each year. Remaining banks includes all other respondents

II. PROFILING THE STUDY PARTICIPANTS

To answer the question: *Can banks compete profitably in small business lending?*, Oliver Wyman released a detailed survey to leading banks in early 2014. Due to the sensitivity of the requested data, Oliver Wyman signed a non-disclosure agreement with each study participant to ensure the confidentiality of the participants' responses.

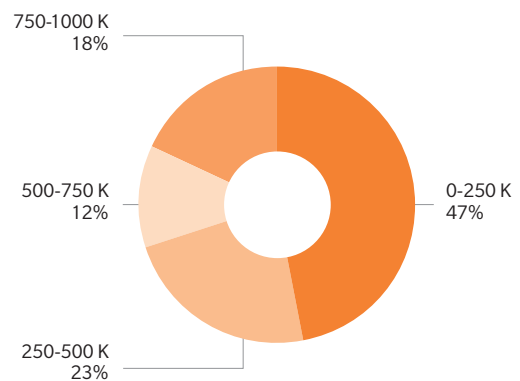
Consequently, we are unable to provide a detailed list of the participants (though we thank them all for their participation). Nonetheless, we can state that the respondents are mostly CBA member banks, which include many of the top 25 US banks (by total C&I loans) along with several large regionals outside of the top 25.

The skew of loan sizes among the participants varies significantly, with some of the participants having a heavy concentration in loans under \$250 K and others favoring loans over \$500 K. The distribution of loans outstanding by exposure size is shown in Exhibit 7. When broken out by product type, the participants' portfolios are mostly comprised of term loans. The distribution of loans outstanding by exposure type is summarized in Exhibit 8.

Having a wide array of large bank participants in the study enabled us to see a large percentage of the entire US small business lending market and make meaningful industry-level conclusions. It also allowed us to investigate in detail the differences in the operating models and outcomes of these businesses.

Exhibit 7: Percent of loans outstanding by exposure size

All loans < \$1 MM, 2013

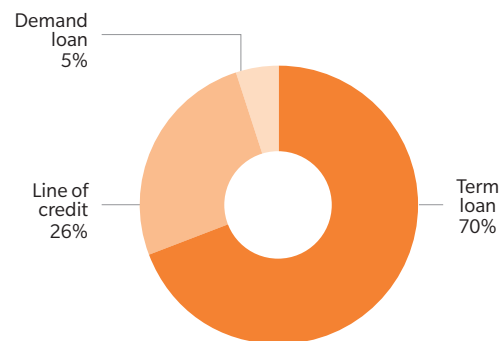


Source Oliver Wyman analysis

Note All loans includes term loans, lines of credit, and demand loans

Exhibit 8: Percent of loans outstanding by exposure type

All loans < \$1 MM, 2013



Source Oliver Wyman analysis

Note All loans includes term loans, lines of credit, and demand loans

III. CURRENT STATE OF LENDING PROFITABILITY

The short answer to the question of whether banks can compete profitably in small business lending is absolutely yes – some banks already do. But others in the industry are still working to get there. The first challenge will be increasing our collective understanding of the true economics of small business lending:

- **Understanding of lending economics is at a low level of maturity relative to other lines (e.g. credit card):**
Banks generally do not claim to have a strong understanding of their lending economics, particularly on the cost side. Additionally, among those that do track lending economics with some rigor, degree of confidence varies. As a result, the data is only infrequently well integrated into day-to-day and strategic decision-making
- **Variation of economic assumptions in pricing/profitability models suggests opportunities for improvement:**
We asked participating banks to run several sample loans through their pricing/profitability models. The results were highly skewed due to widely varying parameter values and model methodologies. Our sense is that these skews are too wide to reflect actual

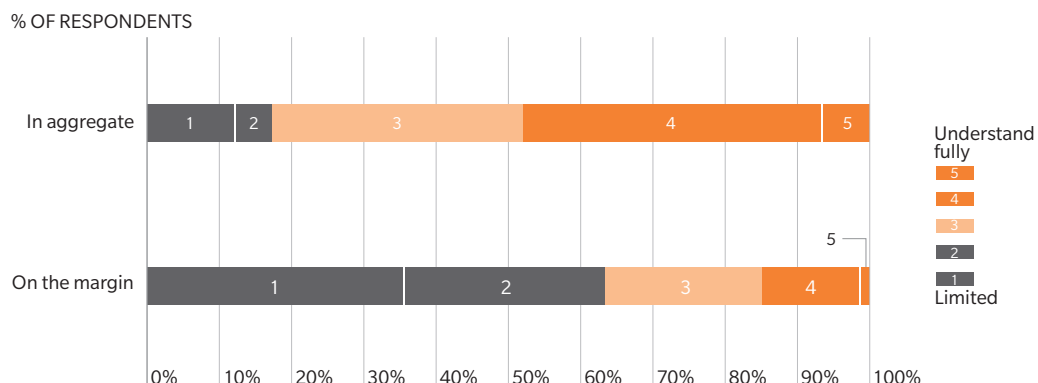
bank-to-bank differences alone. This implies that the understanding of loan-level profitability can be meaningfully improved at many banks. Put simply, a portion of the business that each bank is putting on its books is due to idiosyncrasies in how that bank estimates loan-level profitability

A third observation which we will explore in more detail below (along with the those described above) is that:

- **Productivity metrics show extreme skews:** Cost figures are difficult to compare across banks, so as an alternative, we compared headcount productivity, which should correlate strongly with cost. In this study, analysis of headcount productivity indicates notable skews across banks. While this may be disconcerting for those banks on the bottom side of the skew, this is great news for the industry as it means that those at the top are already delivering credit profitably. These top performers may offer some perspectives on what other banks can do to get to comparable levels of productivity and profitability

Now we will walk through each of these three points in further detail.

Exhibit 9: Level of understanding of overall lending-related costs, in aggregate and on the margin



Source Oliver Wyman analysis

Note Credit-related costs include direct to sale staff costs, underwriting and approval costs, fulfillment costs, monitoring and review costs, and loan workout costs

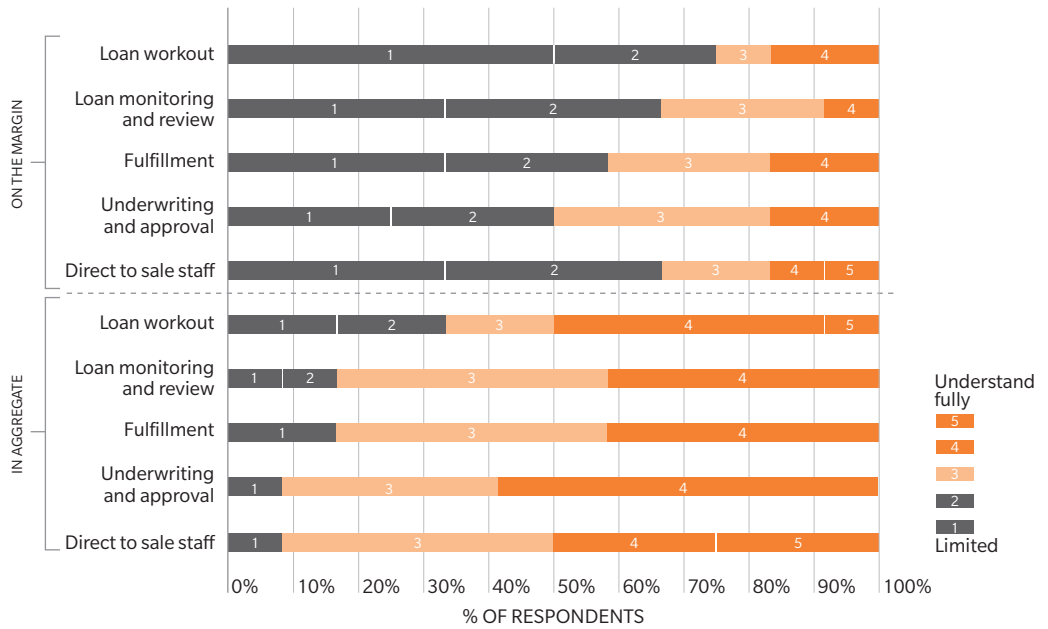
A. UNDERSTANDING OF LENDING ECONOMICS IS AT A LOW LEVEL OF MATURITY RELATIVE TO OTHER LINES (E.G. CREDIT CARD)

We asked participating banks to characterize their understanding of their lending costs at the portfolio level (in aggregate) and at the marginal loan level (i.e. the cost of sending an incremental loan through underwriting, approval/booking, and servicing). Overall, as illustrated in Exhibit 9, the results are mixed. At the portfolio aggregate level, about half of the banks reported that they almost fully understand their credit-related costs. However, the results at the marginal loan level suggest that fewer than 20% of respondents possess a similar level of confidence in understanding their costs.

We then probed further as to whether participants understood costs of certain processes better than others (across sales, underwriting, fulfillment, and monitoring/reviews). The disaggregated findings generally follow the pattern seen above – some banks struggle to decompose their lending costs into their constituent elements.

As shown in Exhibit 10, the understanding of fulfillment and underwriting and approval costs are most mature, relative to staff incentives, loan monitoring and review, and loan workout. One positive finding is that over 50% of respondents have MIS that provide a strong understanding of aggregate costs. Achieving a more robust understanding of marginal costs will empower banks to more effectively and profitably direct day-to-day activities. It should impact which customers you market to, which loans to approve, how to design processes for approval and monitoring, etc.

