Accelerating Digital Lending for Community Banks

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Executive Summary

The Fed's 2020 Small Business Credit Survey (SBCS) notes that small businesses were 12 percentage points more likely to receive financing through a fintech or online lender in 2018 than in 2016, with a nearly equal decline in the likelihood of borrowing from a community or mid-size bank.

The table below shows the steady decline in market share among banks, credit unions, and traditional finance companies caused by the fintech disruption.

YEAR	BANK	CREDIT UNION	TRAD. FINANCE CO.	FINTECH
2018	28%	21%	13%	38%
2017	30%	22%	13%	35%
2016	32%	23%	16%	29%
2015	35%	25%	19%	21%
2014	39%	28%	22%	11%
2013	40%	31%	24%	5%

Source: TransUnion

This disruption has transformed banking with improved end to end digital experiences, especially in lending. In contrast, a majority of community and mid-size banks have been lagging behind.

There are clear benefits to modernizing and improving lending operations and technology capabilities. FDIC analysis shows that community banks that deployed digital lending capabilities – online loan applications, automated underwriting and online loan closures – had higher ratios of loans to assets and achieved higher growth.

The key challenges faced by community and mid-size banks with their lending operations are:

- Sub-par customer loan experience with lengthy decision times due to a lack of online/mobile capability and digital signatures
- Manual and expensive underwriting operations that do not scale
- Inability to leverage alternative data such as bank statements for improved risk and margin

To close these gaps and enable them to develop digital business capabilities, community banks are turning to partners that can provide the right combination of people, processes, and platforms.

Community Banks and an Overview of their CRE, Small Business and SBA Lending Scenario

The Fed's November 2020 Economic letter highlights the role of community banks in lending to SMBs, and especially to those small businesses that were hit hard by restrictions that limited their ability to pay operating costs during the COVID-19 crisis.

The FDIC's 2020 Community Banking Study points out that at the end of 2019, there were 4750 community banks with over 290,000 branches across the country. The number of community banks decreased by 30% from the end of 2011 to the end of 2019 – the attrition was due to mergers, closures and bank failures.

The FDIC defines a community bank as a bank that is localized to a region, with less than $2B in assets and takes a "relationship" approach to banking unlike that of a larger bank's "transactional" approach. Despite their declining numbers and a fall in their share of industry assets, these small community banks continue to account for a sizable share of CRE, small business and SBA lending.

Let's look at each of these areas from the lens of the FDIC study.

CRE Lending

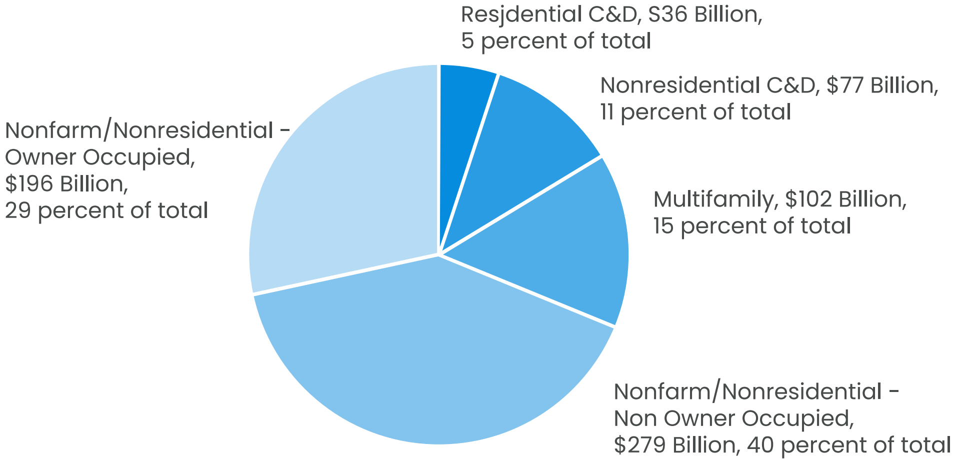
CRE loans provide opportunities for businesses to own commercial property, for housing within communities, and for the provision of retail and other services to metropolitan, micropolitan, and rural areas. Community banks originate various types of CRE loans: multifamily lending grew in the years between 2011 and 2019, and community banks are active lenders to a wide range of industries, including industrial, retail, and hotel industries.

