EXECUTIVE RESEARCH REPORT | DECEMBER 2013

BAI RESEARCH

TAPPING THE POTENTIAL OF SMALL BUSINESS

Opportunities to Attract, Retain and Expand Primary Bank Relationships

Based on Insights from the BAI Research Study: Small Business Demand for Banking Services

Inside:

Sponsored by:

Deloitte.

BAI is pleased to present findings and analysis on a recently completed study of small businesses and their financial needs and activities, sponsored by Deloitte. The research and actionable insights presented in this report are designed to help bank executives identify opportunities for building new small business relationships while preserving and expanding existing ones.

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EXECUTIVE SUMMARY

As financial institutions look to create deeper and more sustainable relationships with potentially profitable customer segments, small businesses are receiving increased attention. Despite the seemingly good relationship that already exists between small businesses and banks, this is a segment with significant untapped potential.

Yet, how well do institutions know the small business segment, and what these customers want and expect when it comes to banking services? As shown by BAI's 2012 *Solutions Demand Pulse*[1] survey of retail banking executives, there are disconnects between bankers' and small businesses' views in several crucial areas. To better understand both the drivers of these disconnects and other characteristics of small business usage patterns and preferences, BAI launched the study of *Small Business Demand for Banking Services*, sponsored by Deloitte.

The research uncovered crucial preferences, attitudes and trends for bank executives that have been categorized in primarily three areas - **Banking Relationships, Product and Service Usage and Means of Engagement and Channel Usage**.

The study reveals that small businesses demonstrate strong loyalty to their primary financial institution. The banking relationship has a significant longevity of over 15 years. When asked about overall satisfaction with their Primary Financial Institutions, 75% of small businesses indicate they are satisfied. However, more than half of the respondents also indicated a willingness to consolidate with one bank if all their needs are met or if they received a financial incentive from that bank. Given the potential opportunity for growth, and risk of losing loyal customers, banks should consider being proactive in understanding the needs of their small business customers and knowledgeable about their business. Ideally, this understanding should encompass looking at small business owners' personal and life-stage transitional needs as well, with a focus on consolidation of business and personal relationships. Using this knowledge to engage in relevant and distinctive ways with small business customers can potentially provide the highest level of satisfaction with the goal of becoming their primary bank for all their financial needs.

The research also uncovered that a small business's primary institution holds a high share of wallet with respect to core products (deposit and loans). However, the lower consolidation and penetration of additional services, like merchant credit card processing, demonstrates the lower uptake for other services. Banks should consider focusing more on cross sell/up sell strategies for fee-based solutions, products and services as well as thinking beyond traditional products to potentially meet and exceed the financial needs of small businesses.

Similarly, the findings indicate a significant usage of traditional channels such as branch and phone with 60 to 70% of transactions taking place in the branch. However, an increase in usage of alternatives such as online and mobile technologies is being witnessed. Banks may have an opportunity to maintain the in-person channel with value-added services important to small businesses, in addition to potentially encouraging the use of online and mobile channels, particularly for lower complexity transactions, providing an omni-channel experience that is likely to offer value and consistency within channels.

[1] Please see page 14 for details about this study.

KEY STUDY FINDINGS:

- Small business owners are loyal to their primary financial institution (FI)
- Work with one or two institutions for an average of 15 years
- 75% are satisfied with their primary FI
- Less than one-third would switch FIs for more innovative product/service offerings
- Have high share of wallet at their primary FI for both deposits and loans
- Conversely, have a low share of wallet with primary FI for investments
- Half consider their small business primary FI to also be their personal primary FI
- Strongly prefer paper checks to any other payment method
- Only 25% are comfortable conducting banking transactions on a mobile device
- Less than 10% use remote deposit capture
- Conduct 60% to 70% of banking activities in the branch
- Only 20% prefer online banking to in-person banking
- Less than 20% say their primary FI proactively recommends financial solutions