Exhibit 10: Level of understanding of lending-related costs by cost component

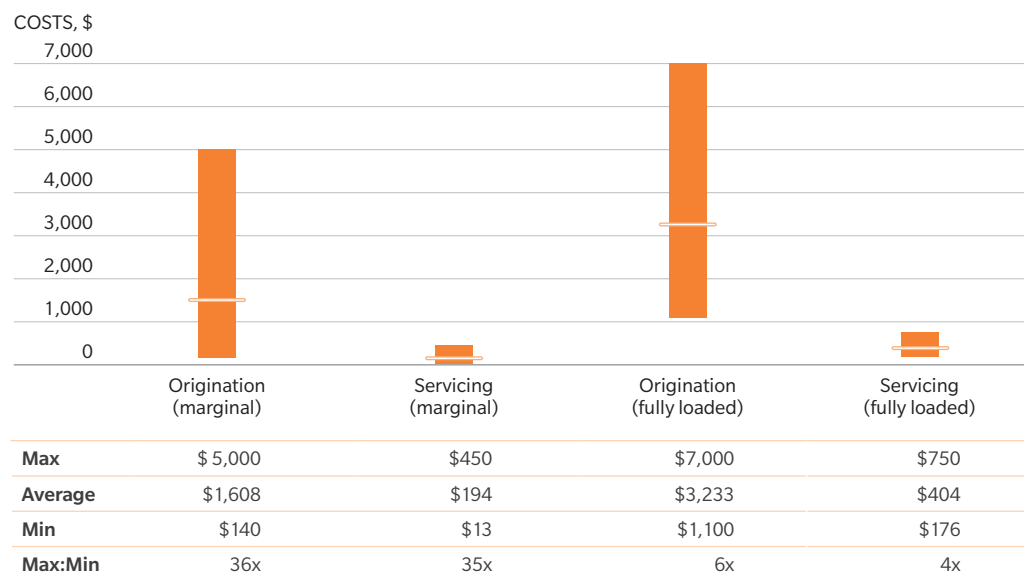


Source Oliver Wyman analysis

We also asked banks for specific cost parameters on their per-loan costs where they knew them (which only a minority of banks did). As above, we asked about marginal direct costs (e.g. the cost of an

underwriter and approver's time) and fully-loaded costs (attributing allocated and indirect costs to the loan level). The ranges we found were very large and are summarized in Exhibit 11.

Exhibit 11: Range and average per-loan marginal and fully loaded costs for origination and servicing 2013



Note Marginal includes staff incentives, compensation allocations for staff directly involved in the lending process, and vendor costs not passed through to the borrower; fully-loaded includes marginal plus line and corporate overhead, IT systems, full allocation of management overhead, etc.

As you can see, some of the high ends of the ranges are ~35x the bottom side of the range. There are two possibilities

- The data are right and banks' actual cost to lend ranges vary widely – we're quite skeptical of this given the size of the ranges
- The data are not right and some banks are continuing to evolve their understanding of costs to originate and service

We support the second view given the reported low level of confidence in costing measures that was discussed earlier in this section.

B. VARIATION OF ECONOMIC ASSUMPTIONS IN PRICING/ PROFITABILITY MODELS SUGGESTS OPPORTUNITIES FOR IMPROVEMENT

The finding that many banks can continue to mature their understanding of their small business lending economics is reinforced by the variation we observed in pricing model parameter assumptions, methodologies, and results. To recap our approach, we provided participants with four loan examples, including inputs such as type, size, and term to run through their pricing/profitability models. Exhibit 12 summarizes the examples used in the study.

With these loans, the banks reported the parameter assumptions they use for funding costs, operating costs, and capital. The reported parameters vary widely from

Exhibit 12: Characteristics of the loan archetypes used in study

	LOAN 1	LOAN 2	LOAN 3	LOAN 4
Product	Line of credit	Line of credit	Term loan	Term loan
Size	\$300 K	\$300 K	\$750 K	\$750 K
Term	1 year	1 year	3 years	3 years
Amortization	NA	NA	3 years	3 years
Rate	Prime + 100 bps	Prime + 100 bps	Prime + 100 bps	Prime + 100 bps
Probability of default	2% (or closest option)	0.5% (or closest option)	2% (or closest option)	0.5% (or closest option)
Loss given default	50% (or closest option)	50% (or closest option)	50% (or closest option)	50% (or closest option)
Cross-sell	No	No	No	No
Expected utilization	75%	75%	NA	NA

bank to bank. We understand that banks will have legitimately different economics for delivering lending – different cost of funds, different capital treatment, different operating efficiencies, and different levels of corporate overhead. However, some of the variation witnessed seems too extreme to be the result of these differences alone. We therefore attribute part of the variation to differences in calculations of parameter values driven by level of model sophistication, not by bank idiosyncrasy.

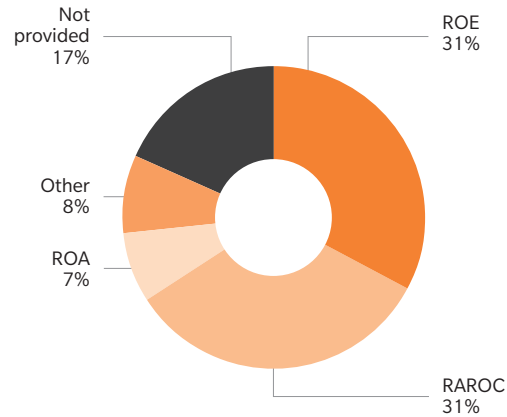
Exhibit 13 highlights some of the differences in parameter assumptions for the loan examples. Of all the model parameters, operating costs tended to have the largest variation. Interestingly, some participants did not include an estimate for operating costs as they do not use costs in their loan-level pricing models.

In addition to reporting parameter values, participants reported the pricing model methodology and return metric used for

Exhibit 13: Parameter assumptions used in study

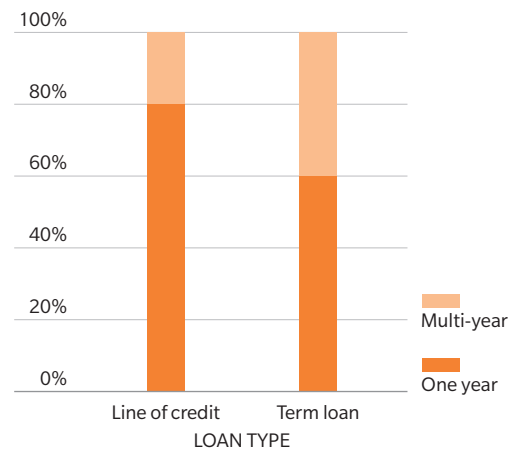
		LOAN 1	LOAN 2	LOAN 3	LOAN 4
Cost of funds (Funds Transfer Price)	Range	0.2 - 1.0%	0.2 - 1.0%	0.4 - 1.8%	0.4 - 1.8%
	Mean	0.6%	0.6%	0.8%	0.8%
Operating costs	Range	0.4 - 2.2%	0.4 - 2.2%	0.3 - 1.7%	0.3 - 1.7%
	Mean	1.3%	1.2%	0.9%	0.7%
Economic capital	Range	2.9 - 9.5%	1.4 - 7.1%	7.0 - 10%	1.0 - 8.0%
	Mean	6.6%	4.4%	8.1%	4.6%
Regulatory capital	Range	2.7 - 10.3%	1.4 - 7.0%	2.7% - 11%	1.4 - 7.0%
	Mean	6.5%	4.9%	6.6%	4.9%

Exhibit 14: Return metric used for loan examples



Source Oliver Wyman analysis

Exhibit 15: Duration of model used for loan examples



Source Oliver Wyman analysis

their decisioning on these example loans. Participants had widely varying mechanisms for measuring and evaluating profitability. As illustrated in Exhibit 14, to measure the return of a loan, the participants used metrics that include ROE, RAROC and ROA. As shown in Exhibit 15, the types of models used to evaluate the loans' returns included both one-year models and multi-year models.

The variation of the parameter inputs and skews in the model methodologies led to a wide range of return estimates coming out of the models. Exhibit 16 illustrates these outputs using ROE and RAROC (the most common return metrics used). The skew in

returns suggests that banks' perceptions of loan level profitability are not well aligned, which suggests an opportunity to mature these capabilities across the industry.

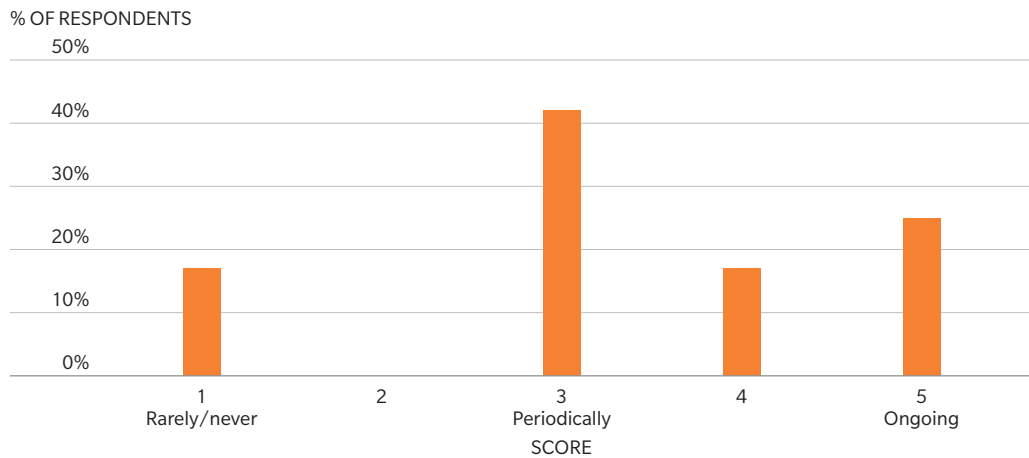
We recognize that the survey participants may not have been able to describe their model parameters and outputs perfectly given the limited amount of information we provided them on the sample loans. However, the variation is still intriguing and worth further investigation.