At the end of 2019, community banks had $690B of CRE loans which represented 30 percent of the banking industry's CRE loans. This is a significant size when related to the banks' representation in the banking industry —community banks hold only a 12% share of the banking industry's total assets.

Further, community banks headquartered in rural and small metropolitan areas held more than two-thirds of CRE loans held by all banks headquartered in those smaller geographic areas.

Commercial Real Estate Loans Held by FDIC-Insured Community Banks, Year-End 2019

(Total $690 Billion)



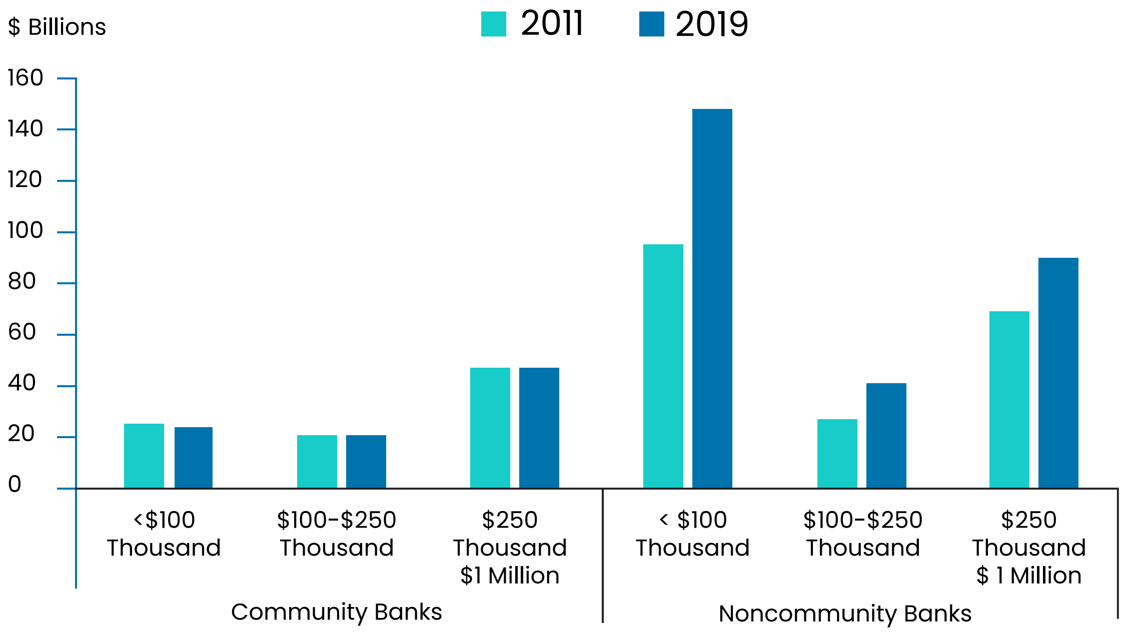
Source: FDIC.
Note: C&D stands for acquisition. construction. and development loans.

Small Business Lending

Small businesses are key to the U.S. economy, representing the vast majority of all businesses by count and employing almost half of the private sector workforce. These businesses often need funding for several reasons, such as for inventory, working capital, or accounts receivable financing. Despite holding only 15 percent of total industry loans in 2019, community banks held 36 percent of the banking industry's small business loans. Community banks focus on building relationships with small business owners and tend to make loans that require more interaction with the borrower.

However, over the years, fintech's and big banks have grown to dominate this segment, especially the smallest category of business loan originations as shown in the chart below. These loans below $100,000 make up a big share of this lending segment and are typically business credit lines which tend to use a scoring model that requires little interaction with customers.

