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The Future of SMB Lending: Three Top Trends

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Prepared for:

TABLE OF CONTENTS

LIST OF FIGURES

EXECUTIVE SUMMARY

The Future of SMB Lending: Three Top Trends, commissioned by Hyland Software and produced by Aite Group, explores how the ecosystem of small and midsize business (SMB) lending—found to be so systemically significant in a favorable way during the pandemic—has transformed since the COVID-19 crisis.

Key takeaways from the study include the following:

- SMB lending is profoundly more digitalized.
- It's vigorously targeted by criminals and credit abusers.
- Soon, it will be subject to one of the largest bodies of regulation to be narrowly focused on the business of financing small organizations.

INTRODUCTION

Weary though we may be with the loss, fear, and economic mayhem of the pandemic, we can now readily see tenuous but compelling signs of the end of the COVID-19 crisis. An ever-increasing number of passenger jets leave contrails in the sky. Dinner reservations now appear on our calendars. Maskless interactions are now possible as more of our friends, relatives, and neighbors become fully vaccinated. And with the transition from the crisis, the ecosystem of SMB lending—found to be so systemically significant in a favorable way during pandemic—emerges transformed in three primary ways. This white paper examines these three trends and their implications for financial institutions.

METHODOLOGY

Primary among the data sources underpinning the findings in this white paper are surveys recently undertaken by the analyst examining the state of SMB lenders during the pandemic, how these financial institutions seek and achieve scale, and an examination of fraud in SMB lending. Driving the findings within the piece on Section 1071 of the Dodd Frank Act are the author's discussions with lenders, regulators, and lobbyists. Also contributing to this report are the author's 14-year career as a commercial lender between 1992 and 2006 and his three years of experience as an industry analyst covering the SMB lending ecosystem.

THE POST-COVID-19 SMB LENDING ENVIRONMENT

Found by Aite Group to be the most significant post-pandemic phenomena in the SMB lending industry are a significantly enhanced embrace of automation in general and digitalization in particular, the persistence of fraud in SMB lending, and the forthcoming oversight of SMB lending by the Consumer Financial Protection Bureau.

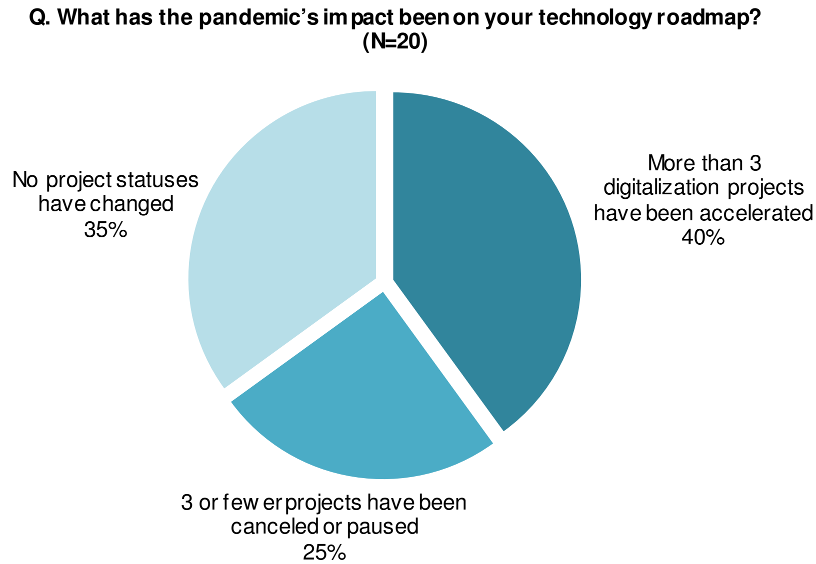
POST-COVID-19 – DIGITALIZATION IS NOW TABLE STAKES

Prior to the pandemic, automation in general and digitalization in particular had been rather unevenly embraced by business lenders. Even electronic document signature—a 20-year old and highly mature technology—lacked broad embrace. Some of the reasons for poor automation and digitalization were reasonable. After all, community lenders actually do their lending in the community, finalizing terms maybe at a Friday night football game, and perhaps signing a loan document at home or after church. Other barriers to technological processes were not so reasonable, such as resistance to change or lenders' perception that automation would diminish their roles or threaten their jobs.