In addition to evaluating the parameters themselves, we also asked respondents to characterize the frequency with which they

Exhibit 16: Reported return ranges and averages by loan example

		LOAN 1	LOAN 2	LOAN 3	LOAN 4
ROE	Range	1.6 - 24%	14 - 34%	17 - 25%	25 - 34%
	Mean	13.9%	25.2%	19.6%	30.8%
RAROC	Range	7.8 - 15%	16 - 58%	8.8 - 43%	19 - 238%
	Mean	13.5%	35.8%	20.2%	92.3%

Exhibit 17: Frequency for updating cost-to-lead estimates or parameters in pricing/profitability model



Source Oliver Wyman analysis

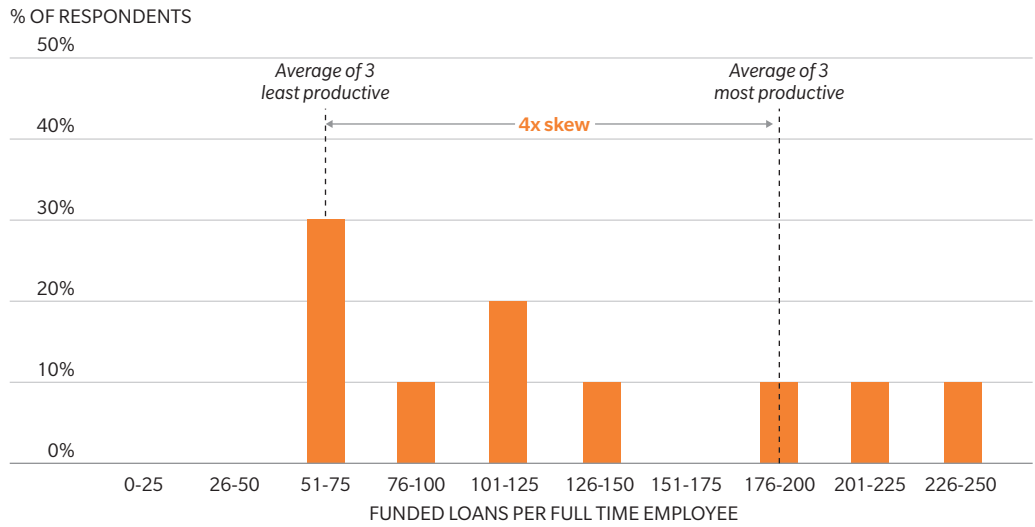
update cost parameters in their pricing/profitability models. As summarized in Exhibit 17, there is a range of discipline in updating model assumptions. This range of practices may potentially be driving some of the parameter skews highlighted above.

C. PRODUCTIVITY METRICS SHOW EXTREME SKEWS

Cost figures are difficult to compare across banks due to issues with the underlying data, including availability, integrity, and consistency. As an alternative, we compared headcount productivity, which should correlate strongly with cost. The responses from the participating banks reveal a large skew in productivity.

To categorize a bank's productivity, we divided the number of new loans in 2013 by the number of full time employees directly involved in the underwriting of these loans. Since banks reported their data differently, we worked with each survey participant to understand their submission and adjusted full time employee numbers to standardize which roles were included in our calculations. As Exhibit 18 highlights, the major productivity variation means that some banks are getting nearly 5x more loans booked per full time employee, with the skew from the bottom 3 banks' average to the top 3 banks' average being 4x.

Exhibit 18: Number of funded loans per full-time underwriting employee
2013



Source Oliver Wyman analysis

Note Full-time employees include those individuals directly involved in the underwriting process

We'll explore lending productivity and its drivers further in the next section but found this skew encouraging as it illustrates that some banks are operating at very high levels of productivity. While we can't directly link this to marginal lending profitability, it is

highly likely that these banks are already lending profitably. The overall finding is that there exist combinations of organizational models, processes, and technology that can make small business lending work.

MICROLENDING

A SPOTLIGHT ON PROFITABILITY CHALLENGES

A major theme in our discussions with the participant banks throughout this exercise has been concern that smaller-dollar small business lending is a particular profitability challenge. This concern was driven by several underlying themes including increased regulatory scrutiny, pull-back from automated decisioning, and wariness of credit loss volatility.

In order to evaluate these concerns, we analyzed the relationship between average loan size in banks' portfolios and portfolio losses, net booking rates, and net interest margins. We have summarized the results of this analysis in the charts to the left – the main findings are as follows:

Exhibit A: Smaller average loan sizes lead to higher credit losses. While we expect these loss levels to moderate as legacy crisis-driven credit problems roll off, we expect the shape of the relationship to remain the same.

Exhibit A: Net charge-offs (% 2013) fall as average exposure size increases

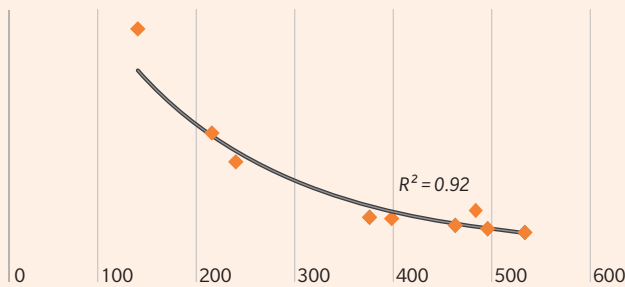


Exhibit B: Net booking rate increases with average loan size in the portfolio

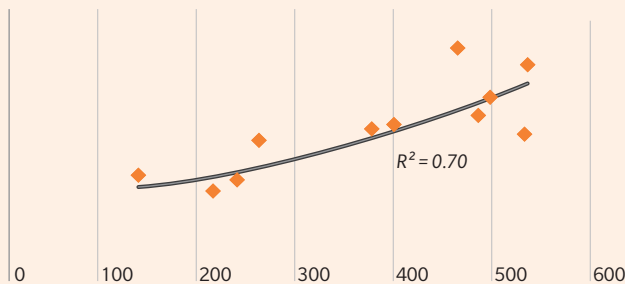


Exhibit C: Portfolio net interest margin by average loan size

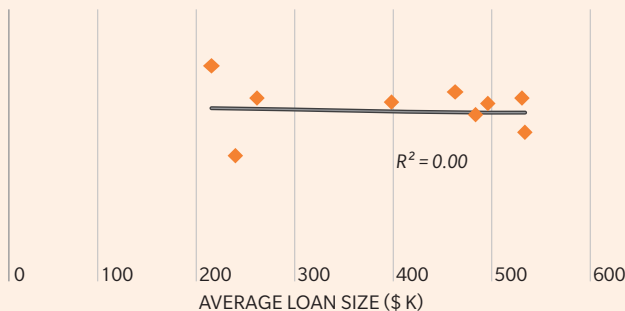


Exhibit B: Smaller average loan sizes lead to low net booking rates suggesting that banks are more selective about what risks to take on. In an environment with low decision automation, low booking rates imply banks are spending scarce manual underwriting resources on small loans and receiving a low return on that manual effort.

Exhibit C: Portfolio-level net interest margins do not correlate at all with average loan size meaning that lenders are not being compensated for additional risk and operating expense. We expect that this result may be partly clouded by varying FTP methodologies from bank to bank, though it is certainly not an encouraging observation and suggests that pricing should rise – or costs need to come down.

Note that this analytical approach has weaknesses in that it uses overall average loan size within portfolios as the independent variable. Therefore the findings do not necessarily indicate microlending in your portfolio suffers the profitability challenges noted here. However, the overall correlations are quite high and suggests that further analysis would be worthwhile. Assuming these findings are directionally correct (and some respondents indicated that they are), there are two potential courses of action for banks to take in light of these findings:

- **Tolerate the status quo**, potentially by reducing the amount of credit made available for smaller loan sizes and likely providing credit primarily as a means to retain more profitable broader relationships with small businesses.
- **Fix the status quo**, potentially by revisiting product structures and automated underwriting and loan monitoring approaches. We discuss such alternatives later in this document particularly in the context of alternative lenders and new sources of data enabling superior credit analytics

The first solution is obviously an undesirable outcome for the health of the US small business sector, and the growth of the banking sector. A preferable solution outside the control of the banks is to identify ways to enable banks to make small-dollar loans more profitably via regulatory change (recent changes to SBA documentation requirements is potentially a good example).

IV. WALKTHROUGH OF KEY COST DRIVERS

As discussed in the previous section, banks maintain varying levels of cost tracking and analytics. Instead of looking directly at cost figures, we evaluated a broad range of cost drivers in order to better understand what might drive the reported cost variations across banks. Cost drivers were grouped into three categories: organizational design, process design, and technology. Exhibit 19 below shows the list of drivers that we sought to evaluate in the study. We have highlighted the cost drivers that offered the most interesting insights.

The rest of this section walks through the findings and implications of this selection of drivers.

