No Strange Bedfellows:

Community Banks and Merchant Processors Can Find Lending Success Together

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A local merchant walks into a bank, inquires about a working capital loan, and walks out with a to-do list a mile long.

It sounds like the start of a really bad joke, but unfortunately, it's not. Ten years ago, banks were the only option for small businesses in search of a loan, but securing capital required a great deal of time and patience.

What gave one bank an edge over another had more to do with relationships than any other factor.

Fast forward to today, and the business lending landscape is barely recognizable. Competition has shifted from "bank versus bank" to bank versus, well, everyone—alternative lenders, digital giants, and even shipping providers like UPS. What was once a "lending pool" is now an open ocean, and a new class of digital-first lenders has moved in on what used to be the exclusive territory of banks. If it seems like anyone and everyone can provide capital to small businesses, it's because they can.

The expectations of business owners have changed too. Merchants want *speed* and *convenience* above all else, and digital-first lenders like Stripe and Square offer exactly that—they can deploy cash within 24 hours without any physical interactions with the business owner.

Where does that leave community banks that have worked hard to build and maintain relationships with small businesses? Although the lending ecosystem is rapidly evolving, there's still a place in it for community banks. If you offer merchant services to your small business customers, read on. You're already ahead of the game—and with the right tools and strategy, outpacing the competition will be easier than you might think.

Here's the bottom line: to stay in the game, community banks need to leverage their competitive advantages while offering a more efficient and convenient way of securing capital.

And they need to do that as soon as possible.

What Community Banks Can Learn from Merchant Processors

Merchant processors jumped into lending because they enjoy low acquisition costs (i.e., they're lending to existing customers) and because it's a natural cross-sell opportunity that drives retention in a hyper-competitive market.

Clearly, merchant processors have an advantage. But zoom out for a moment—another key factor is giving banks a run for their money: Merchant processors were able to gain a foothold into lending because the demand for working capital from small business owners **wasn't being met by banks and credit unions.**

According to a December 2020 survey from Biz2Credit[1], small banks approved just 18.3% of non-PPP business loan requests in November 2020, in sharp contrast to November 2019, when small banks granted more than half (50.5%). Due to a general hesitancy to extend capital during economic uncertainty, banks have missed out on a huge opportunity to grow their assets and increase their market share.

Merchant processors, in turn, swooped in.

[1] http://www.globenewswire.com/news-release/2020/12/08/2141168/0/en/Biz2Credit-Small-Business-Lending-Index-Reports-Loan-Approval-Rates-at-Banks-Declined-in-November-2020-Are-Down-More-Than-50-Percent-from-One-Year-Ago.html

So what can small banks do to regain their competitive advantage?

— For starters, banks can focus on the factors that enabled merchant processors to outpace them in the first place

- **The Data Advantage:** Merchant processors have real-time data on their customers, giving them a leg up over traditional financial institutions that rely on lagging indicators of creditworthiness, such as last year's tax returns, credit scores, collateral, and owner wealth. Specifically, merchant processors see every transaction the business makes—sales, returns, cash versus credit, and more. These real-time data points are much more reliable in assessing the strength of a small business.

- **Pre-Approvals:** Because of the data advantage, merchant processors can screen businesses to determine which ones are most likely to need capital and, therefore, jump on an offer. They can also calculate the optimal amount to approve the business for based on the revenue the business is earning. When retailers receive pre-approval letters directly from their merchant processors, it means that *borrowers don't have to be the initiators* of the process.

- **Speed of Delivery:** The entire process of getting capital from a merchant processor consists of just three steps:
    1. Pre-approval
    2. Acceptance of Terms
    3. Disbursement of Capital

  And it's automated, streamlined, and convenient. Merchant processors can deploy capital in under 24 hours, the new benchmark for the delivery of funds.

- **Low Cost:** With low marketing and acquisition costs, merchant processors incur little marginal cost to become lenders.

Community banks need to be as flexible, efficient, convenient, and proactive as the fintechs.

With High Stakes for Community Banks, Change Must be Rapid

Fintechs are changing the rules of the game and forcing all other financial institutions to evolve.

On the one hand, large banks have built their own payment processors to keep pace with fintechs (think Chase Paymentech and US Bank's Elavon). Second, partnerships in Big Tech, such as PayPal and eBay, provide merchant processors with access to new audiences.

> Smaller banks are getting hit from every side, and here's the proof that it's actually stifling their growth: Fewer small business owners are applying to their community banks for a loan.

Fact:
Applications for small businesses credit to small banks dropped 23% from 2016 to 2019, while applications to online lenders rose 73% during the same time period:

The reality is that the brave new world of business lending is evolving in ways that were nearly impossible to forsee 10 or even 5 years ago—and those changes are here to stay. The good news is that community banks have a number of competitive advantages that, if leveraged correctly, can level the playing field with the competition—or even put them ahead.