Whatever the pre-pandemic barriers to automation of business lending might have been, they've been all but vaporized by the social distancing required of the pandemic and the digitalization required of the Paycheck Protection Program (PPP). This loan program, despite its poor initial structuring and various warts, was, in fact, broadly seen as a vast and successful proof-of-concept project for high levels of automation in business lending. In their institutions' success at rapidly ramping up all-remote lending operations, senior management teams were suddenly able to prove that transactions and processes could be automated and digitalized successfully and with little or no harm to the borrower experience. Business bankers and loan officers learned that digitalization of lending could mean less busy work for them, more time with customers, and more time spent as their borrowers' trusted advisor rather than as a process manager. Customers—although they were pleased to have meetings or document signings at the local pizza joint or football game—discovered they were far more pleased to complete processes electronically, in a way that gave them more time to spend on their businesses.

Interestingly, digitalization under the pandemic can expect to be a permanent change rather than a one-time fix relied upon during a crisis. Lenders, in fact, are protecting their digitalization-specific technology budgets rather than cutting into them as a cost-cutting measure to survive the conclusion of the COVID-19 pandemic (Figure 1).

Figure 1: Accelerated Embrace of Digitalization Is Among the Impacts of the Pandemic



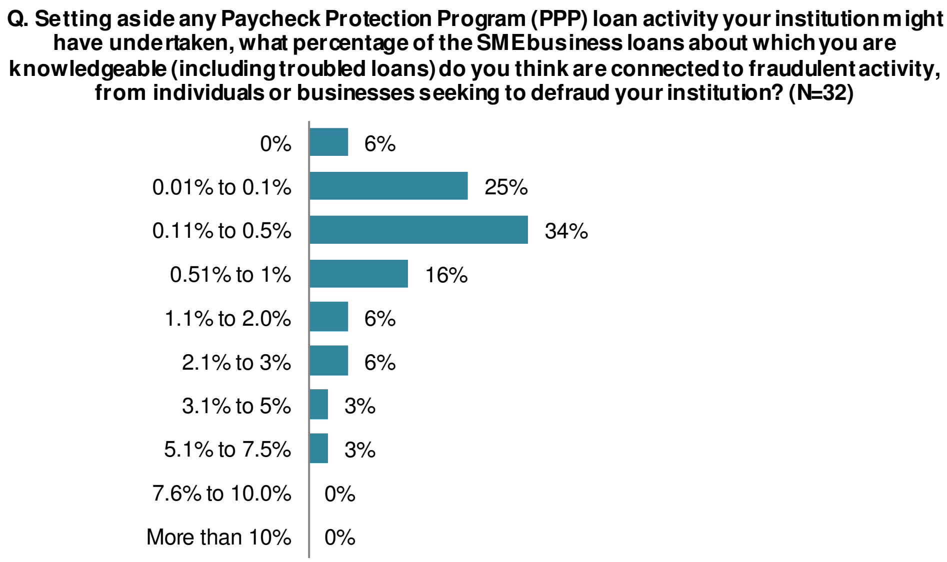
Source: Aite Group survey of 20 business lending financial institutions, Q3 2020

Despite this, the lessons of digitalization—though instantiated thoroughly at some institutions—have not been pervasive. During the final rounds of PPP, Aite Group has observed some banks so overwhelmed by PPP in general and in forgiveness rounds that employees not normally associated with lending, such as Treasury management product managers, have been effectively conscripted into the PPP battle. Lenders that aren't also spenders when it comes to digitalization should rethink their strategy, or they risk getting left behind.