A. APPROVAL AND BOOKING RATES

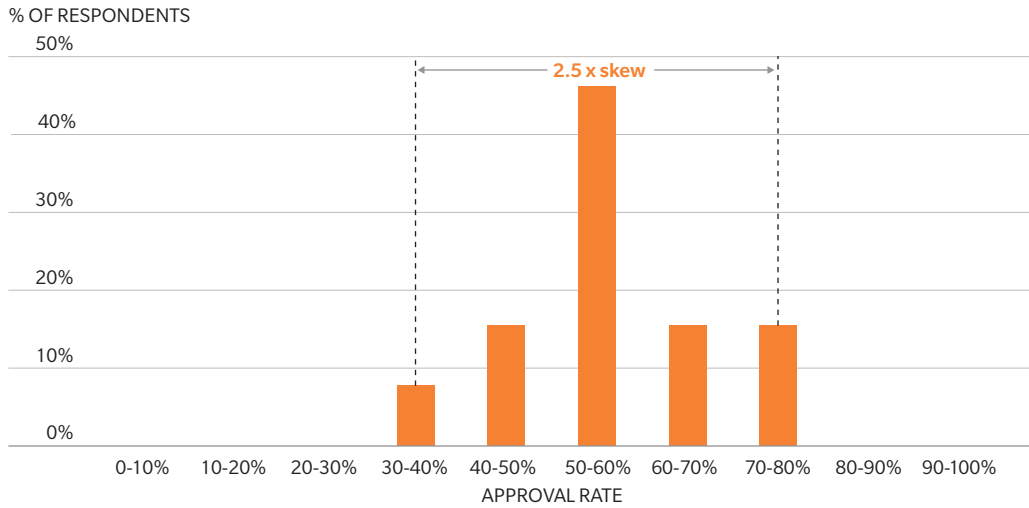
One of the single largest process variations observed in this study is the variation in approval rates across banks. As summarized in Exhibit 20, some respondents approve 30% of loan applications whereas others approve 75%. As discussed in the previous section, this 2.5x difference likely has a meaningful impact on overall efficiency, and hence profitability. This is especially true if the banks with low approval rates spend a lot of time working to sell and underwrite loans that will not be approved. We should note that this isn't always the case and that some banks do a good job weeding-out loans with low potential value very early in the process.

Exhibit 19: List of cost drivers by category

ORGANIZATIONAL DESIGN	PROCESS DESIGN	TECHNOLOGY
<ul style="list-style-type: none"> • Location strategy • Roles and responsibilities • Authority delegation • Distribution of roles 	<ul style="list-style-type: none"> • Marketing and sourcing <ul style="list-style-type: none"> – Exclusion criteria • Underwriting and approval <ul style="list-style-type: none"> – Approval and booking rates*1 – Productivity*1 – Auto-decisioning*1 – Touches – Credit write-ups*1 – Product standardization • Monitoring and reviews <ul style="list-style-type: none"> – Differentiated review processes*1 	<ul style="list-style-type: none"> • Automation*1 • Integration • Satisfaction

*1 Cost driver that offered most valuable insights

Exhibit 20: Percent of loan applications that are approved
2013

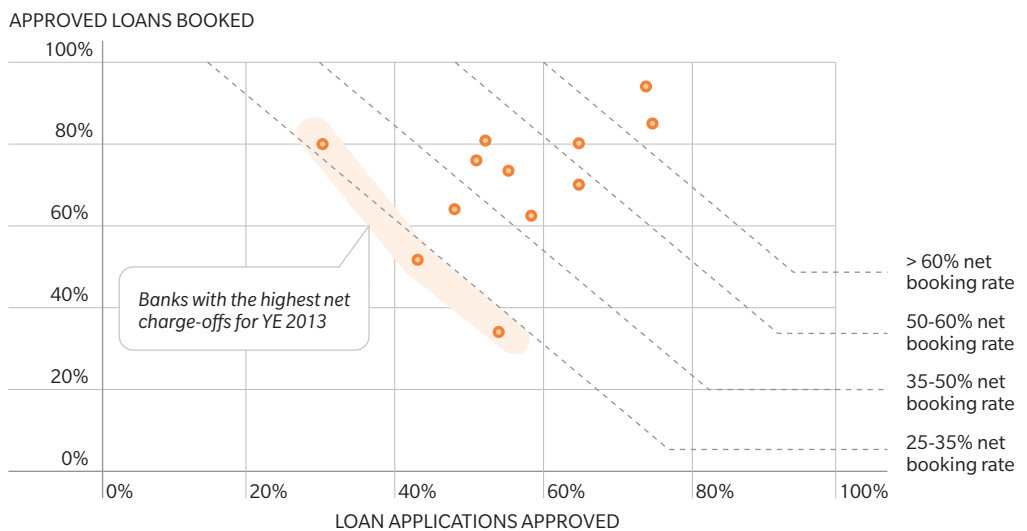


Source Oliver Wyman analysis

Respondents also presented a wide variation in the booking rates of approved loans – in some cases with very extreme fallout (i.e. only 30% of approved applications being booked). Exhibit 21 summarizes the respondents’ approval and booking rates.

The variation in approved-to-booking rates further exacerbates the impact of the 2.5x approval rate skew described above. It leads to a nearly 4x skew in terms of net-booking rate (i.e. percentage of total applications that get booked).

Exhibit 21: Percent of loan applications approved versus percent of approved loans booked
2013, sample of responses



Source Oliver Wyman analysis

Another important insight from Exhibit 21 is that the same net-booking rate can be achieved in different ways. Some banks have low approval rates and then book a large percentage of the loans they approve. Others have high approval rates and then low booking rates due to customer fall-out. While two banks could have the same net-booking rate, it's a lot worse to get there from the latter category where approval rates are high and booking rates are low. Given the inherent information asymmetries between a bank, its competitors, and potential borrowers, a low booking rate could flag high potential for adverse selection and consequently higher credit losses. We found limited support for this adverse selection hypothesis evident by some correlation between low booking rates and higher credit losses.

Further on the topic of credit losses, a reasonable question to ask is whether those banks with very high approval rates had higher credit losses than others. According to the data, they did not. Instead, the

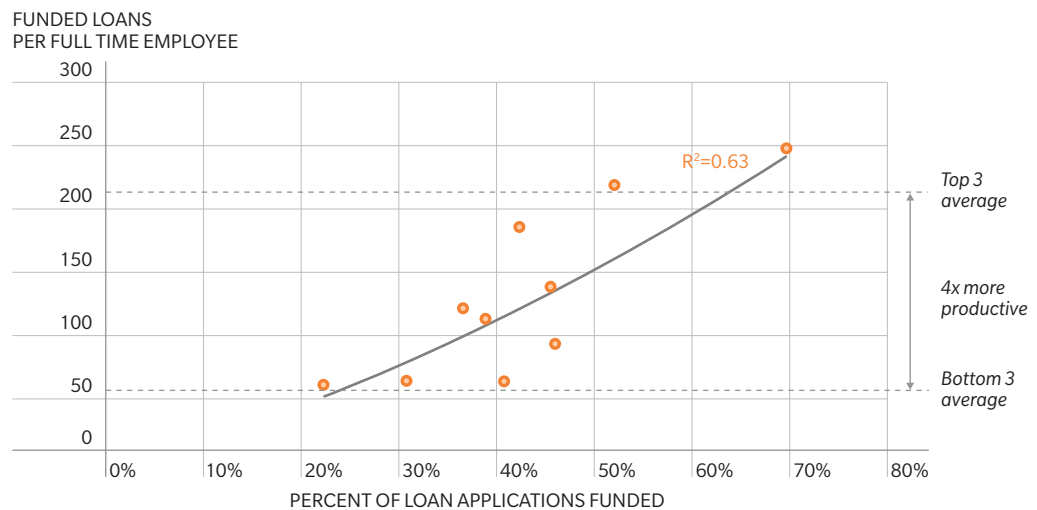
banks with the lowest approval rates had the highest credit losses. This is flagged in Exhibit 21. While other factors such as local market competitiveness may be at play, these results indicate that low approval rates do not necessarily mean better filtering-out of "bads" in the credit process for all banks.

B. PRODUCTIVITY

Earlier in this report, in Section III Part C, we showed wide skews of productivity across the respondents by looking at 2013 loan volume (in total units) per non-sales full time employees that are directly involved in the underwriting process. The roles included in this calculation are primarily underwriters, portfolio managers and support roles that assist with the underwriting process. This analysis demonstrated that the top three most productive banks are on average 4x more productive than the three least productive banks.