Community Bank and Noncommunity Bank Small Business Loans by Dollar Size,Year-Ends 2011 and 2019

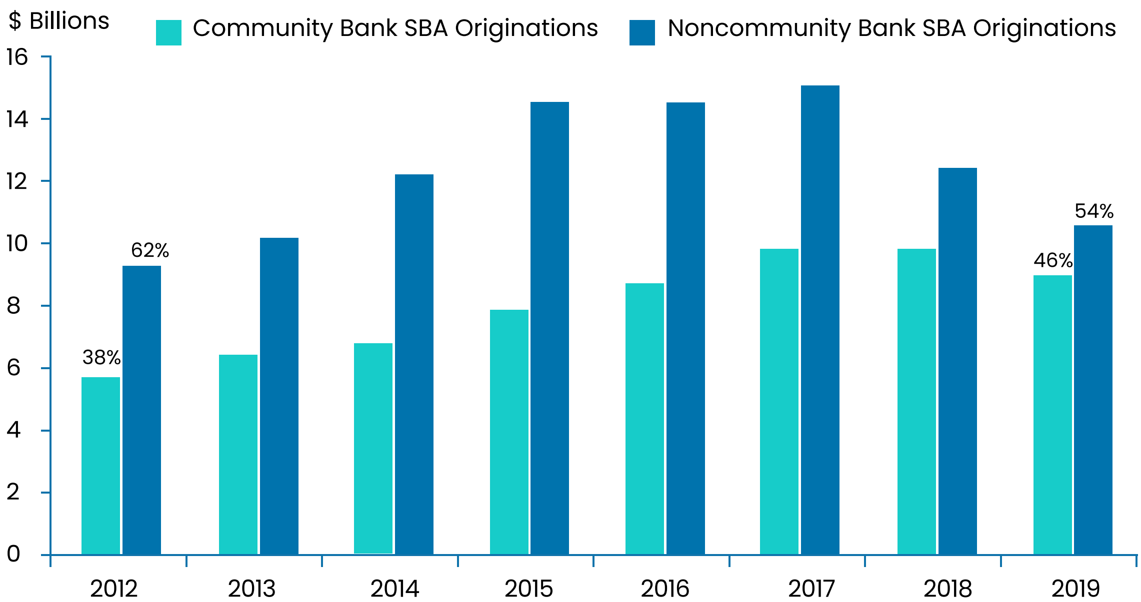


Source: FDIC.

SBA Lending

Community banks are also key players in the SBA-guaranteed 7(a) loan program, which guarantees loans originated up to $5 million. Between 2011 and 2019, community banks saw their share of SBA 7(a) loan originations increase from $5.7 billion to $9.0 billion. Of the loans originated by banks in that program in 2019, community banks originated approximately 46 percent.

Small Business Administration 7(a) Loan Originations



Sources: Small Business Administration; FDIC.
Notes: Represents only those SBA loans made by Insured depository Institutions. Percentages on bars represent share of total.

Lending Challenges Faced by Community Banks

Here we look at the challenges faced, especially from the Covid-19 pandemic perspective. Even before the pandemic, community banks have been losing market share to the fintechs and big banks.

Covid-19 Pandemic Impact on Bank Operations

The COVID-19 pandemic brought about an unprecedented situation, shaking the fundamental structure of our social and economic behavior. Digitalization catapulted from a consideration to a necessity for every industry. While on one hand the crisis generated severe repercussions on many businesses, we also saw winners from technology focused digital businesses like online retailers and fintechs.

In a PriceWaterhouseCoopers (PwC) survey of 6,000 U.S. bank customers conducted in May and June 2020, 24 percent stated they were less likely to use their bank's branch offices. As with other sectors, bank customers are increasingly preferring a contact-less way of working with the bank. Community banks need to transform their operational procedures to adjust to this trend, and this has long-term effects on branch structure and operating expenses.

Essentially, community banks are at the crossroads between traditional and new ways to service their customers. Although the traditional methods including in person interaction have their place, there is an urgent need to adapt to what customers increasingly want, with simple end-to-end digital products. Delivering to this need will ensure mid-market banks remain competitive and profitable.
It becomes evident now that the increase in demand for contact-less banking will require community banks to expedite the adoption of new technology, especially digital lending.