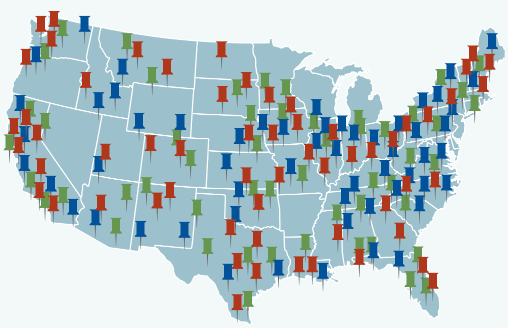
SMALL BUSINESS PROFILE: STUDY PARTICIPANTS

The participants of the *BAI Small Business Demand for Banking Services*[2] study included owners and high-level employees from more than 1,500 small businesses across the United States. The broad survey obtained detailed intelligence on a range of banking activities, behaviors, attitudes, beliefs and preferences. The small businesses that participated were arranged into three sub segments based on annual revenue — $100,000 to $1 million, $1 million to $5 million, and $5 million to $10 million.

The survey results were also augmented with qualitative findings from an online discussion board of respondents. More information on the methodology is presented at the end of this report.

Study Respondent Business Locations

More than 1,500 small businesses, fairly evenly distributed across three annual revenue categories, participated in the survey throughout the United States.



Small Business Annual Revenue

$100K to $1M $1M to $5M $5M to $10M

BANK PERSPECTIVE: DEFINITION OF SMALL BUSINESS

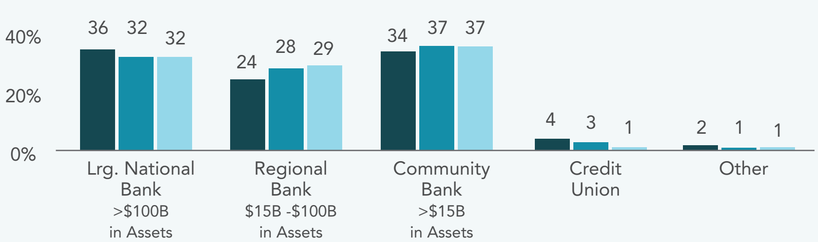
While individual banks may differ on the definition of small business customers, generally, these businesses have under **$10 million in annual revenue and a $1 million loan cap**, as revealed in the 2012 *BAI Solutions Demand Pulse* survey of retail banking executives. These limits also align with the three revenue sub segments used in this study of small businesses, which is the focus of this whitepaper — $100,000 to $1 million, $1 million to $5 million, and $5 million to $10 million.

That same BAI survey of banking executives showed there are differences in how financial institutions view the small business segment, depending on the size of the institution. Larger institutions typically have a higher revenue threshold than smaller institutions.

The 2012 *BAI Solutions Demand Pulse* study defines small institution as less than $2.5 billion in assets, and large institution as $2.5 billion in assets and above.

Source: 2012 *BAI Solutions Demand Pulse* Research (Survey of Retail Banking Executives)

Where Small Businesses Bank



Small Business Annual Revenue

$100K to $1M $1M to $5M $5M to $10M

Primary Financial Institutions by Type

Of the businesses that participated in the study, those in the smallest sub segment by annual revenue were somewhat more likely to bank at large national financial institutions whereas businesses with higher annual revenues leaned towards community banks.

[2] Please see page 14 for additional details about this study.

BANKING RELATIONSHIPS

Small business banking relationships are characterized by loyalty, but vulnerability and opportunity exist.