Exhibit 22: Percent of accepted loan applications funded versus funded loans per full-time employee

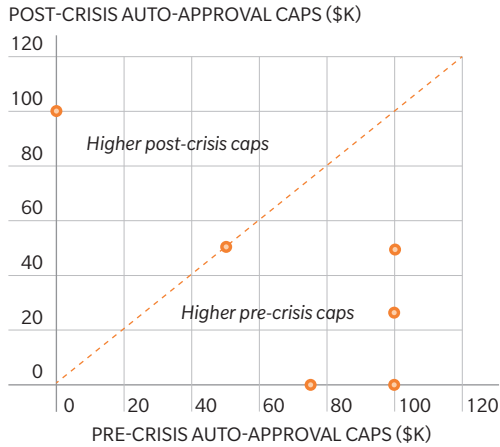
Sample of responses



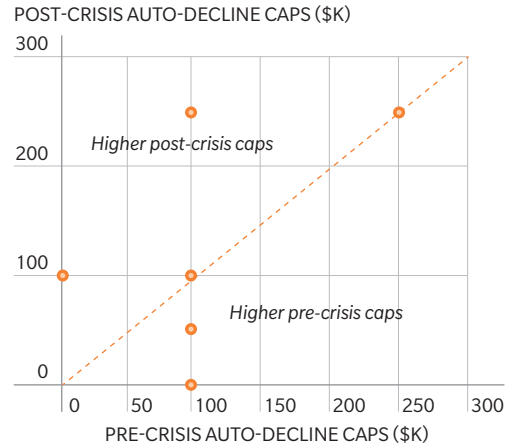
Source Oliver Wyman analysis

Exhibit 23: Auto-approval and auto-decline caps – pre-crisis versus post-crisis
Sample of responses

AUTO-APPROVAL LOAN SIZE CAP



AUTO-DECLINE LOAN SIZE CAP



Source Oliver Wyman analysis

Given the results of the prior section, we wanted to see the extent to which approval and booking rates played a role in skewing productivity. As Exhibit 22 shows, the rate at which banks book their loan applications (i.e. high approval and booking rates) strongly correlates with the productivity skew.

Interestingly, when comparing the most productive banks to their peers, we found that the most productive banks' portfolios contain the greatest portion of small business loans greater than \$500 K. This almost certainly means the highly productive banks are not only more productive at putting units on the books, but those units generate disproportionately more revenue than the loans at other banks. Ultimately, the revenue skew is likely larger than the 4x unit productivity skew.

C. AUTO-DECISIONING

Respondents' use of auto-decisioning has declined significantly post-crisis. Exhibit 23 summarizes auto-approval and auto-decline caps in use by banks pre- and post-crisis.

When segmenting the banks based on productivity, we found no meaningful difference in the use of auto-approval between the highly productive banks and the other banks. The study results also indicate there is no significant difference in the use of auto-decline between the two groups. However, as will be highlighted in Section V, the highly productive banks, when compared to other banks, view increasing the use of auto-decisioning as a very important way to manage the economics of their small business lending practices.

D. CREDIT WRITE-UPS

In addition to asking respondents for detailed information about their processes, we also requested several redacted “typical” credit memos. We evaluated these memos to approximate the amount of work being done to prepare the average credit application for approval. With only a few example memos, there was still a significant amount of variation across documents and the templates supporting them. The high-level differences are summarized in Exhibit 24.

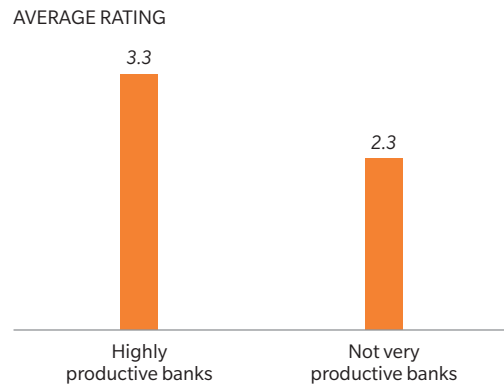
Exhibit 24: Qualitative analysis of credit write-ups

DIMENSIONS	RANGE OF OBSERVATIONS
Page length	3 versus 15
Form standardization	Completely standard versus largely non-standard
Question type	Fixed answer versus free response

E. DIFFERENTIATED ANNUAL REVIEWS

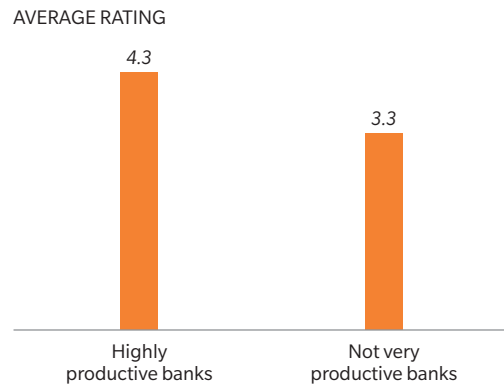
Respondents varied significantly in their perspectives and practices on differentiating annual reviews (i.e. by size and/or risk) as a lever to drive higher profitability. We first asked them about their current state of maturity of differentiating annual reviews based on loan or client characteristics. Here, we found a divergence between the five most highly productive banks and the remaining banks based on funded loans per full time employee. As summarized in Exhibit 25, the highly-productive banks reported a significantly higher level of maturity when it comes in differentiated annual reviews.

Exhibit 25: Current state of maturity of differentiated annual reviews by productivity category



Note 1 – Not a historical focus area; 5 – Highly mature model; little remaining opportunity

Exhibit 26: Focus on differentiated annual reviews as a lever for managing the economics of small business lending by productivity category



Note 1 – We do not consider this a focus area; 5 – We carefully monitor statistics and view them as key drivers

Similarly, as shown in Exhibit 26, the highly productive cohort reported a greater forward-looking focus on this lever.

F. AUTOMATION

In the study, we asked the respondents about the extent to which they are leveraging technology to automate various steps in the credit process. On average, banks describe their level of process automation to be fairly low. Where processes are more automated than manual, we also find that banks are generally tepid in their satisfaction with current systems.

One of the most surprising findings in the study emerged when we compared the highly productive cohort with less-productive banks. In 8 of the 12 steps in the credit process that we posed to participants, the highly productive banks reported lower levels of automation. Exhibit 27 details this finding.

In several steps, including risk-rating and gathering customer data, the highly productive banks had significantly less automation when compared to the rest of the respondents. However, we do not believe one can construe this result to mean that automation leads to lower productivity. Instead, it suggests that streamlined processes focused on differentiation, speed, and getting loans approved can work even with very manual technology – and that a high level of automation doesn’t guarantee effective/efficient processes.

Exhibit 27: Level of automation in credit process by productivity cohort

PROCESS STEP	HIGHLY PRODUCTIVE BANKS	NOT VERY PRODUCTIVE BANKS	DIFFERENCE
Approving loans/iterating on feedback	2.3	2.0	0.3
Funding	2.7	2.3	0.3
Creating the credit write-up	2.3	2.3	0.0
Booking loans into the accounting system	3.0	3.0	0.0
Preparing documents	2.3	3.0	-0.7
Document repository	3.0	3.7	-0.7
Providing feedback to client on loan status (e.g. via a customer portal)	1.0	1.7	-0.7
Spreading financials	2.3	3.7	-1.3
Calculating risk ratings/scores	2.7	4.0	-1.3
Tracking client reporting items against loan requirements	1.0	2.3	-1.3
Gathering customer data (e.g. customer portals)	1.7	3.7	-2.0
Tracking 3rd party communications and documents (e.g. appraisals, environment)	1.0	3.7	-2.7

Highly productive banks report higher average score Not very productive banks report higher average score

Note 1 = “Fully manual”; 3 = “Mixed 50/50”; 5 = “Fully automated”

V. EVOLUTIONS AND REVOLUTIONS

None of the banks that participated in the study are standing still – the fact that CBA members were highly interested in completing this study reinforces that. Similarly, we have perceived in our client dialogue a recent uptick in the amount of interest in improving lending profitability, effectiveness, and client experience.

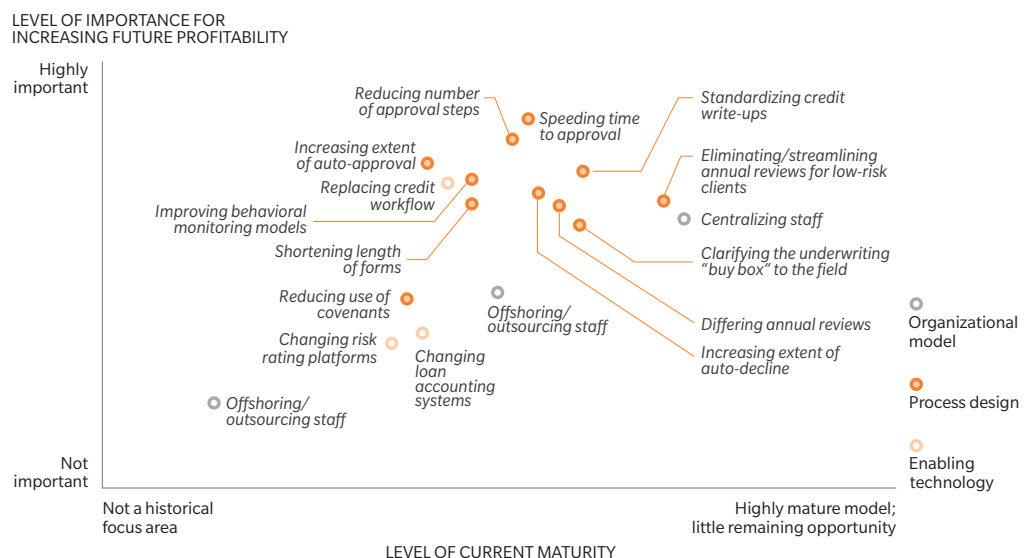
This section describes what banks are up to from an evolutionary standpoint. Specifically, we dive into which areas banks are focusing on to increase the future profitability of their small business lending practices. The section also details which process levers banks see as most important in managing the economics of their business units. Later

in the section, we offer some views on potentially revolutionary developments in the small business lending market, focusing on new data sources and alternative small business lending models.