Customers Turning to Fintech and Online Lenders

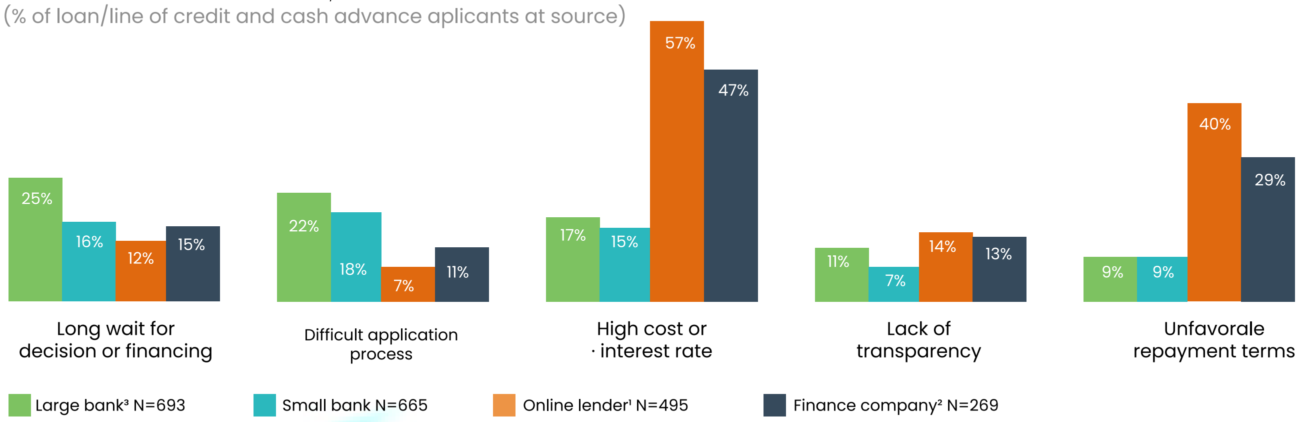
The Fed's 2020 Small Business Credit Survey (SBCS) highlights the challenges with lenders from the customer perspective of the firms that look to obtain loans. fintech's and online lenders are increasing their market share at the expense of community banks.

Specifically, the study notes that small businesses were 12 percentage points more likely to receive financing through a fintech or online lender in 2018 than in 2016, with a nearly equal decline in the likelihood of borrowing from a bank lender.

Difficult Application Process and Lengthy Decisioning Times

The application process and the wait time for decisioning are crucial factors that impact the lending outcomes. Customers rate community banks poorly in both these areas. In the chart below we see that fintech's do much better than banks (both community and non-community) when it comes to the application process or wait times. fintechs and big banks are able to deliver superior experiences with leading UI/UX, mobile and technology capabilities. Further, they also leverage data for risk scoring models and have invested in digital lending capabilities to give them a competitive advantage.

CHALLENGES WITH LENDERS, Select Lenders[4]
(% of loan/line of credit and cash advance aplicants at source)



Source: Fed's 2020 Small Business Credit Survey

Impact of Technology Adoption on Bank Performance

The FDIC paper goes into what differentiates high performing vs low performing community banks. One of the clear insights is that technology adoption, especially in digital lending leads to increased asset and revenue growth.