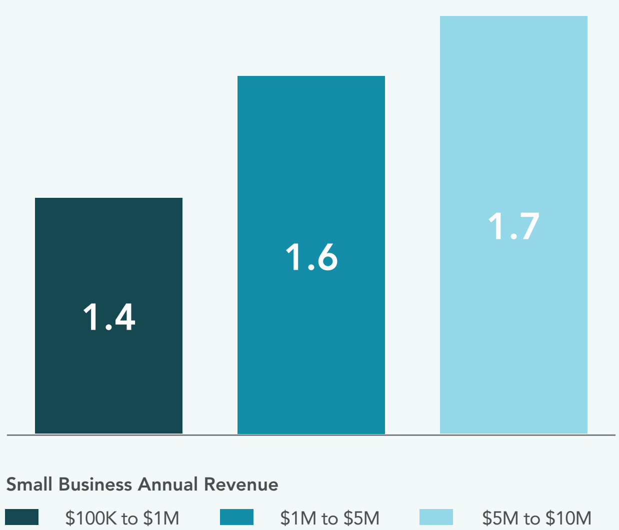
CHALLENGE: Significant Inertia in Banking Relationships

The *BAI Small Business Demand for Banking Services* study reveals significant inertia in small business banking relationships. Most of the owners and executives surveyed bank with only one or two financial institutions on average for core services and 75% are satisfied with their primary financial institution. In addition, these banking relationships are marked by longevity as most respondents have been with the same primary institution for 15 years or longer. While these long-standing relationships with existing customers can be seen as a strength of the primary financial institution, it also represents a challenge to attract new customers for growth, as these customers already have long-standing relationships with other banks.

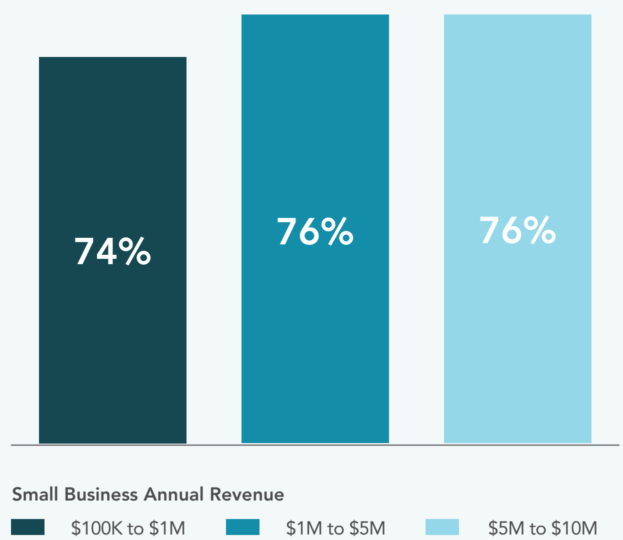
Tenure with Primary Financial Institution

Regardless of size of annual revenue, businesses that participated in the study had generally been with their primary bank for more than 15 years.

Number of Financial Institutions Used



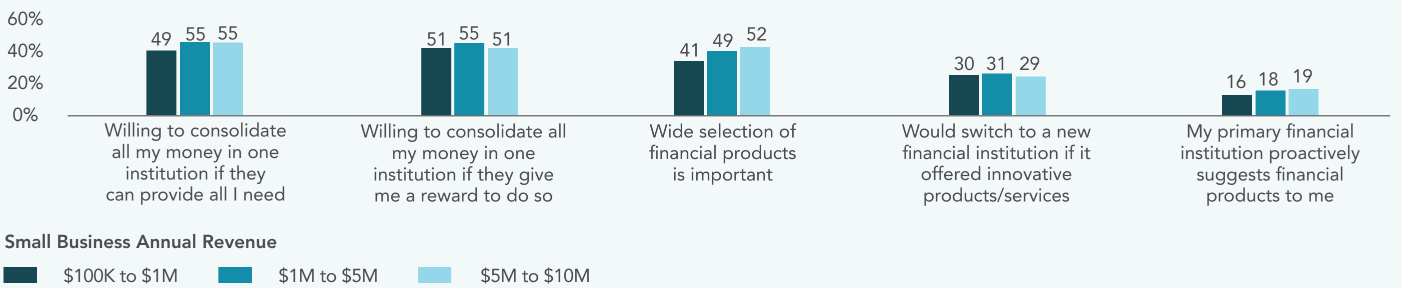
Percentage Satfisfied with Primary Financial Institution



OPPORTUNITY: Consolidate Personal and Business Relationships

Despite the apparent inertia in small business banking relationships, opportunities for growth and expansion exist – particularly in the consolidation of personal and business relationships. Approximately 25% of respondents are not satisfied with their existing financial institution. This suggests some switching opportunities for banks that can provide better service. Perhaps even more telling, nearly one-half of small businesses would consider consolidating with one institution that provided everything they needed or if they were incentivized to do so.