The Solution: Community banks can lend through their merchant processing partner.

Merchant Lending at Community Banks: A Crash Course

Like many community banks, you may already offer merchant services to your small business customers. With this mind, the merchant processor you work with is a partner in your success (and vice versa)—not a competitor. This partnership gives you the same runway to screen and pre-approve businesses for a loan—allowing borrowers to digitally accept terms and get capital efficiently.

Here's How Merchant Lending Works

Given that the merchant processor sees every transaction a small business makes, this information is your ticket to extending capital more efficiently (and to lower your risk in the process). You can pre-qualify business customers—and approve them—without manual, paper-based processes that require customers to stop into a branch.

For example, say you see that one small business customer had 10% more receipts in one month compared to the same month last year. Congratulations! You've identified a strong-performing business that's generating the very thing that makes them a creditworthy borrower: CASH!

You no longer need to wait for the business owner to stop in and apply for a loan. Through your merchant processor, you can send them an immediate pre-approval, with the amount you approve them for stemming from the revenue they're bringing in.

> Leveraging the relationship with your merchant processor means giving small business owners the best of both worlds: the personal touch of your bank combined with the efficiency of technology and real-time data.

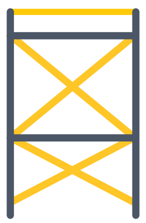
Your community bank already has plenty of advantages that set it apart from other lenders vying for your customer's business. Namely, you can:

- **Offer flexible payment terms:** With merchant lending, payments can either be a fixed, flat, daily fee or be based on a percentage of each transaction.

- **Be a (truly) full service bank**: Unlike fintechs, your bank can provide every product small business owners need, from deposit accounts to merchant services to everything in between, but you need to make the process easy and efficient from them—or they'll go elsewhere. Be a one-stop shop for your small business customers, who don't want to expend energy working with more companies than they need to.

Easy Setup, Rapid Results:
A Smart End-to-End Solution

In a rapidly evolving lending ecosystem, the true cost of doing business is measured in time. Given the pace of change, community banks should consider a partnership that helps them get a merchant lending program up and running in a matter of weeks. The right all-in-one solution should help you implement your program quickly and include:



- **Infastructure:** Adopting a system that works as scaffolding to support your entire merchant lending operation is vital. An end-to-end solution will provide the infrastructure to manage your entire merchant lending program, including offer generation, borrower communication, loan servicing, and more.

- **Underwriting Support:** The key to merchant lending is that you're assessing creditworthiness (and issuing pre-approvals) based on a business' real-time cash flow. That might be new to many banks, but it doesn't need to be daunting. After all, companies like Square, Stripe, and others do it everyday, and they're growing by leaps and bounds.[2] The right partner will help you build the credit model that enables your bank to grow, but also manage your risk.

- **E-Contract Capabilities:** Make sure the system can easily prepare digital contracts for the pre-approval offers you send out. Remember, you're only as fast as your slowest step, and small businesses customers want the speed and convenience of handling everything online.

- **Process Support:** New to merchant lending? Don't worry, you're not alone. It's new to everyone. Partner with a company that brings not just the latest technology to the table, but also a consultative approach in terms of how to get up and running successfully. Your bank deserves a partner that can guide you.

[2] https://www.nytimes.com/2021/03/29/business/money-is-pouring-into-start-ups-that-are-eager-to-upend-wall-street.html?searchResultPosition=1

Future-Proof Your Business Lending Program

Community banks stand to gain yardage by seizing the opportunity to start, and scale, a merchant lending program. The potential (and sizable) benefits include:

- **Higher bank value and revenue:** Merchant lending means more loans, and more loans mean more interest revenue, fees, and stock value. In a competitive economy where many financial experts predict that many community banks will be acquired by larger banks as the year(s) progress, adding a new stream of revenue helps enhance your appeal to potential buyers.

- **Higher customer retention**: Competitors are hitting up your customers every single day with capital offers. Merchant lending gives current customers another reason to stay, and proactively send pre-approval offers puts you at the head of the pack to win that customer's business.

- **Lower risk**: Usually moving faster means exposing your bank to greater risk. In this case, accelerating your process means the opposite. Leveraging real-time cash flow data gives you the best of both worlds: a thorough analysis of a business' need for capital, and the ability to make smarter decisions.

- **Winning new customers**: Being a one-stop-shop can also attract new customers who want just one all-encompassing banking relationship. Offering merchant lending services that other banks don't can put you ahead of the curve—and help you target new businesses. From there, you're poised to win the entire banking relationship.

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Ready to make your small bank a more competitive player in the new lending landscape?

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