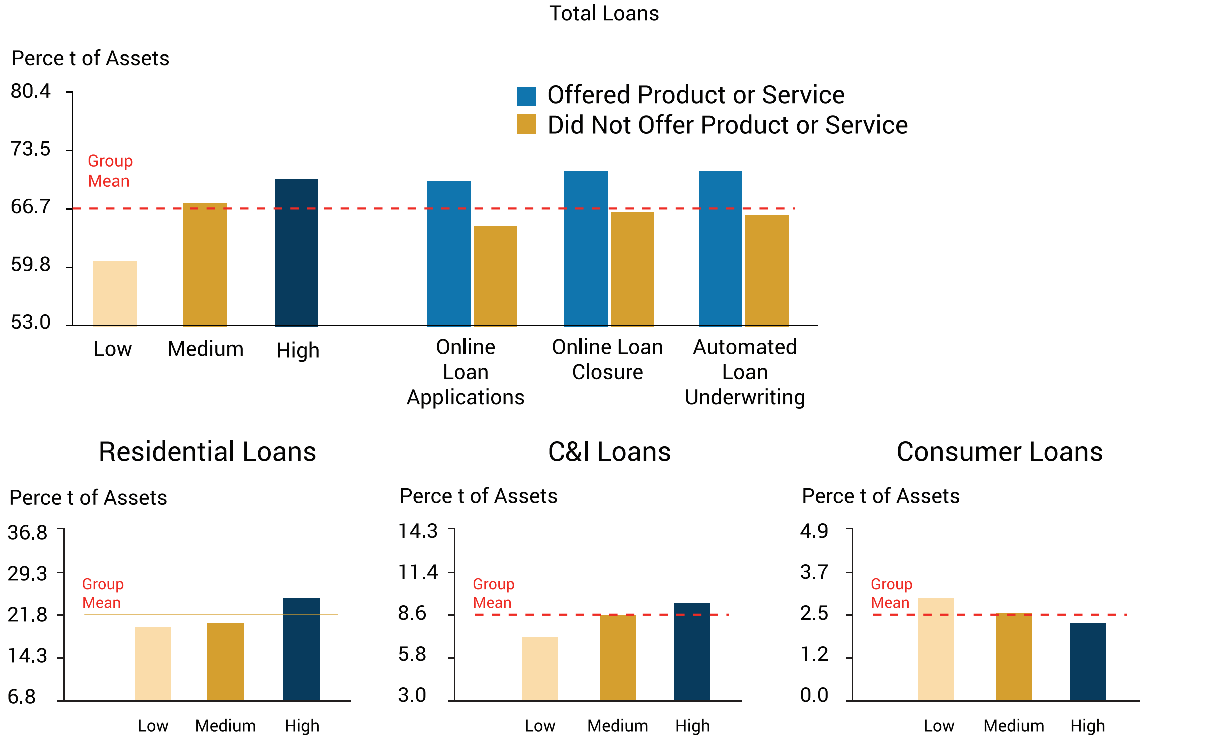
Digital Lending and Bank Performance

Loans constitute about two-thirds of a typical community bank's assets. There are three main ways digital lending enables bank performance:

- It improves current lending efficiency and lending volumes by increasing the speed and convenience of the application process and producing faster underwriting decisions.
- It increases lending through new and expanded products and entry into new markets.
- It reduces risk and increases bank profitability by leveraging existing and alternative data sources to make the optimal risk and credit decision

The FDIC chart below clearly indicates the performance advantages of community banks that invested in digital lending capabilities – automated underwriting, online loan applications and online loan closures. These banks had higher ratios of loans to assets, higher growth, even after differences in size were accounted for. Similarly, banks that faced greater competition, had more optimistic expectations, and had more positive attitudes toward technology were more likely to be "high adopters."

Total Loans as Share of Assets by Technology - Adoption Category and Product or Service Offering, First Quarter 2019



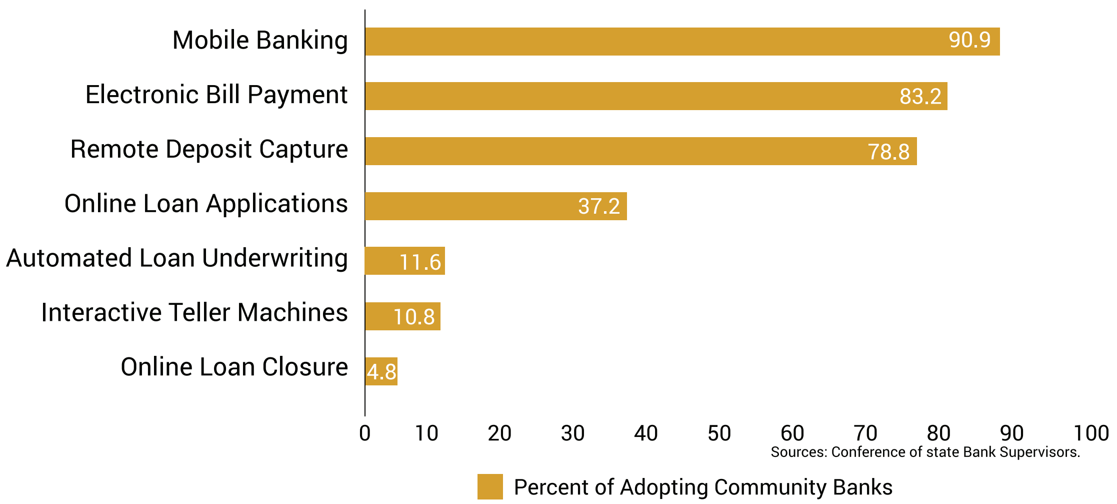
Sources: FDIC and Conference of State Bank Supervisors.
Note: To indicate the significance of the differences between the technology adoption categories, the y-axis of each chart was scaled to be roughly one stanard deviation below and above the mean for all community banks in the survey.