LENDING FRAUD—THE STEALTH PROFIT REDUCER

Fraud in business lending, a phenomenon annually studied by Aite Group in partnership with the Small Business Financial Exchange, remains a thorn in the side of business lenders. SMB lenders, in fact, report to Aite Group that fraud incidence rates, although improved from last year, remain concerning. Among institutions examined by Aite Group, 18% report a fraud incidence higher than 1.0% in 2021 (Figure 2)—an encouraging improvement compared to the 26% who reported a fraud incidence rate higher than 1.0% a year earlier.

Figure 2: Fraud Incident Rates Are Concerningly High



Source: Aite Group and SBFE survey of 32 U.S.-based lenders, December 2020 to March 2021

While improved, fraud statistics in this market remain concerning. Among the examined institutions, only 31% had fraud incidence rates that were negligible. About this statistic, concerning are the facts that fraud losses are always equal to at least 100% of the value of the credit commitment, and spreads in the SMB credit market—the profits by which fraud losses are cushioned—are razor thin as a result of an oversupply of credit in the SMB market. In its examination of fraud in the SMB credit market, Aite Group identified four primary fraud vectors attacking SMB lenders: loan stacking, submission of counterfeit statements other than tax returns, submission of tampered bank statements, and submission of bank statements from which data has been omitted.

Asked to identify the enablers and barriers to success in detecting and deterring fraud, the examined institutions emphasized access to data, strong and process-enabled due diligence, and fraud-specific talent (Figure 3). Discussions with professionals tasked with detecting and deterring fraud in SMB lending emphasized strong processes, crafted by fraud subject-matter experts, supported by systems, enabled by data, and with little room to override, no matter how optimistic borrower-facing personnel might be about an absence of fraud or criminality.

Figure 3: Promoters and Inhibitors to Successful Fraud Detection and Deterrence

Success promoters

- Fraud-specific talent
- Fraud-specific analytics
- Collaboration across financial-crime disciplines
- Granular due diligence

Success inhibitors

- Lack of a business case
- Lack of budget
- Lack of access to data

Source: Aite Group and SBFE survey of 32 U.S.-based lenders, December 2020 to March 2021

THE ONCOMING REGULATION FOR WHICH LENDERS ARE POORLY PREPARED

Though it may seem like a point of regulatory trivia from the last economic cycle, embedded within Section 1071 of the Dodd Frank Act is a clause that amended the Equal Credit Opportunity Act by requiring the Consumer Financial Protection Bureau (CFPB) to issue a rule on how data will be collected on small-business loan originations. One lawsuit by a consumer advocacy group 12 years later has the CFPB finally getting around to promulgating a law conformant with the legislative requirements of Section 1071.

Though loose in its current formulation and uncertain in its ultimate outcome, this regulation resides on a definitive roadmap that must be met by the CFPB and is expected to result in legislation during 2022. Widely expected as impacts on the SMB lending industry are the following:

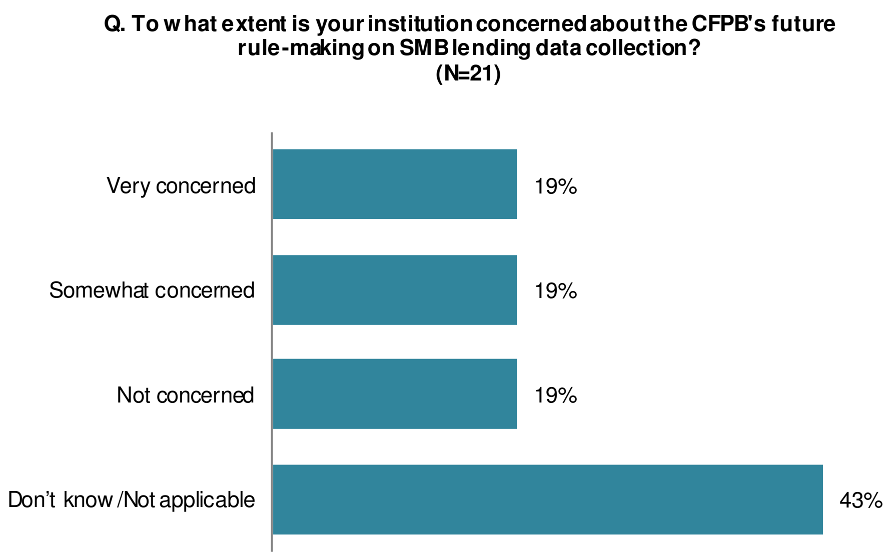
- **Peril for disparate impacts:** In its examination of lenders' business lending data sets, the CFPB can readily be expected to be on the lookout for "disparate impacts" in lenders' credit policies or operational practices—sometimes referred to as redlining—that unfairly favor one group over another in a way that is discriminatory. Expected are meaningful findings and fines for lenders found to be lending with disparate impact, be they intentional or not.
- **Onus on the safeguarding of data:** Also within the scope of scrutiny of Section 1071 will be the safeguarding of data acquired by FIs in the process of underwriting SMB loans. With every headline-grabbing hack such those upon SolarWinds and Colonial