Willingness to Switch Institutions



Of the owners and executives who use their primary financial institution for business, only a little more than half also keep their personal accounts there – indicating additional opportunity for competing banks. Small businesses that only have a personal relationship with a bank may be receptive to moving their business account there too.

TAKEAWAYS

While the relationships between small businesses and their financial institutions are typically solid, there are opportunities to further strengthen these as well as establish new relationships. Example actions include:

- **Assisting with business performance.** Proactively offer services and tools to better manage cash flow, build peer networks and provide tips from industry experts. (e.g. specialized seminars, branch meeting facilities, industry roundtables, peer-networks)
- **Providing peer-based insights.** Leverage data across your customer base to generate insights around usage patterns and financial characteristics for specific segments. Provide advice and insight based on comparative financial analysis with peers.
- **Meaningfully rewarding customers for extending relationships.** Strengthen the relationship with current long-term customers to deter attrition by providing cross-product, relationship-based loyalty programs and tangible, financial value for consolidating their business and personal relationships
- **Involving customers in service improvement.** Administer customer experience surveys after key transactions to get immediate feedback, taking advantage of emerging, real-time, voice-of-the-customer engagements to respond or recover in a timely manner (e.g., via mobile apps to 'rate' an app, SMS-based feedback).
- **Identifying retail customers who may be small business owners.** Leverage analytics to identify opportunities with personal banking customers who have no business banking relationships, noting for example:
  - Large number of payment transactions
  - Usage patterns/use of bill pay services for business purposes
  - Inbound deposits/payments for certain types of products/services

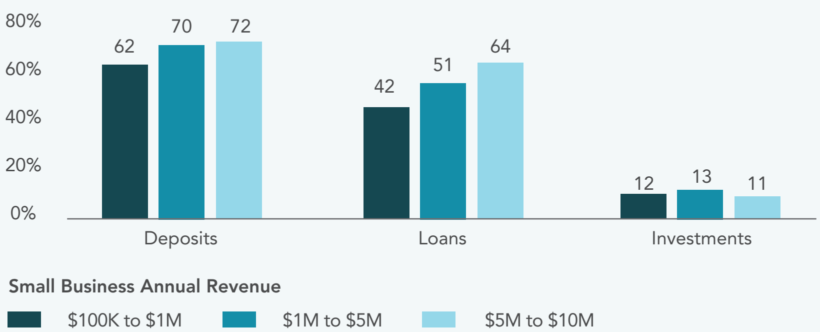
PRODUCT AND SERVICE USAGE

Small business product usage is heavily skewed towards traditional core products; opportunities exist to extend fee-based services and strengthen loan offerings.

CHALLENGE: Strong Reliance on Traditional Core Products

While technology has dramatically changed behaviors with retail consumers, small businesses continue to rely heavily on traditional core products, such as deposits and loans. Share of wallet at the primary financial institution is significantly higher for small businesses than for consumers and it increases for businesses with higher annual revenue. This is very evident in traditional core product usage, where small business share of wallet ranges from 62% to 72% for deposits and from 42% to 64% for loans.

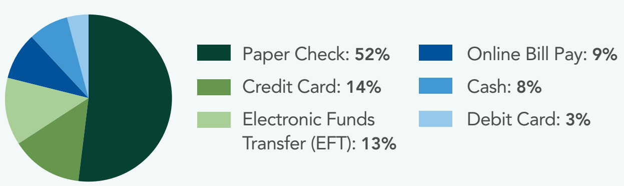
Share of Wallet by Account Type



The largest small businesses in the study maintain the highest share of wallet at their primary bank, except when it comes to investments, which is low across all three sub segments – creating an opening to grow existing relationships or pursue new ones.