Digital Lending Capabilities Lacking Amongst Majority of Community Banks

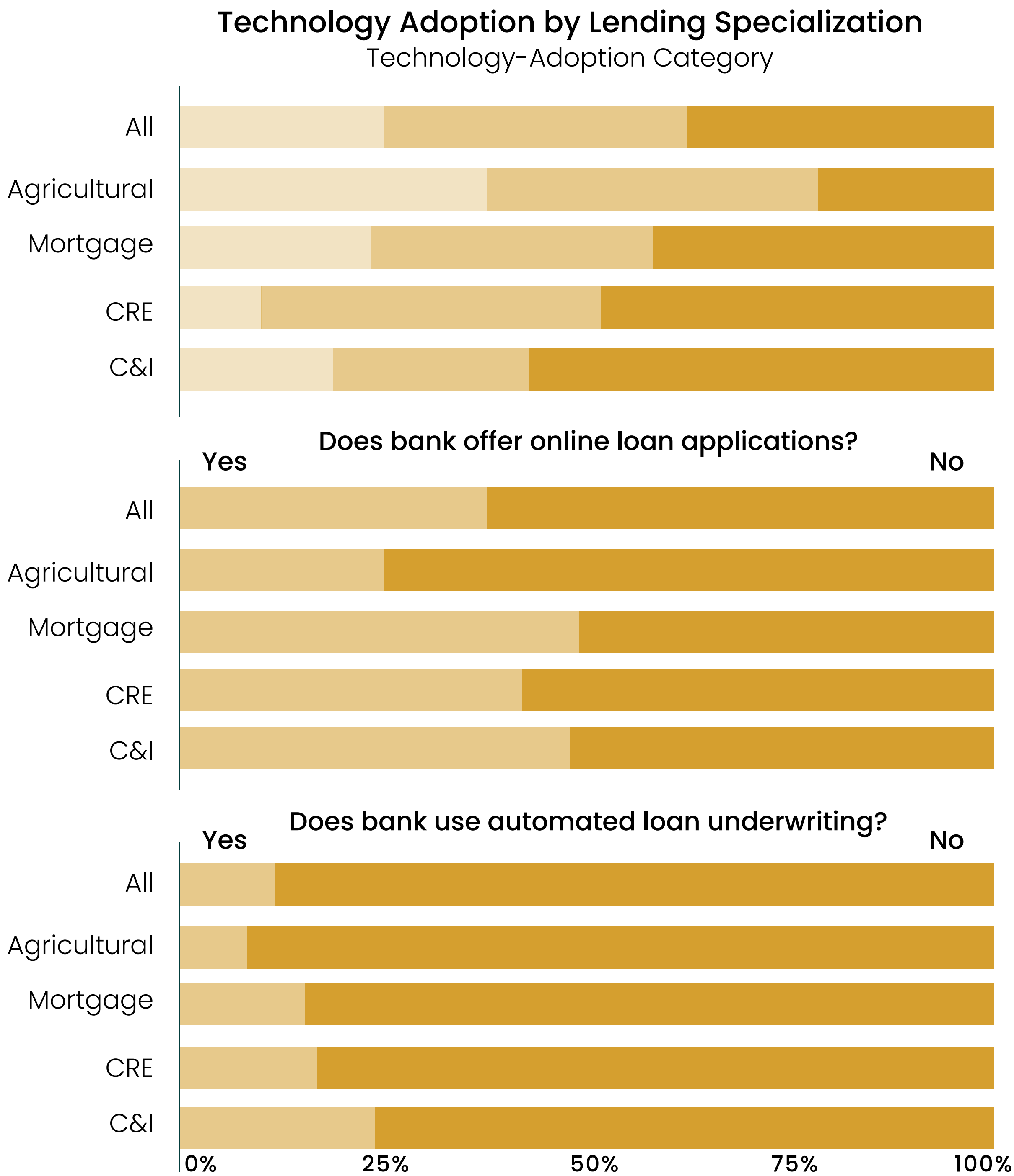
Data from a 2019 survey conducted by the Conference of State Bank Supervisors (CSBS) indicate that "low adopters" of several recent technologies were distinguished mostly by their smaller asset size and lower revenues.