A. PRIORITIES FOR THE FUTURE

The variations in productivity among participants indicate that many banks have ample room to improve along a number of dimensions. We asked banks which profitability levers they envision as being important to them in the future. We also asked banks to rate their current level

Exhibit 28: Profitability levers: Current maturity versus importance for future profitability



of maturity with respect to these levers. The levers, which were grouped into the categories of process design, organization model, and enabling technology, were rated differently across the banks. We averaged the results and summarized them in Exhibit 28.

The levers contained within the process design category were generally rated as being most important to increasing profitability in small business lending.

As the results show, a consistent theme for how banks are evolving is eliminating work and increasing speed of process. The top 3 most important profitability levers according to respondents are:

1. Increasing extent of auto-approval
2. Use of differentiated annual reviews
3. Use of short-form underwriting documents

We are encouraged that these profitability levers come out on top because we believe these are among the right priorities for banks based on our client work.

B. PROCESS LEVERS TO FOCUS ON IN THE FUTURE

In addition to areas of future importance for profitability, we also asked the participants to report which process levers are focus areas for managing the economics of their small business lending practices. We wanted to test whether highly-productive and less-productive banks are prioritizing the same or different process levers. We segmented the respondents into cohorts based on the productivity measure used throughout our study (i.e. approved loans that are funded per full time underwriting employee).

Exhibit 29 compares the level of focus between the cohorts of most productive and least productive banks. A score of 5 signifies that the bank carefully monitors statistics and views a specific lever as a key driver of economics, while a score of 1 means that the bank does not consider that process lever a focus area.

Exhibit 29: Areas of focus for managing business economics by productivity category

PROCESS LEVER	HIGHLY PRODUCTIVE BANKS	NOT VERY PRODUCTIVE BANKS	DIFFERENCE
Increasing use of auto-approval and/or auto-decline	3.7	1.3	2.3
Use of differentiated annual reviews	4.3	3.3	1.0
Use of short-form underwriting documents	4	3	1.0
Time-to-approve	5	4.3	0.7
Complexity of approval process	4	3.3	0.7
Increasing approval rate	3.7	3.5	0.2
Level of standardization in loan packages	4.3	4.3	0.0
Complexity and extent of use of covenants and borrowing bases	2.3	3.0	-0.7

Highly productive banks report higher average score Not very productive banks report higher average score

Note 1 = "We do not consider this a focus area"; 5 = "We carefully monitor statistics and view them as a key driver of economics"

We see that the most productive banks are relatively more focused on five key efficiency levers, which are:

- Increasing approval rate
- Use of differentiated annual reviews
- Increasing use of auto-approval and/or auto-decline
- Time-to-approve
- Complexity of approval process

C. REVOLUTIONS IN THE CREDIT MARKET?

While participant banks are focused on stepwise process improvements, a focus which we believe is largely the right one, we see two potentially more revolutionary developments in the market:

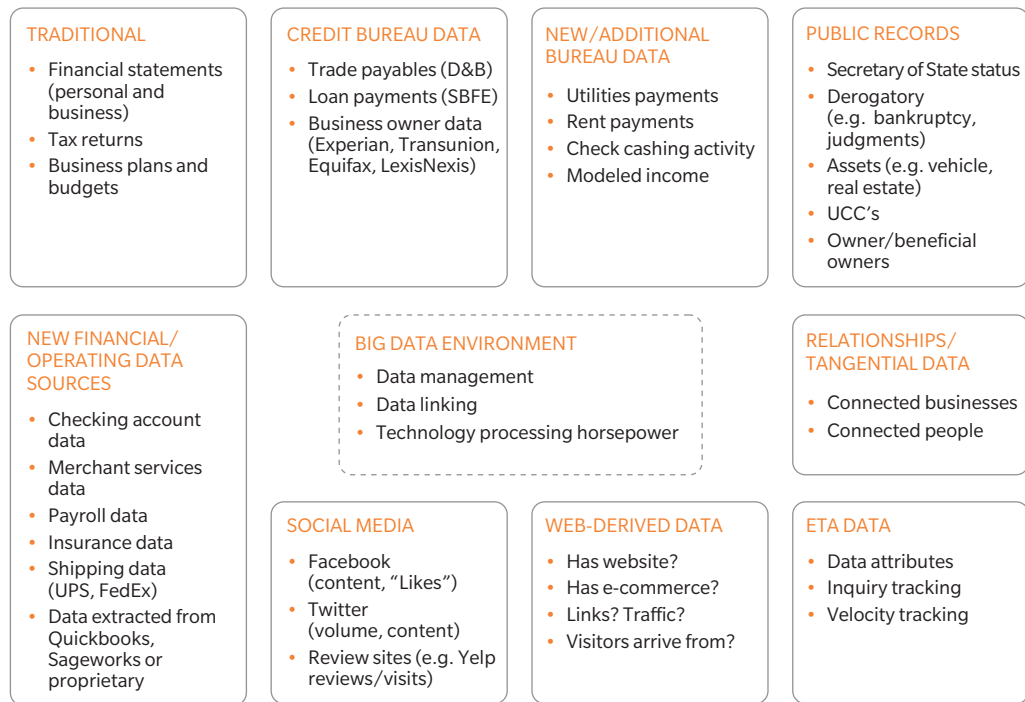
- Use of alternative data sources
- Alternative lender partnerships

1. USE OF ALTERNATIVE DATA SOURCES

As noted earlier in this document, the industry's focus on driving auto-decisioning to higher thresholds pre-crisis did not end well. However, the state-of-the-art in those days was to use consumer and business bureau scores as the primary ingredient in scoring models. The environment for data on small businesses is now much richer than ever before. An open question is whether banks can put this data to use to help provide insight into fraud and credit risk and thus use this insight to augment and streamline processes currently conducted by people.

In Exhibit 30, we provide a summary taxonomy of the small business data environment.

Exhibit 30: Taxonomy of small business data types and sources



A conversation with

BEN CUTLER

Senior Director of Small Business Risk Management,
Financial Services, of LexisNexis

What are the primary concerns of your small business banking clients currently?

We repeatedly hear that our banking customers need a clear, concise understanding of business entities and their relationships with authorized representatives and other businesses. However, coverage gaps and over-combining and under-combing of information seem to be plaguing the industry.

How has LexisNexis worked to mitigate these concerns and better serve its small business banking clients?

We have invested significantly in our content and content-linking capabilities. In terms of content, we are currently pursuing an aggressive data acquisition strategy that involves traditional data as well as alternative data. We are also now partnering with the Small Business Financial Exchange to host its industry-leading contributory data-warehouse of loan performance information on US small businesses.

And in terms of content linking?

We realize that vast data points are an asset only if correctly linked, and we are near completion of a multi-year initiative to re-platform and re-link our vast data sources. We have patented a process that is flexible for multiple definitions and business formats, and this new data linking process significantly reduces over and under-linking issues. Our system accommodates a range of business entities, including location-based entities, legal entities, and business groups, and it reveals entity-to-entity associations that other processes miss.

Overreliance on credit models are something often blamed for high peak losses in small business lending during the crisis – do you think models are going to be fundamentally better than last time or do we risk repeating history?

We believe that credit models are, and will continue to be, critical to the small business lending process. Overall, post-crisis credit models benefit from better data inputs, new data types, and advancing analytics.

How is LexisNexis contributing to these better models?

As mentioned before, we have invested significantly in our content and infrastructure to ensure that we provide a crisp view on small business entities. We provision this in various formats, including our own risk models and soon through data attributes to fuel lenders' in-house modeling.

What's new in terms of data that didn't exist 5 years ago?

There have been two major advances in recent years: Big Data technology and content availability. In terms of Big Data technology, we can now process greater than 3 BN records quickly with very high precision and recall and identify non-obvious connections that were previously obscured by disparate, unmaintained, and unconnected content. With regards to content availability, we can now access a greater number and variety of data sources. The web continues to facilitate business to have a public presence, though some newer data points must be more carefully vetted for quality, value, and veracity.

How about in terms of analytics?

Data mining and metadata capabilities have also advanced significantly in recent years. Technology horse-power and better understanding of content source is enabling companies to mine their data-stores and create valuable metadata for use in analytic scoring models.

With these advancements in mind, how does LexisNexis envision its relationships with banks changing over the next 5 years?

Our customers have recently shown increasing interest in risk decisioning on small businesses and have become more engaged in pushing for new and more insightful products and more co-operative lender/vender approaches. We see this trend both with our core offerings and through our data management partnership with the SBFE, and we expect it to continue in coming years.

As this taxonomy shows, we've come a long way from just the two upper left boxes in terms of what is available. The industry is now facing several main challenges, which we offer brief thoughts on the next page:

- **Determining what can be useful:** There has been a lot of media attention on the opportunity to enhance credit analytics using social media, web-derived data, and meta-data. We do believe these data sources have their place, particularly in fraud analytics. For credit analytics however, we believe banks should focus first on new financial/operating data sources for several reasons:
 - They can provide much more timely and likely more accurate insight into the current state of business activity than traditional financial statements can (which are fraught with inaccuracies and are certainly not timely)
 - Banks already have access to some of these data sources via information on existing checking and/or merchant customers
 - These data have been used successfully by many of the alternative lenders

Overall, banks need to take stock of the information available to them either from their own systems, third party data sources, and data aggregators like the bureaus and conduct their own evaluation of where data can improve fraud detection and credit analytics.

