

A PROFIT GROWTH STRATEGY FOR SMALL BUSINESS BANKING

HOW TO TARGET, ACQUIRE AND RETAIN HIGH-VALUE SMALL
BUSINESS CUSTOMERS

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HOW TO TARGET, ACQUIRE & RETAIN HIGH-VALUE SMALL BUSINESS CUSTOMERS

Banks are starved for profitable growth. But the small business sector is still very profitable for banks. So, although the sector itself isn't growing that fast, an effective strategy to gain share within the sector could be a major source of profit growth. However, any bank that wants to seize this opportunity will need to embrace a radical change of strategy. Fine-tuning the traditional approach to the small business sector just won't cut it.

THE OPPORTUNITY

Oliver Wyman's research¹ shows that banks make a lot of money from the SB sector. To be specific: we estimate that banks earn around \$14 BN in accounting profit and \$10 BN a year in economic profit² from small businesses, making the SB sector one of the largest, lowest-risk profit pools in the entire industry.

This profit is not uniformly distributed across SBs though. We define three basic SB profitability segments:

- High (\$500 or more per year of economic profit)
- Low (\$0 to \$500 per year of economic profit)
- Negative (Negative economic profit)

In product terms, our analysis shows that most profit is contributed by higher-balance DDA accounts (\$10,000 or more average balance) and medium-to-high volume merchant services accounts (>\$100 K of receipts per year). Credit and charge cards, savings and CDs also contribute but are all tertiary sources of SB profit to banks. Traditional bank loans show an accounting profit but, for most banks, do not contribute economic profit on a through-the-cycle basis.

The small business sector is still very profitable; an effective strategy to gain share in the sector could be a major source of profit growth. But fine-tuning the traditional bank approach just won't be effective

Small business is one of the largest yet lowest risk profit pools, however profit is not uniformly distributed

1 An Oliver Wyman 2011 survey of ~5,000 SBs with analysis of the profitability to banks of the SBs' FS activities.

2 "Economic profit" is defined as profit over-and-above the required return to economic capital; zero economic profit is equivalent to making the required rate of return on capital which today would be roughly 11-12% return in economic capital, after tax.

Three profitability segments in small business: the highest profitability segment consists of just 23% of all businesses but contributes over 100% of total economic profit

Using these definitions, the national market data for the profitability of small businesses to their banks and other FS providers is as follows:

EXHIBIT 1: SMALL BUSINESS BANKING PROFITABILITY, US 2011 \$ BN

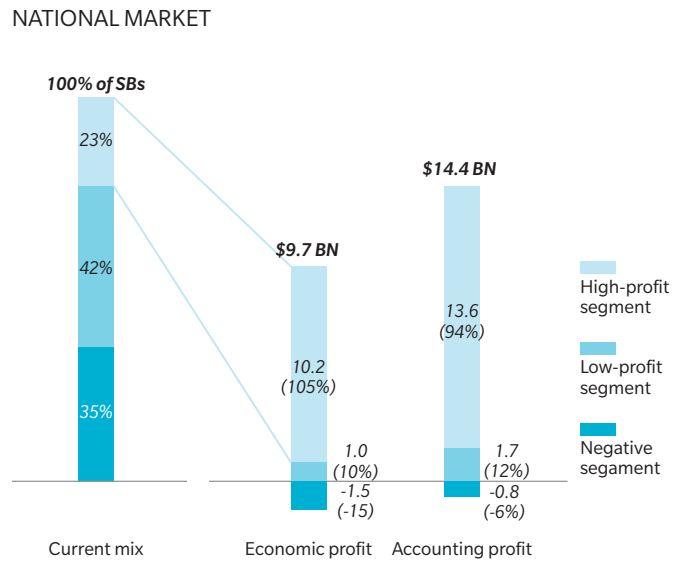
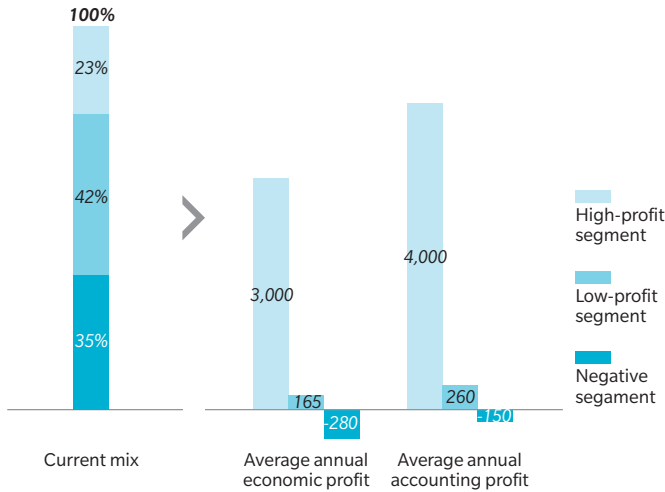


Exhibit 1 shows that just 23% of small businesses contribute – in effect – the entire profit pool of the sector. Exhibit 2 shows the data at the average individual SB level.