Pipeline, cyber criminals are found to be ever-more effective. Lenders can expect the CFPB's bar for data safeguarding to be high indeed.

- **Discomfort in the gathering of data:** In its goal of detecting disparate impacts, the CFPB will need data, and lots of it—and data about which lenders care infinitely less than their borrowers' creditworthiness. Yet to be determined, and challenging in its crafting, are how exactly lenders and regulators will determine parameters about borrowers and credit seekers, such as their race, ethnicity, gender, or sexual preference.
- **Concerns about the release of data:** Among the many warts of the PPP was the public disclosure of loan data. Ire was invoked among the public when it learned that large franchises, composed of many legally separate SMBs, received large loans. Still smarting from these public disclosures, some FIs that lend to SMBs fear more will be on the way with the ultimate codification of Section 1071.

Perilous though the anticipated outcomes of Section 1071 may be for lenders, these stand in contrast to the ambivalence with which SMB lenders view this law. Recently asked about the law, just 19% of examined lenders were "very concerned"; the remainder were less concerned, ambivalent, or uninformed (Figure 4).

Figure 4: Lenders' Ambivalence About Section 1071



Source: Aite Group's survey of 21 lenders and 16 vendors active in the SMB credit market, Q1 2021

Important is some context about lenders' attitudes about Section 1071. All of the data was gathered over the phone, and among the respondents who identified as "very concerned" are those who, with spirit, expressed a mixture of dread, ire, and resentment about the forthcoming regulation. It's therefore possible that among those who "don't know" about the regulation are those who will become "very concerned" upon learning of the expected weight of the regulation when it's finally codified.

CONCLUSION

With transition from the COVID-19 crisis seemingly underway, the SMB lending ecosystem emerges almost triumphant, so siege-like was its performance under the PPP program. And with the experience of PPP came for SMB lenders both an embrace and instantiation of the benefits of automation in general and digitalization in particular, both of which had been held bay with skepticism for too long. But also characterizing the landscape for SMB lenders are two concerning trends: the persistence of fraud and a forthcoming body of regulation of SMB lending yet to be codified, but about which most lenders are either gravely concerned or completely uninformed. On all three trends, lenders need both partners and a well-thought-out technological roadmap. The lessons of digitalization, though profound for many FIs, appear to have been learned somewhat unevenly across the industry. Those SMB lenders that go back to the pre-pandemic and poorly automated old normal will lose market share as their more transformed rivals succeed in delighting during the borrower experience. Technology will also be required in the fight against credit abusers and criminals, who have been found by Aite Group to remain successful in defrauding SMB lenders. And lastly, Section 1071, in whatever form it is finally codified, will demand of SMB lenders extensive back-end data sets that are secure and enable FIs to prove to the CFPB that they are not lending in discriminatory ways.

ABOUT AITE GROUP

Aite Group is a global research and advisory firm delivering comprehensive, actionable advice on business, technology, and regulatory issues and their impact on the financial services industry. With expertise in banking, payments, insurance, wealth management, and the capital markets, we guide financial institutions, technology providers, and consulting firms worldwide. We partner with our clients, revealing their blind spots and delivering insights to make their businesses smarter and stronger. Visit us on the web and connect with us on Twitter and LinkedIn.

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