As this chart below shows, a lot of community banks are at a low level of maturity with respect to technology adoption and especially Digital Lending. Only 11.6% of community banks use automation for underwriting.

Adoption Rate of Surveyed Community Banks by Product and Service, 2019



This chart below shows more detail on adoption by lending specialization. These banks would benefit from digital lending capabilities by increasing their efficiencies, loan volumes and risk reduction.



Sources: FDIC and Conference of State Bank Supervisors.
Nore: Appendix A outlines the criteria for each lending speciality.

Ways for Community Banks to Catch Up with the FinTechs and Big Banks

Community banks risk being squeezed between global banks that have invested large amounts of money and skilled staff and the nimble fintechs that can easily deliver superior experiences through data and technology. FinTechs especially have been at the forefront of driving digitization and mobile solutions in the banking industry leading to their increased market share at the expense of community banks.

Digitalization and Digital Lending as the Way Forward

Providing digital lending and depository products and having the ability to scale operations through automation and technology capabilities will enable the community banks to improve their offerings, reach a larger audience, and infuse greater efficiency.

This will open the opportunity for community banks to explore various classical and new lending models that benefit from speed, agility and enhanced customer experience leading to business growth and profitability. Digital lending can no longer be looked at myopically as a cost savings play or a method to overcome time-consuming and complicated manual efforts. It must be viewed as a way to accelerate loan volume and velocity resulting in asset growth and margin improvements.

Advantages of a Secure, Cloud-based Digital Lending Platform

With constrained budgets and a race against time, the simplest and easiest go-to-market solution for community banks is the deployment of a secure SaaS (software as a service) cloud-based digital lending platform.

The benefits of cloud-based solutions are well known – flexibility, speed to market and strategic value. Especially for community banks, the cloud solution is the most viable one as it provides a pay-per-use subscription model that can provide immediate value, and it avoids the need of deploying and maintaining an in-house complex IT solution that is compliant with regulations such as SOC2 and ISO / IEC 27001.

Some of the crucial points that need to be considered while evaluating the capabilities of a digital lending platform to address their challenges and opportunities are:

- End to end compelling and engaging digital experience for customers
- Underwriting automation to reduce costs and improve efficiencies and shorten the time to close
- Fraud reduction with improved identity collection
- Regulatory compliance and analytics
- Reduce credit risk with data insights and improved loan scoring

The right partnership is key

Once the decision is made to move forward with the digital lending initiative, it is key for the community banks to choose the right partner for digital transformation.

Choosing a partner requires careful vetting and consideration of the factors below:

- Product fit and differentiators
- Product support
- Product customization and integration capabilities
- Partner's agility
- Partner's financial strength & longevity

Banks should view this partnership as a long-term journey to achieving digital transformation of their lending operations. This agile transformation doesn't have to be expensive or disruptive to current operations or a bank's clients.

The benefits are well worth it – banks could expect to see significant improvement in their lending volume and velocity, decrease their credit risk, and open new customer segments.

Case Study: Midwest Community Bank Overcomes Challenges and Scales Operations with Digital Lending Platform

Expects **400%** ROI on Underwriting Process Transformation

Pre-transformation Challenges that the Bank was Facing

- **Lengthy and expensive decisioning timeline:** This community bank used to take over two weeks and incur costs of over $1000 to process each CRE and C&I loan. This was due to their manual process of gathering the firm's and guarantors' financial and tax statements. Their third-party outsourced underwriter who handled most of their loan volume would take up to 10 days to complete their manual analysis and loan spreads. And these processing delays had a detrimental effect on the bank's loan conversion rates.

- **Inability to scale operations:** The bank wanted to enter an attractive high volume, lower $ value lease loan segment. However, their current manual underwriting process and small lending operations team did not allow them to scale up and enter this market. Further, they did not have the systems and automation in place to allow the end customer to easily apply for a loan online and get fast turnaround on the decision time.