EXHIBIT 2: SMALL BUSINESS BANKING PROFITABILITY, US 2011
US \$

PER BUSINESS



High profit relationships are
15–20X more profitable than low
profit relationships

Exhibit 2 makes it clear how important it is for a bank to get its fair share (or more) of high-profit SBs: the average accounting profit of the high-profit segment businesses is \$4,000 per business – far greater than SBs in the other two segments. Overall profit for any one bank on its small business portfolio will be heavily driven by relative share gains or losses in the high-profit segment.

It is instructive to compare the profit contribution of a SB portfolio that reflects these industry averages with the contribution of a portfolio with a better mix across segments – one that has an above-average share of the high-profit segment and a high share-of-wallet with this segment. The following table shows what a difference this can make.

Plausible shifts in small business mix could drive a 2X growth in accounting profits

EXHIBIT 3: SMALL BUSINESS SEGMENT MIX

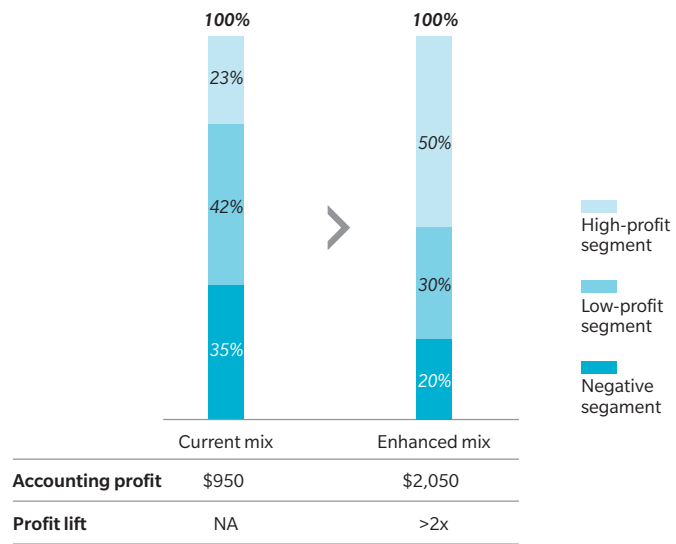


Exhibit 3 shows that a shift in portfolio mix of these proportions, with high-profit SBs going from 23% of the portfolio to 50% – a shift that does not seem to require heroic assumptions – would more than double run-rate profitability. If portfolio composition could be changed in this way over five years, the implied rate of profit growth would be over 14% p.a.

But how can such a change be effected?

THE CHALLENGE

Growing share in the high-profit segment is easier said than done.

There are 3 specific challenges:

1. Effective targeting
2. Getting people to switch
3. Cost-effective selling

1. EFFECTIVE TARGETING

Current bank sales and marketing methods do not differentiate very effectively between high-, low- and negative-profit SB prospects. That's why all banks tend to end up with a portfolio of SB relationships that includes a market-reflective mix of all three segments. For a targeted approach to work, we need to build an effective method for ranking SB prospects by expected relationship value before we take action to win their business.

Our analysis shows that using traditional segment markers like sales volume and industry type to target prospects is not that effective because there are numerous high-profit small businesses in every sales volume range and every SIC code. However, it should be possible to use available third-party databases to build a preliminary ranking tool that is accurate enough to be effective. This ranking tool can target a bank's new account acquisition activities towards the highest-value prospects. And imperfections in the ranking tool can be corrected for later in the sales process, as we shall see.

2. GETTING PEOPLE TO SWITCH

Research (and experience) shows that SB owners choose their primary bank based largely on locational convenience – and then rarely switch. The typical owner-operator does not have a chief financial officer whose job it is to optimize a banking relationship, so nobody is really focused on the bank relationship; business owners say they “just want a checking account that works right the first time and every time” and leaves them free to focus on their business. Consequently, a typical SB owner, on any random day, is simply not “open-to-buy”. Otherwise put: they are very hard to sell to when they aren't already looking – and they do not often go looking. This shows clearly in their low responsiveness to banks' marketing efforts today, as we also discovered in our recent Small Business research.