In keeping with their use of traditional products, small businesses show a continued high reliance on the paper check. In contrast to consumers' preference for electronic payment alternatives, half of small businesses say the best payment method is paper check. Along with creating an easy-to-follow paper trail, check processing is entrenched in their accounting and payables systems. Small businesses typically remain low users of online bill pay, mobile pay and other payment channels. The challenge for banks is to create a compelling reason for small businesses to further adopt electronic payments technologies.

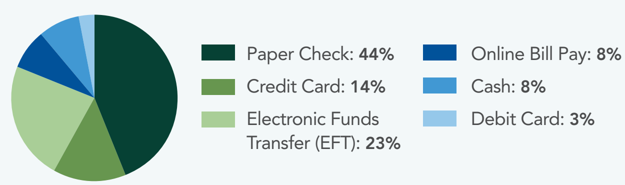
Best Payment Method for Business in Total



Overall, roughly half of small businesses strongly prefer paper checks to any other payment method.

Less than 1/2 of 1% of study respondents indicated that Mobile Bill Pay was the best method for payment.

Best Payment Method: Remote Deposit Capture (RDC) Users



Even the more technologically advanced small businesses that use RDC services still prefer paper checks overall. However, they are more partial to Electronic Funds Transfer (EFT) than other study respondents who do not use RDC.

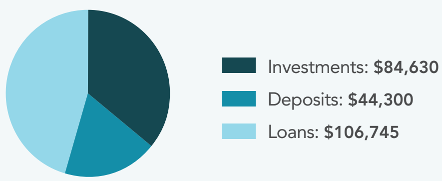
OPPORTUNITY: Expand Fee-Based Products and Loan Offerings

Despite the high share of wallet for traditional products, the degree of usage and extension of the banking relationship for fee-based products is much less developed. Additionally, small businesses report a varying level of satisfaction with respect to loan offerings.

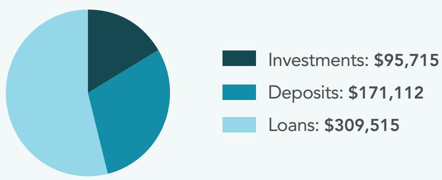
Balances by Size of Small Business Annual Revenue

Not surprisingly, balances across all three sub segments rise as the size of the small business' annual revenue increases.

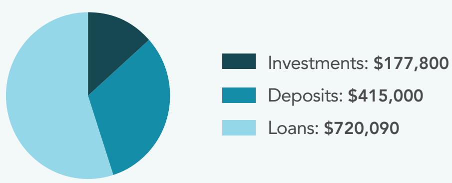
$100K to $1M Annual Revenue



$1M to $5M Annual Revenue



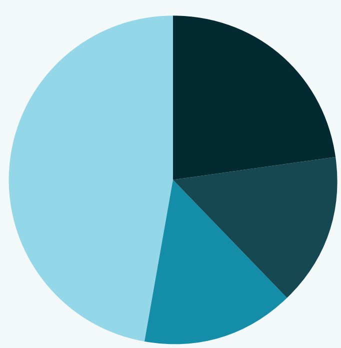
$5M to $10M Annual Revenue



Merchant Credit Card Processing Usage

- Primary Financial Institution: 23%
- Non-Primary Financial Institution: 15%
- Non-Financial Institution: 15%
- Do Not Use: 47%

Chart represents small businesses with annual revenues of $5 Million - $10 Million



As shown by its low share of wallet in the chart on the previous page, investments is a fairly overlooked area, but one worthy of exploring. The percent of overall investment balance held at the primary bank is 13% or lower, across all three sub segments. Yet, there is likely to be value there, especially for larger small businesses, which have total investment balances held anywhere of $177,800 on average (not including 401ks). Investments may provide a path for larger institutions to penetrate and take some of those larger small businesses from their community bank providers.