- **Making it useful:** After evaluating the broad range of sources and how they might provide risk insight, banks then need to determine how to use the

insights in a way that improves efficiency and/or effectiveness of credit processes. The single overriding goal we think banks need to achieve is to differentiate the way their credit processes work in ways that increase overall speed by intelligently reducing the amount of work. For example:

- Flagging quick auto-declines with rigorous rules to ensure they then don't sneak back via a separate process
- Putting in place an explicit underwriting process tiering based on model output and rules (e.g. new to bank vs. existing bank client, industry x vs. industry y)
- Using a standardized credit memo process in the low risk underwriting path that focuses underwriter attention on where they can add value beyond what you've already learned via models or data
- Cutting out covenant tracking for some product structures (e.g. demand facilities or annually renewable facilities) and instead relying on real time risk indicators to flag deterioration
- Tiering the annual review process and cutting to the bare minimum for clients performing as expected with no unusual risk flags

We believe that many of these process changes have already been made by industry leaders without significant investment in new models and data. Bringing these into the process will only increase the potential effectiveness of credit processes.

A conversation with

MICHAEL STEFANICK

Senior Vice President, Commercial Data and Analytics, of Equifax

What are recent client trends?

We hear our clients discussing portfolio growth again, but in the context of smart growth. Lenders are aware of the changing small business landscape, which goes beyond regulation and now includes advances in automation and analytics. Lenders are really focused on how automation can improve the speed of decisions for small size business lending, and businesses are looking for new ways to borrow outside of traditional products like credit cards. Flexible lines of credit tied to incremental business expansion in the next 6 to 9 months seem to be of particular interest among our clients.

With this in mind, how is Equifax working to better support its clients?

One way Equifax is supporting our clients is through our commercial data. Equifax provides the most reliable source of data on 26 MM small size businesses in the US, with a detailed view of the 15 MM most active businesses. Additionally, Equifax provides insights to all types of businesses via our analytics. Equifax is rapidly expanding our analytics offering via “Big Data” for business health, business activity, and business capacity.

It seems like many companies are currently focusing on data. Does Equifax have enhanced capabilities in this area?

Equifax can successfully link related businesses as well as businesses owners. Further, Equifax is currently expanding its data assets by acquiring “Big Data.” This will give insights into customer and market behaviors.

How about in terms of analytics?

We believe the days of the data dump are gone, and the conversation is about precise analytics and actionable insights. Our analytics model is solution-focused, which opens the door for data, technology, and advanced analytics. Already a big data company, we are expanding our data science capabilities in order to become the intermediary expert who vets data sources and then applies strong technologies and analytic methods.

Do you notice increased demand for such analytics?

We are finding that the demand for analytics is expanding on every level. We are building out additional small business insight capabilities to help provide our clients with richer market insights. This really goes hand-in-hand with our solutions and is integral to our client relationships.

Given this increased demand, where do you believe clients are headed with respect to small business analytics?

We think the availability of on-demand cloud applications will influence the prevalence of automation and the quality of insights from analytics. Cloud will also allow for the real-time integration of customer data sets with verified IDs, company linkages, trade data, and behavior data set. All of this data will be combined via dynamic learning algorithms that produce insights. These algorithms will use “data” to train the models in producing new insights based on patterns.

How do the changes in analytics tie into risk?

We still believe risk scores are powerful and have rich financial trade, non-financial trade, and credit attribute repositories to help identify and manage risk. In conjunction with verified business identities and affiliate and consumer linkages, we can help strike the right balance between risk and reward.

With the evolving market in mind, what does Equifax see as the next big thing and where does it fit?

Understanding how the business-to-business network among small size businesses affects the ability of a specific business to grow over time is “what’s next”. Insights related to the ecosystem of a firm, associated supply chain partners, sales partners, and the surrounding business radius is the next frontier of small size business analytics.

2. ALTERNATIVE LENDER PARTNERSHIPS

Just like the alternative data theme, alternative small business lenders have been garnering a lot of press attention recently. These take several forms

- Mainstream alternatives (e.g. OnDeck, CAN Capital)
- Merchant cash advance providers (e.g. AmeriMerchant)
- Peer to peer lenders (e.g. Lending Club)

In this section, we are primarily focused on the first category because we believe it has the most direct relevance to the banking sector. These lenders generally:

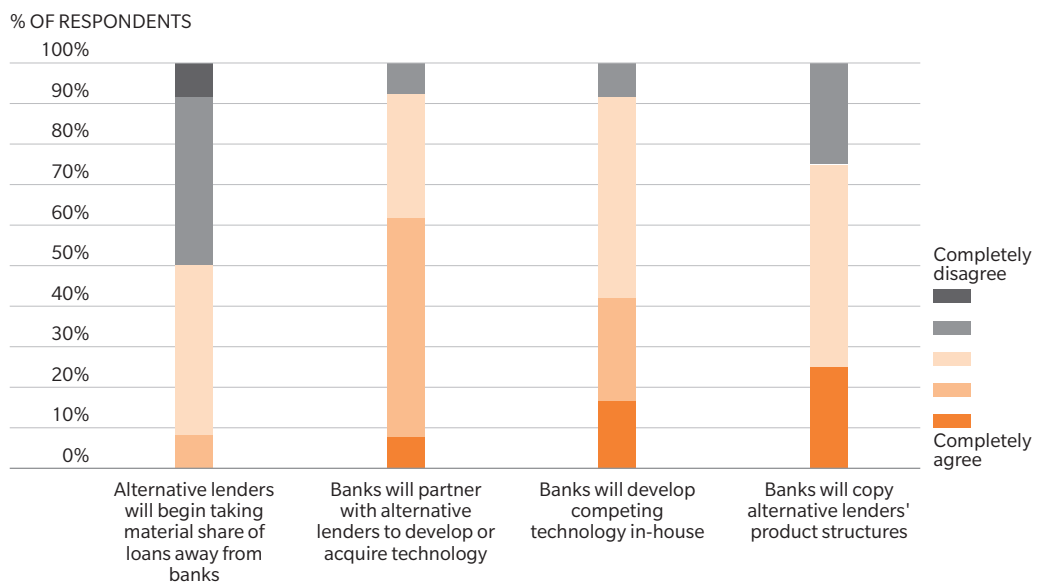
- Offer a fast and convenient underwriting process, leveraging the advanced analytics and data sources we discussed in the previous section
- Rely on real time monitoring and daily remittance

- Have focused on higher-risk segments, offering higher APRs, due to their need to cover higher funding costs and most notably higher acquisition costs

We asked study participants a number of questions about their thoughts on alternative lenders.

We first asked banks how they perceive alternative lenders fitting into the market over the next five years. As shown in Exhibit 31, banks aligned on some topics but varied on others. Banks largely agree that alternative lenders will not take away material share of loans from banks. They are more divided on whether banks will partner with alternative lenders to develop or acquire new technologies as well as whether banks will develop competing technologies and mimic alternative structures. This is consistent with what we have seen working with our clients to develop their strategies in this space.

Exhibit 31: Perceived role of alternative lenders in the 5-year time horizon



Source Oliver Wyman analysis

A conversation with

NOAH BRESLOW

CEO, of OnDeck

What do you believe prevents traditional lenders from achieving greater profitability when lending in amounts <\$1 MM to small businesses?

It's not an issue of capital or losses that make it unprofitable for traditional lenders to lend small dollar amounts. It's really a process issue – meaning the same process used to underwrite and service a \$1 MM loan is too cumbersome and expensive for a \$30 K loan.

With that in mind, what does your company bring to the market that allows it to more profitably lend in these amounts?

OnDeck has developed an end-to-end platform that leverages technology and data to efficiently underwrite and service SMBs. From my perspective, four things differentiate OnDeck from traditional lenders: data aggregation; credit philosophy; a small business oriented customer experience, and automated daily/weekly payments.

We have heard a lot about data aggregation recently. What is OnDeck currently doing on this front?

We use a big data approach that involves collecting over 2,000 data points for every customer application in order to automatically score loan applications. Our data sources include traditional types of data such as credit bureaus and cash flow, as well as newer types such as publicly available government and social data.

And this use of data aggregation informs your credit philosophy?

Yes, absolutely. FICO can signal a business owner's long-term propensity to repay, but the health of the business and its cash flows are stronger predictors of repayment in the short term. OnDeck's underwriting model leverages our data points to quickly split out the health of the business from the business owner.

How does the combination of these things yield a better lending process?

Using digital data and technology, OnDeck is able to make approval decisions in minutes and fund in as fast as 24 hours. To create a great customer experience, we're focused on serving customers through their channel of choice. We've built a self-service process for customers to complete the loan experience online, from application to checkout. In fact, 70% of our borrowers perform at least some portion of the loan process online. We also have dedicated funding specialists available to speak with customers 8am-8pm and on weekends, because we're sensitive that business owners don't lead 9-5 lives.

How do you balance such fast decisioning with the associated risks?

To help mitigate risk, we deduct payments either daily or weekly directly from business' checking accounts. Not only does this smooth cash flow for the business, but it provides us with real-time monitoring insights. This real-time data also helps us to iterate on our credit models faster.

Looking ahead, how do you envision the relationship between banks and alternative lenders such as yourself?

We see increased cooperation and believe banks will be a core component of our business. We're seeing banks leveraging our technology platform to offer capital on demand to their customers. While banks possess an embedded customer base, transactional data, and relatively low-cost capital, OnDeck offers an efficient platform to help deploy that capital. We can help utilize data for pre-approvals, instantly underwrite and quickly fund customers – all as a bank white-labeled product with limited investment.

If you could deliver one message to the head of small business lending at a leading bank, what would that message be?

