THE STATE OF COMMERCIAL DIGITAL LENDING

CORNERSTONE ADVISORS

THE DIGITAL DISCONNECT

When it comes to the use of digital technologies in the commercial lending space, there's a big disconnect between what commercial banking executives believe about digital lending and what they're actually doing to prepare for a digital lending future.

Nearly nine out of 10 (86%) respondents to the BCG Corporate Banking Executive Survey said they believe digital technologies change the competitive landscape of commercial lending. But fewer than half (45%) said their institution has a clear digital strategy for the future.

Digital is a High Priority, but Banks are Moving at Different Speeds

	AGREE OR STRONGLY AGREE	NEUTRAL	DISAGREE OR STRONGLY DISAGREE
Digital will fundamentally change the economics and competitive landscape in corporate banking	86%	10%	4%
In the battle for market share, third-party providers (i.e., fintechs, technology companies, and players from other industries) will become serious competitors for my organization	57%	10%	33%
My organization has a clear digital strategy and vision for the corporate bank and a well-defined roadmap for digitization	43%	57%	
I consider my organization to be market leading with regard to digital capabilities	19%	38%	43%
To move fast on digital, my bank has already embarked on cooperation models with fintechs or even fully integrated them	52%	33%	15%
My banking technology infrastructure is complicated and a hindrance to quickly enabling digital interactions with my customers	86%	10%	4%

Source: BCG Corporate Banking Executive Survey, 2017

"Financial institutions are going to face a day of reckoning if they don't find ways to serve their commercial lending clients digitally," said Cornerstone Advisors Senior Director Joe Ganzelli. "The danger lies in falling so far behind the fintech lenders like OnDeck, Kabbage, PayPal and Amazon that it's difficult, if not almost impossible, to catch up."

Big Digital Challenges Lie Ahead

Research compiled by Cornerstone Advisors makes the digital lending challenge faced by financial institutions, including commercial banks and credit unions, clear. PayPal is now the largest online small business lender in the country, funding more than $4 billion in small business loans in 2018. PayPal is followed by OnDeck ($2.5 billion), Kabbage ($2 billion), Square Capital ($1.6 billion) and Amazon ($1 billion).

Commercial banks and credit unions are operating on borrowed time when it comes to adopting a clear digital lending strategy.

While commercial lending volume among the fintechs is soaring, it's falling at community banks. In 2017, the monthly volume of small business loans closed per loan officer fell by 23%, while the volume of small business loans closed per branch fell by 9%.

	2017 Median	2015 Median	2015-2017 Median % Change
Small business loan dollars closed per loan officer FTE/mo.	$160,022	$207,984	-23%
Small business loans closed per branch/mo.	0.60	0.66	-9%

Source: Cornerstone Performance Report for Banks 2017

"Fintech and alternative lenders have entered the digital lending market and established a foothold," said Cornerstone Advisors Senior Director Joel Pruis. "They are going to continue to grow as digital lenders, so commercial banks and credit unions are operating on borrowed time when it comes to adopting a clear digital lending strategy."

Coming Up Short

Commercial banks and credit unions are coming up short in three key digital lending areas:

1. Utilizing technology — Many banks and credit unions aren't leveraging available technology to make the borrowing experience easier, faster and more transparent. For example, some financial institutions are still using Word documents and Excel files in their loan applications and underwriting and closing processes.

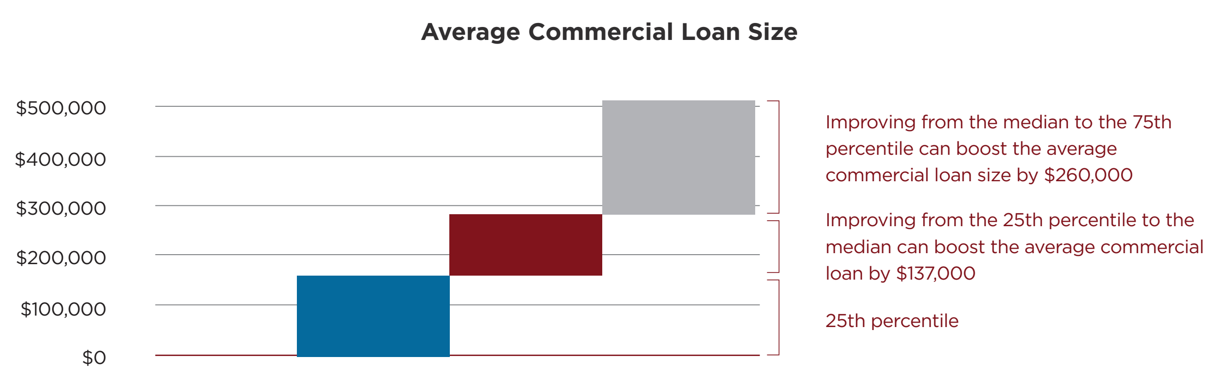
> **Financial institutions need to right-size the amount of effort and resources they put into loan underwriting based on the dollar amount of the transaction and complexity of the deal.**