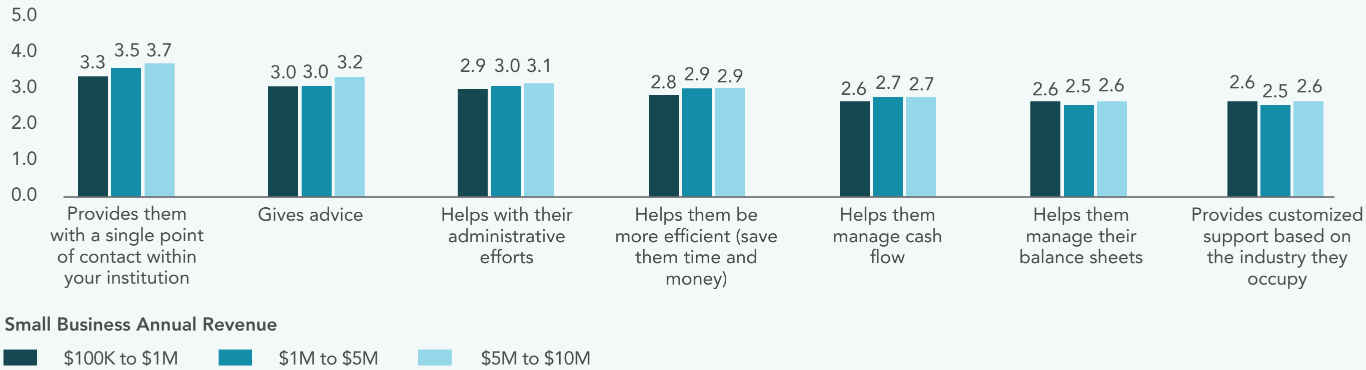
Many small businesses try to avoid fees entirely unless the service is a necessity or the fees can be justified based on the value obtained. Approximately 40% of respondents indicate fees are a primary consideration when choosing a financial institution. Most could describe in detail, the fees paid and for what services. Larger size businesses were more willing to pay for value-added services, such as merchant services, while smaller firms tended to be more fee-adverse.

Merchant services is another fee-based opportunity with currently low penetration. As noted above, larger size businesses are more receptive to paying for value-added services. In keeping with that trend, 53% of businesses surveyed with between $5 million and $10 million in annual revenue use merchant credit card processing. And, of that 53%, one-half use merchant card processing through their primary financial institution. As this service typically provides high returns for banks, it suggests unexplored revenue opportunities.

While some small businesses are using PayPal if they have an online presence or Square if selling while not at their physical store, many are not yet using next generation payment offerings. A number of the small businesses surveyed do not accept PayPal or Square payments from their customers because of fees or due to a lack of need. However, those businesses that do accept these forms do so because of their presence online or to provide expanded payment options to their customers.

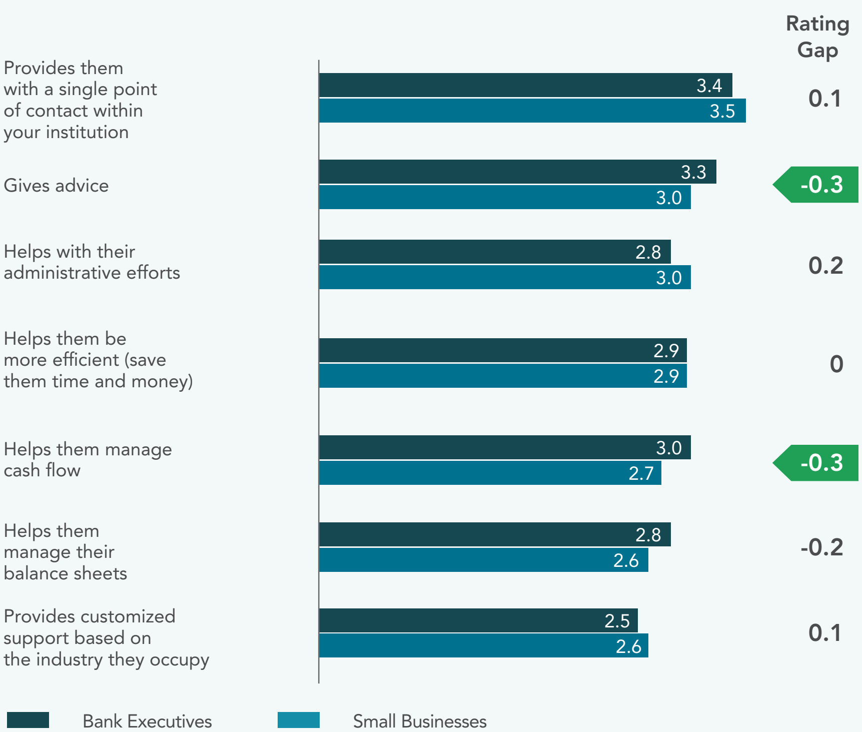
Interestingly, while small businesses show loyalty, when asked specifically about service, they highlight some gaps in satisfaction with the service levels received. This is likely to create opportunities for banks to better serve existing customers and draw new ones in the door. While having a single point of contact within the financial institution earned high marks, small businesses generally gave lower marks when it came to getting help managing cash flow and giving advice. While there may not be fees attached to these advisory services, they are of value to small businesses.