However, the value to a bank of acquiring a new, high-profit SB relationship can be very high indeed. Referring back to the exhibits on pages 4 and 5, if we approximate the after-tax NPV of new accounts at a 10x multiple, then the NPV of a new high-profit SB is

Effective targeting of high-profit SBs – who are your competitors' best customers – is critical

Getting small business owners to switch is a big challenge

~\$40,000 on average. The underlying data show that the NPV of a new high-profit SB is about \$30,000 at the median for this group. Even an “entry-level” high-profit account, with economic profit of \$500 per year will typically have an accounting NPV of between \$5,000 and \$6,000.

These values are so high that they can justify an entirely new and much more effective strategy built around new sales tactics. Simple financial economics suggest that it is worth spending a material fraction of these amounts to book accounts of such high value. It may be worth spending \$500 to win an account worth \$5,000. This brings into play the concept of a “Switching Offer”.

We advocate the use of a face-to-face sales approach and targeted non-cash incentives to break through the low open-to-buy status of most high-profit business owners and win these high-value relationships. But this is not the only factor in getting people to switch. Overall, we see four important elements of a switching offer:

- A. Switching incentives that are hard to refuse
- B. Strong table-stakes products and features
- C. A no-hassle switching guarantee
- D. A defined customer value exchange

Multi-pronged strategy to encourage switching required

Need to present a hard-to-refuse offer...

A. Switching incentives that are hard to refuse

In our research, SB owners report a high degree of willingness (in principle) to switch their primary bank based on proffered one-time incentives that range in cost from \$250 to \$500. Among a number of suggested incentives, free air tickets seem to be highly valued – and valued well above their actual cost. Further research can define the incentives that would be most effective. Offering a direct incentive to switch may seem like the old “free toaster” bank marketing gimmick. But the problem with the free toaster offer was always that it was untargeted and tended to attract too many new customer whose NPV was less than the cost of the toaster. Here, it is critical that the new sales tactics target the right businesses, and calibrate the incentive to the expected value of the account, as outlined below.

...a competitive core value proposition...

B. Strong table-stakes products and features

Our research suggests that while SB owners can exhibit reasonably strong preferences regarding product features and pricing once they decide to switch their bank, marketing messages that focus on such features will not usually stimulate or initiate new-purchase behavior: the preferences are only “active” when customers are already

looking. However, in the context of sales tactics that target high-profit prospects with an offer featuring significant non-cash switching incentives, it would be vital to have at least a table-stakes competitive product suite. There may even be specific product features that could help overcome reluctance to switch. For example, if a particular high-profit prospect were located closer to his current primary bank's nearest branch than to ours, the addition of free remote-deposit capture and even of a smart-cash capability – both of which tend to reduce the otherwise-critical importance of branch location convenience – might persuade a target that he would not be giving anything up in order to avail himself of the switching incentive.

C. A no-hassle switching guarantee

Changing a banking relationship can be a high-hassle experience for consumers or small business owners, even when they are motivated to switch. It is important to overcome this natural resistance of a business owner to change his or her primary banking relationship by offering a “no-hassle switching guarantee” that minimizes his psychic switching cost. Under such a guarantee, the processes for converting a new account (e.g. establishing the new DDA with online access and bill-pay, plus the transfer of all vendor/payee information, and the conversion of merchant terminals, etc.) must routinely be accomplished in 1-2 business days, on pain of a penalty paid by the bank. This is also the perfect opportunity to achieve a high share-of-wallet with these high-profit segment businesses, winning their checking, merchant services, and credit card accounts at the time of the switch.

D. Guaranteed value exchange

Having persuaded the owner to migrate and activate his new banking relationship – it is critical to ensure that the small business will fully engage and utilize its new accounts. This is important for the customer, to get the full benefits of the value promise that was initially made, and critical for the bank to ensure appropriate levels of activity and profitability to justify the investment made in customer acquisition. Traditional “30 to 90” customer engagement tactics can help here, however best practice may be to follow the lead of the wireless carriers by building activity floors and ceilings into the product terms and conditions at the outset.

...a convenient switching experience – one that is guaranteed...

...terms and conditions that guarantee value exchange

Taken together, we believe these four elements can generate switching behavior at a much higher rate than is achievable through conventional bank marketing methods.

A carefully scripted sales approach will ensure high customer conversion, at the right all-in cost

3. COST-EFFECTIVE SELLING

The overall economics of this new approach have to work for the bank, and work well. Clearly, it makes no sense to provide an incentive that costs \$500 in order to win a relationship that is only worth \$250. But the earlier analysis showed that high-profit SBs are typically worth considerably more than the approximate cost of switching incentives that business owners at least say would induce them to switch banks.