2. Distinguishing between small business loans and commercial loans — Handling small business and commercial loan requests the same way with regard to data gathering, underwriting analysis, documentation and closing is highly inefficient. "Banks and credit unions need to offer expedited processing and streamlined, score-based underwriting criteria for small business loans," said Ganzelli.

Or, as Pruis put it: "Financial institutions need to right-size the amount of effort and resources they put into loan underwriting based on the dollar amount of the transaction and complexity of the deal. Without a technology-based segmentation strategy, a $100,000 line of credit application could be processed in the same way as a $2 million application. This leads to gross inefficiencies."

Financial institutions in the lower percentile levels typically are not properly segmenting, which drags the average commercial loan size down and reduces the income of the commercial loan portfolio.

IMPACT OF PROPER LOAN SEGMENTATION ON AVERAGE COMMERCIAL LOAN SIZE



3. Identifying commercial loan opportunities — Financial institutions should provide client-facing staff with the tools needed to identify potential small business loan opportunities with existing customers as well as prospects. However, many still rely heavily on maturing loan reports or one-off referrals from centers of influence to identify good loan opportunities.

Meeting Higher Expectations

There's no question that borrowers' expectations when it comes to their financial institutions' digital lending capabilities have been raised considerably. This is especially true for younger business owners and entrepreneurs, such as Millennials. "They see digital technology being used in every other area of their lives and wonder why commercial lending is still so paper-based, document-intensive and outdated from a technology standpoint," said Pruis.

In fact, digital lending capabilities are becoming a much more important factor in how businesses choose a financial institution. "I saw a survey recently where digital lending capabilities were listed among the top three factors corporate clients weigh in a banking relationship," said Ganzelli. "A few years ago, this wouldn't have even been in the top 10."

IMPACT ON THE ORIGINATION PROCESS

According to Cornerstone Advisors Consultant Michael Rempel, embracing commercial digital lending requires more than just a technology shift at financial institutions. It also requires an organizational shift.

“Who is going to own the digital channel going forward?” Rempel asks. “This decision has to be intentional — the responsibility can’t be thrust on someone who just falls into this role. I’ve talked to banks that say they want to be ‘digital-first’ or ‘focused on the mobile experience,’ but when we ask who is going to own the digital channel, everybody just looks at each other. This discussion needs to happen internally before a financial institution really starts to ramp up its digital lending efforts.”

Digital technologies can help financial institutions benefit by being able to connect digitally with fixed asset dealers, such as vehicle dealerships, before business customers even walk through their doors. “It enables financial institutions to connect with potential borrowers right at the point of sale of the fixed asset, which gives them a better opportunity to become the lender of choice,” Pruis said.

In other words, digital lending helps financial institutions engage with potential borrowers much earlier in the process, instead of just hoping borrowers contact them.

Digital technologies can also help financial institutions improve prospecting by deploying lending teams to focus on intentional markets and industries, instead of being reactive. “Lenders can engage directly with business prospects and capture details while they’re in front of them,” Pruis said. “Too often financial institutions just make prospecting calls in a haphazard way.”

The Online Application Opportunity

One of the biggest benefits digital lending provides financial institutions is the chance to give borrowers an improved user experience. There's no better opportunity for this than with the online loan application.

For example, Pruis said forcing business owners to engage with their lender during normal banking hours "is ridiculous. Owners aren't going to set aside time when they could be managing their business and generating revenue to go to the bank and apply for a commercial loan. Digital lending gives them the flexibility to set the time and place for engagement with the lender."