Most large banks are focused on growing revenues through their top customers, which makes that space extremely competitive. Partnering with a company like OnDeck is an optimal way to better serve the rest of your base and add significant revenue in the process.

We then asked banks whether or not they have had conversations with alternative lenders about possible partnerships. We were not surprised to find that 75% of respondents have already spoken with alternative lenders.

As these results show, banks generally do not view these non-traditional lenders as a direct threat to their market share. Many of the banks are instead looking at partnership opportunities – potentially starting with turndown programs and then evolving into closer partnerships with alternative providers helping banks with their technology and analytics to assume risk directly.

We believe that such partnerships offer potential complementarity, as described in Exhibit 32.

Our view is that most banks should consider partnerships with alternative lenders and that only a select few should seek to replicate what the alternatives offer. While

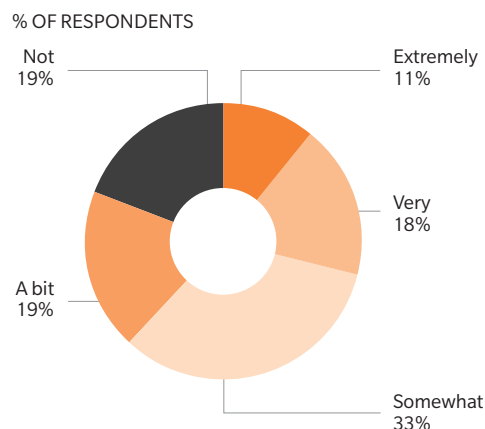
Exhibit 32: Relative advantages (+) and disadvantages (-) of traditional banks versus alternative lenders

	TRADITIONAL BANKS	ALTERNATIVES
Acquisition cost	+	-
Funding cost	+	-
Data management	-	+
Process discipline	-	+
Customer experience	-	+

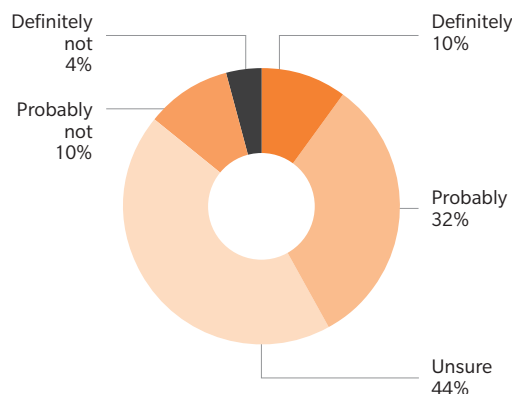
we believe that some of the approaches that alternative lenders offer will help improve the profitability of lending, we believe that the larger benefit banks stand to gain through partnership derives from enhanced acquisition and retention of checking customers by providing a simple and low hassle credit offering.

Exhibit 33: Receptivity of small businesses to alternative lending products

HOW USEFUL WOULD THIS PRODUCT BE?



WOULD YOU USE IF OFFERED BY YOUR PRIMARY BANK?

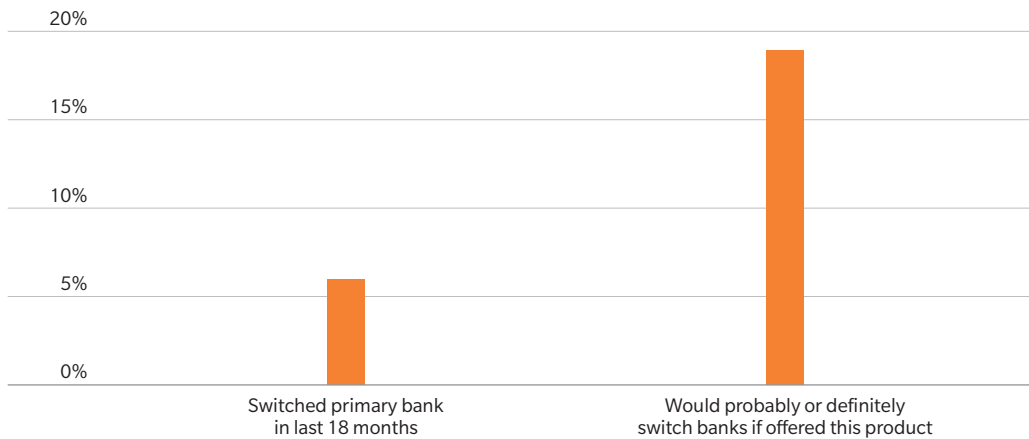


Source Oliver Wyman New-Form Lending Survey of Small Businesses (Q1 2013)

Note Marginal includes staff incentives, compensation allocations for staff directly involved in the lending process, and vendor costs not passed through to the borrower; fully-loaded includes marginal plus line and corporate overhead, IT systems, full allocation of management overhead, etc.

Exhibit 34: Willingness of small businesses to switch banks for an alternative lending product^{*1,*2}

SHARE OF SMALL BUSINESS



Source: Oliver Wyman New-Form Lending Survey of Small Businesses (Q1 2013)

*1 Excludes respondents who would “definitely not” use a preapproved line of credit (Q74)

*2 Of those identified as needing credit

In prior research in 2013, Oliver Wyman analyzed market receptivity to banks providing an alternative lending product (framed as a relatively short term, low hassle product). Exhibit 33 shows the receptivity to the offering – many business described the product as potentially useful (in a market where only 20% of small businesses borrow) and would seek the product if offered by their primary bank.

We then asked whether business owners would be willing to switch banks for such a product. As expected, only a minority of about 20% said they would. However, compared to the typical switch rate of 6%, which is shown in Exhibit 34, as well as the general difficulty in moving the needle on acquisition, this result is startlingly high.

We do think that banks will be slow to this party due to regulatory uncertainty and the challenges of integrating alternative lenders’ capabilities into existing bank systems environments. Nonetheless, we believe that all it will take is 1-2 large banks getting comfortable with regulatory and systems concerns and launching closer partnerships with the alternatives to create a storm of activity. As such, banks should have an active strategy for the alternative lending space and determine how such products might fit into the lineup. They should also be aware of the ways that alternative lenders’ capabilities can augment traditional processes.

VI. IS THE INDUSTRY ON THE RIGHT TRACK?

The central thesis of this paper is that small business lending can be profitable and there are probably some banks already competing profitably. We wish that we could have said something more conclusive and avoided wiggly words like “probably” but the task is shockingly difficult – or perhaps not so shocking for small business executives who face these challenges daily. As discussed above, we did not reveal any silver bullets for achieving profitability, but we do think there are several important takeaways that will help each bank shape its own solution to small business lending profitability challenges.

It’s hard to manage what is hard to measure: Winning banks will have ongoing measurement of their cost-to-lend in aggregate and of key drivers of profitability on the margin. Absent such measurement, there is no urgency to improve and therefore those banks won’t.

Book’em: With a 4x spread between the highest net booking rates and the lowest, winners need to keep a keen focus on bringing in good deals and booking them. This could mean having very clear doability rules up front to avoid wasting time on loans that won’t get approved, or it could mean having very fast turnaround to clients to get an approval back before competitors do. Whatever the lever, it’s imperative to increase the booking rate so that you’re not wasting precious cost dollars on loans that are never going to create any revenue.

Speed it up: The fundamental reason why lending costs are too high at some banks is that people are doing too much work. Don’t confuse work with output. Output means underwriting, approving, and monitoring loans in a way that adequately protects you from risk. Spending an incremental hour of work (perhaps underwriting) **may or may not** make a bit of difference in the output. But it can make a difference on the cost. With the right measurement, you can tee up decisions on whether that incremental hour is necessary or in fact helpful at all. Perhaps this would lead you to reduce work and streamline processes. Perhaps you might also find that you can’t get the right quality of output done at the right cost, and perhaps that means not wasting any time at all on loans that you can’t deliver profitably.

Technology is not a panacea: When Oliver Wyman has helped clients evaluate business cases for credit technology investments, we see cases resting on productivity improvements on the order of 10%. As we’ve shown, some banks seem to require larger performance increases to match their most productive peers. There is no system (yet) that is going to get you all the way there. Sometimes, the worst processes can run on the best systems and the best processes can run on Microsoft Word and Lotus Notes.

If these are the starting points leading to greater lending profitability, do we think the industry is moving in the right direction? The quick version is yes – although we do think there is room for increased focus, awareness, and guided investment.

The fact that the CBA membership wanted to focus on this question indicates that we're all fishing in the same pond, defined by a realization that lending profitability probably isn't where it could be. We've even heard executives at some banks say that they'd be willing to reduce lending to small businesses if they feel they can't easily remediate their profitability concerns – something that would have been unheard of ten years ago. We know of some banks that are just now

reorienting their internal accounts structure and MIS so that they can see cost reporting on credit as a product. The insights that better information will yield, coupled with overall banking cost and revenue pressure, are going to be a call to action on this topic.

As banks strengthen insights into how they're doing, they'll need to revisit their strategies (whom do we lend to, where can we loss lead) and then take all the steps they can to create processes that work. Some of this will be through technology. The harder work will involve rewiring the way people do things and evaluating whether steps are adding real value or are being done because of culture and tradition.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

Founded in 1919, the Consumer Bankers Association (CBA) is the trade association for today's leaders in retail banking - banking services geared toward consumers and small businesses. The nation's largest financial institutions, as well as many regional banks, are CBA corporate members, collectively holding well over half of the industry's total assets. CBA's mission is to preserve and promote the retail banking industry as it strives to fulfill the financial needs of the American consumer and small business.

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