As we said earlier, effective targeting is very important. In addition to initial targeting based on a model, the process itself can be fine-tuned to make sure that incentives are effective. The key parameters of a high-profit relationship are “average DDA account balance” and “annual merchant spend” (where the first should be at least \$10,000 and the second at least \$100,000). These are both measures that are not specifically available to the bank in advance, but which are not especially sensitive things for the business owner to reveal once a sales conversation has been initiated. It may also be possible to underpin such a process by the use of low-cost direct mail/direct response using self-segmentation scripting (“We have a special offer that is only available to merchants with at least \$100,000 annual card spend...”).

A carefully scripted sales process should therefore try to pin down both numbers as early in the process as possible, but without spoiling the tone of the exchange. By adapting and fine-tuning the initial ranking tool in this way, the bank can continually reprioritize sales efforts, as well as calibrate the initial switching offer incentive to expected value.

THE RESULT

We saw earlier that the hypothetical impact of a shift in portfolio mix could be a doubling of profit, or even more. And we have outlined a business approach that might achieve this shift. In a brief one-page note at the end of this report, we show an assumptions worksheet that balances the costs of a well-compensated face-to-face sales force, switching incentives and switching costs with the value added by new, high-profit SB relationships.

The end-note suggests that this approach could more-than-cover its costs in year 1, leaving the bank to enjoy the NPV benefits of all new business booked for the duration of the account tenure. On a per account basis, the incremental pre-tax cost would be \$2,350 and the incremental year-one pre-tax profit would be \$3,000. Contribution in all subsequent years of the account life would be considerably higher. On an NPV basis, the payback of the approach is even clearer: on a per salesman basis, the annual pre-tax cost would total \$235,000 and the pre-tax NPV over \$3 MM.

These estimates do not even include the additional gains possible from winning the personal accounts of the targeted SB owners. Oliver Wyman research indicates that 70% of SB owners consolidate their personal accounts at the bank where they maintain their primary SB accounts, and that the profitability of the personal accounts of SB owners is double, on average, that of non-SB owners.

In addition to the basic economic gain, this approach to the market has the nice advantage that by moving away from broadcast advertising to achieve its sales impact, it would be largely invisible to in-market competitors – at least for a few years. The silent strategy would leave one bank with a disproportionate share of the best accounts in the bank's footprint and its competitors wondering why their own SB portfolios were suffering serial declines in profitability.

Opportunity to double profit and achieve attractive payback – even before accounting for potential upsides from proprietor personal accounts

Potential to spend “less” on marketing or at least “spend better” and “cherry pick” your competitors’ best customers – in stealth mode

MAKING IT HAPPEN

Making it happen will necessitate addressing a series of cultural and organizational shifts

As attractive as the outcome of the proposed strategy might be, the challenges involved in accomplishing it are non-trivial. The biggest challenge is likely to be the cultural and organizational change required to effect this switch from a traditional banking SB mind-set to one focused on the pursuit of a disproportionate share of the high-profit segment.

Several aspects of the traditional approach would need to change significantly in order to support – and not to undermine – the new strategy.

The new strategy approach is summarized in Exhibit 4, namely:

- Target like a direct marketer: Market with a scientific and predictive approach to customer targeting (e.g. Capital One)
- Attract and engage customers like a mobile provider: Offer a hard to refuse value proposition with guaranteed value exchange (e.g. T-Mobile)
- Sell customers like a third party agency force: Prospect and convert like a high-motivation cost effective sales force (e.g. Corcoran)

Need to consider three new strategic and organizational “archetypes” to make it happen