Smaller businesses, in particular, tend to be more receptive to online loan applications. "This is especially true for younger business owners and entrepreneurs," said Rempel. "When Millennials can do nearly 100% of their banking online, why would they be inclined to head into a branch for a business loan? There's certainly an element of education that a banker can provide in person, but the collection of transactional details like business information should be done on line, he said.

Online systems today provide the ability to configure rule sets and workflows as well as integrate with third-party detection tools to prevent fraud from happening with online loan applications.

Unfortunately, some financial institutions shy away from online commercial loan applications due to concerns about fraud. Online systems today provide the ability to configure rule sets and workflows as well as integrate with third-party detection tools to prevent fraud from happening with online loan applications.

Digitizing the commercial loan application also helps streamline the application process by enabling financial institutions to capture and retain all the relevant business data needed for underwriting. As an institution designs its online loan application, it should ask for everything it needs to underwrite the loan, Pruis said. "But only get the information needed to support the next step in the process and ultimately make a credit decision," he said. "If you ask for too much information, your abandonment rates will rise as prospects get frustrated and just give up."

Rempel also stresses the importance of not forcing borrowers to enter the same information over and over. "Few things are more frustrating to borrowers than this," he said. "Instead, make sure you capture the information digitally and store it in a client profile that's easily accessible to everyone who's involved in the underwriting and decision-making process."

Commercial Loan Processing and Underwriting

Adopting digital lending gives financial institutions cutting-edge capabilities that can greatly expedite and facilitate commercial credit analysis. This includes automated decisioning capabilities to evaluate both quantitative and qualitative aspects of commercial loan requests while summarizing key aspects of the credit and citing credit policy exceptions. For example, is the borrower in an industry (as defined by NAICS code) that the institution does or doesn't like to do business with?

A digital lending platform can also ingest OCR financial statements and convert these to spreads to automate a process that has traditionally been done manually by junior analysts. And integration with QuickBooks enables banks and credit unions to pull in financial data from borrowers automatically, thus saving valuable time and money.

In addition, digital capabilities can utilize transaction data — such as vendor payments, account balances, liquidity patterns and account overdrafts — to supplement traditional financial analysis that's based on credit reports. This gives financial institutions a whole different level of insight and provides as much, if not more, value as traditional financial analysis because the data is validated and it's in real time.

Low-cost digital capabilities can help financial institutions look at many different parameters to compute the risk of commercial loans and arrive at appropriate pricing.

Ganzelli said that fintechs have been leveraging these capabilities for years but many banks and credit unions remain hesitant. "I do think we'll start to see wider acceptance and adoption of these capabilities soon," he said.

Digital lending also can help financial institutions improve risk ratings, loan pricing and collateral assessment. "The strongest borrowers should get the best loan pricing — that's commercial lending 101," said Ganzelli. "Using a risk-based pricing methodology is the key here. Low-cost digital capabilities can help financial institutions look at many different parameters to compute the risk of commercial loans and arrive at appropriate pricing."

The Pre-Closing, Closing and Post-Closing Processes

In many ways, the hard work doesn't start until after a commercial loan has been approved. Digital platforms can give financial institutions tremendous flexibility in configuring users to perform granular pre-closing tasks like property appraisals, title work and verification of legal entity good standing — all of which are usually performed using third-party resources.