- **Alternative data to make the optimal credit decision:** The bank lacked the capability of obtaining useful data insights on the applicant firms. FinTechs use alternative data like bank statements, and utility usage that provide useful insights on the risk profile of the applicant company. The bank's manual processes and low level of technology maturity were additional factors holding them back.

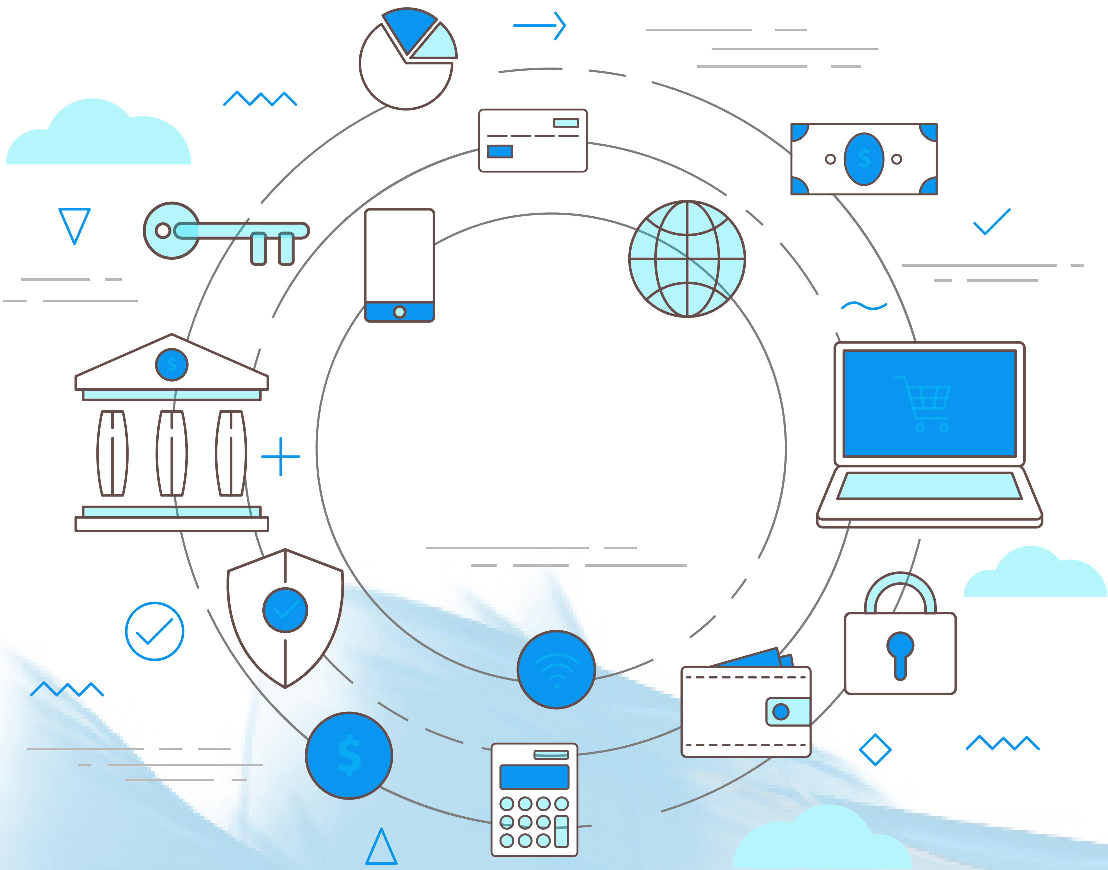
Transformation Features and Post-Implementation Benefits

- A responsive (mobile friendly), easy and engaging self-service online application that cuts down the operational inefficiencies on the bank officer up to 90%

- Automated Loan Spread Generation in less than 5 minutes from 100+ pages of complex company and guarantor tax PDF documents. This provides a very cost effective, efficient and agile alternative and helped the bank reduce/avoid use of the third-party underwriter of $1000 for each loan application. The bank can expect to gain ROI of up to 400%.

- Data integration from alternative data sources coupled with AI/ML helped reduce risk by enabling the loan office to make the optimal risk and credit decision.

- Agility and increased loan types enabled the bank to enter a new high volume lease loan segment and achieve the needed growth.



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