EXHIBIT 4: STRATEGY AND ORGANIZATIONAL ARCHETYPES TO SUCCEED

Key retail sales activities	Targeting	Value proposition			Sales approach
		Switching offer	Activation	Value	
Key objectives	Effective <ul style="list-style-type: none"> • Identify the ~30% that deliver the lion’s share of SB banking profits? 	Hard to refuse <ul style="list-style-type: none"> • Develop an offer that is hard to refuse 	Hassle-free <ul style="list-style-type: none"> • Automated and guaranteed 	Win-win <ul style="list-style-type: none"> • High engagement 	Cost effective <ul style="list-style-type: none"> • Highly productive and cost effective
Traditional branch banking approach	<ul style="list-style-type: none"> • “Walk-ins are our target” 	<ul style="list-style-type: none"> • Run ads about the products and then: “Meet with our SB banker” 	<ul style="list-style-type: none"> • Let the customer do the work 	<ul style="list-style-type: none"> • “We hope you use us” 	<ul style="list-style-type: none"> • Trust the branch based banker will convert the client
Oliver Wyman Archetypes for Next-Gen sales model	<ul style="list-style-type: none"> • Scientific targeting based on a predictive model 	<ul style="list-style-type: none"> • Non-cash offers (e.g. subsidized devices) based on customer’s lifetime value 	<ul style="list-style-type: none"> • Software and support to automate account migration 	<ul style="list-style-type: none"> • Built in floors and ceilings to service contract to ensure share of wallet 	<ul style="list-style-type: none"> • Highly motivated (not necessarily skilled) commission based agents

In our experience of making this kind of change happen for global banks, many of the individual capabilities required to execute will already exist in your bank or can be externally sourced. However, the challenges in creating an integrated plan and “making it happen” will be manifold, for example:

- Getting the permission to do something different (i.e. experiment and innovate)
- Managing the balance between “strategizing” versus actually “doing” something
- Being given the time to experiment, to fail and then to succeed
- Managing potential overlaps and conflicts with the traditional channels (the “give us the prospect list – and we’ll make it happen” syndrome)
- Operating two acquisition models in parallel – and potentially ramping one down in favor of the other
- Operationalizing the incentive offer, switching guarantee and revamped core product offer – along with associated operations and technology implications

Although the essence of the opportunity outlined above is straightforward, realizing the benefits will necessitate more than a BAU approach to execution. Making the shift to the new strategic and organizational archetypes will require experience, instigation and acceleration.

Multiple challenges in managing transition to new archetypes

Making the shift to the new archetypes will require experience, instigation and acceleration

APPENDIX I: ASSUMPTIONS WORKSHEET

Base pay and fringes of account rep/salesman	\$50,000
Number of effective sales contacts/year	300
Close rate	33%
New accounts opened/year	100
Mix of new accounts booked: ³	
High profit	50%
Low profit	30%
Negative profit	20%
Average accounting profit of new business	~\$2,050/SB (averages Hi, Low and Negative)
Average accounting NPV of new business	~\$20,000/SB (ditto)
Accounting NPV of new business booked	\$2,000,000/account rep (\$20,000 x 100)
Incentive pay of account rep/salesman	\$50,000 (~2.5% of accounting NPV)
Switching incentive (at 5% of account NPV)	\$1,000/new account
Switching costs (at \$350 per new account)	\$350/new account

SUMMARY, PER ACCOUNT REP/PER YEAR	
Total cost	\$50,000 account rep base
	\$50,000 account rep incentives
	\$100,000 total switching incentives
	\$35,000 total switching costs
	\$235,000 total/year pre-tax
Annual accounting profit added	\$300,000 pre-tax
	\$205,000 after tax
Annual NPV added	~\$3 MM pre-tax/~\$2 MM after tax

³ We conservatively assume that the targeting tactics will be less-than 100% effective and we will “accidentally” acquire some proportion of new relationships that will not be high-profit ones. It will also be true that a certain amount of new business will come from “walk-in” applicants and that this will reflect the industry norm in terms of mix.

APPENDIX II: A NOTE ON LOANS

This entire document makes virtually no mention of small business lending. This is deliberate and has two main reasons. First, our research shows that only around 15% of small businesses actually have a “small business loan”. And our analysis shows that the economics of small business lending are not that favorable to banks: while loans show an accounting profit under GAAP, the economic profit of small business lending is negative on a through-the-cycle basis. That is to say, these loans – while earning an accounting profit – do not earn enough to compensate banks for the risk capital they tie up.

Moreover, the typical profitability of small businesses that have no SB loans is greater than that of the businesses that do have SB loans (even if you ignore the negative economic profit of the loans themselves). Thus a strategy that focuses on DDA, merchant services, cards and auto loans seems to make much more sense than one that focuses on lending.

But the second reason not to focus much on lending in this document is that despite the poor profit performance of traditional small business loan portfolios, we do see great potential in an innovative approach to SB lending that employs a new method for loan underwriting and loan administration. The new approach uses internal bank data (on the DDA and merchant services accounts) to assess creditworthiness and monitors and administers these lines and loans on a new, daily-cycle platform. However, as promising as this new approach may be, we do not see it making any fundamental difference to the logic of the strategy as laid out above. Also, it is a sufficiently interesting subject that we have made it the focus of an upcoming Oliver Wyman paper.

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.

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