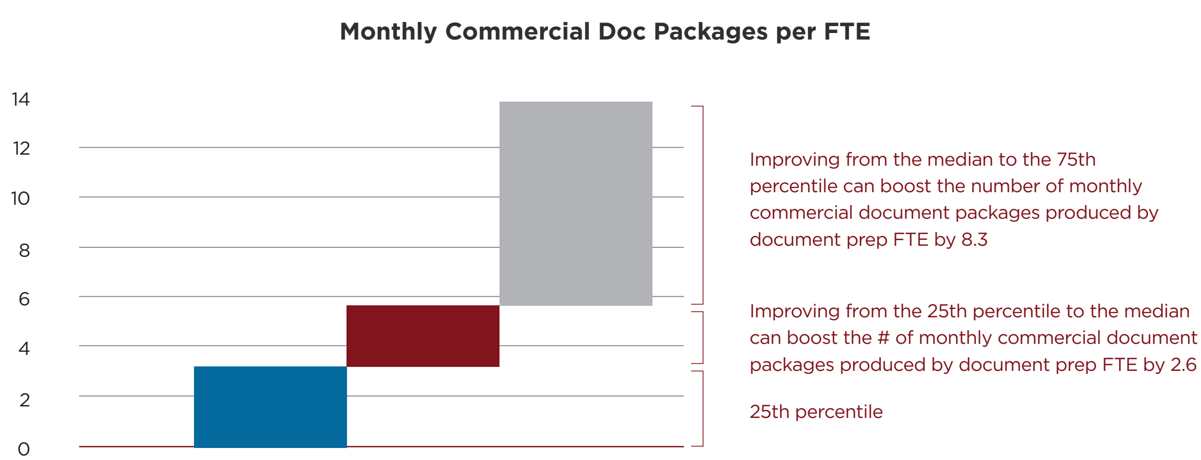
There are numerous digital platforms that let vendors and borrowers submit information via a secure web portal. Financial institutions can define rules to generate items required for commercial loan approval automatically and assign items needed prior to closing. This eliminates manual effort, improves transparency and accelerates the loan closing. Financial institutions need to understand these benefits and clearly explain them to commercial borrowers.

When it comes to document generation, financial institutions don't always have a good idea of when documents can be pushed straight through to the borrower and when they need to be attorney-prepared. "For example, is the decision based on the dollar amount of the loan, its complexity or the level of risk?" asked Cornerstone Advisors Director Tom Hill.

Digital platforms give financial institutions the capability to do more document generation in house. But Hill noted that digital data often comes back from attorneys in a paper format that has to be re-entered manually before it's entered into the core processing system. "There's a big gap there," said Hill.

Financial institutions in the lower percentile levels are typically very reactive to daily changes in loan production volumes and very manual in their production capabilities, dragging down the overall capacity per FTE.

IMPACT OF TRANSPARENCY ON COMMERCIAL ORIGINATION PROCESS AND PRODUCTION PER FTE



Some financial institutions are running automated logic tests against data to make sure it's accurate before passing it through to the core processing system. You need to ensure that clean data is passed through to the core, Hill said.

Of course, signatures are a key part of the closing process. Many industries use electronic signatures, but Hill said financial institutions have been slow to adopt them. "The E-Sign Act was passed almost 20 years ago but many financial institutions still require paper-and-ink signatures," he said. "This leads to a lot of inefficiency and extra cost."

Detailed analysis after a commercial loan closes is critical to ensuring ongoing loan quality, and digital lending platforms make it easy for financial institutions to automate this analysis. Automation takes out the human element and moves controls upstream.

Finally, digital toolsets allow continual risk monitoring and assessment of commercial loans, providing feedback to credit decisioning engines. This becomes critical in creating automated decisioning models used to score small business loans. These models can be validated on a consistent basis and provide feedback so adjustments can be made in order to stay within credit policy guidelines.

RECKONING IS OVERDUE

The clock is ticking for financial institutions that haven't yet formulated and adopted a commercial digital lending strategy. There's still a calm before the next inevitable storm, but banks and credit unions are overdue to face a digital lending reckoning head on.

Myriad reasons exist for financial institutions to embrace digital commercial lending — not the least of which are the performance improvements that can be realized through improved efficiencies. There are also the competitive pressures banks and credit unions face from fintechs and the need to meet clients' expectations for the use of digital technology in commercial lending.

There's still a calm before the next inevitable storm, but banks and credit unions are overdue to face a digital lending reckoning head on.

Yes, there may be some short-term pain during the transition process from paper-based, manual processes to a digital lending platform. But the long-term benefits of commercial digital lending far outweigh any short-term pain that might be suffered.

5 Questions to Ask

As you assess your progress along the digital lending roadmap, ask yourself these **five critical questions**:

1. Are you eliminating paper loan applications and utilizing an online portal instead?
2. Have you defined distinct "cradle-to-grave" micro vs. traditional commercial loan processes?
3. Have you identified consistent risk-based pricing metrics and are you tracking and collecting at least 95% of third-party vendor costs?
4. Are you targeting auto-debit for at least 90% of all commercial loans and charging a 25-50 bp premium for borrowers that don't accept auto-debit?
5. Are you tracking how many times borrower, loan and credit data is entered and where?

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480.423.2030