How Small Businesses Rate the Services They Receive



Average Star Rating — Out of 5 Stars

Service Perceptions: Bank Executives vs. Small Businesses



Average Star Rating — Out of 5 Stars

A negative gap indicates that bank executives believe they are doing a better job than their small businesses think they are.

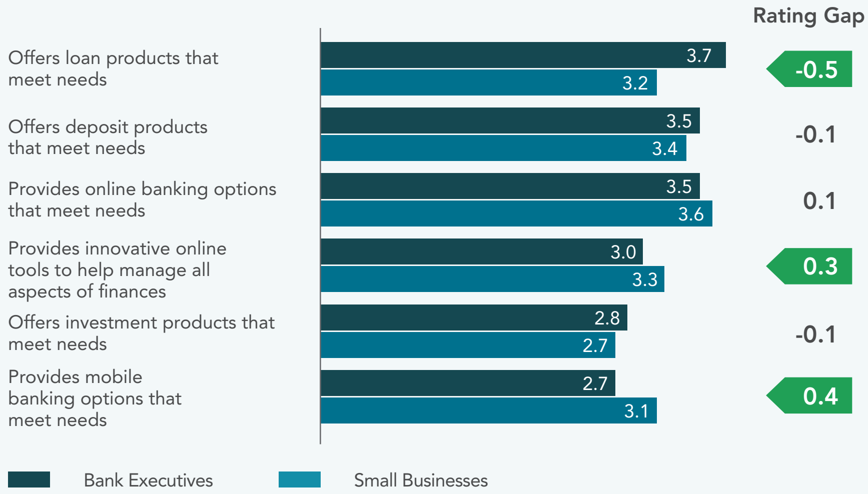
A positive gap indicates that bank executives are underestimating their service capabilities relative to what their small business customers believe.

Sources: 2012 *BAI Solutions Demand Pulse Research* (Survey of Retail Banking Executives)
2012 *BAI Research Study: Small Business Demand for Banking Services* (Survey of Small Business Owners)

Generally, bank executives and small businesses share similar perceptions about the bank's ability to provide service support. However, there are some gaps in how well banks believe they are providing advice and manage cash flow and balance sheets.

While small businesses show high overall satisfaction levels with their primary financial institution, they also look to them to act as facilitators, from offering education classes on small businesses and how they work with financial institutions to enabling contact with venture capital funds.

Product Offering Perceptions: Bank Executives vs. Small Businesses



Average Star Rating — Out of 5 Stars

A negative gap indicates that bank executives believe they are doing a better job than their small businesses think they are.

A positive gap indicates that bank executives are underestimating their product offerings relative to what their small business customers believe.

Sources: 2012 *BAI Solutions Demand Pulse Research* (Survey of Retail Banking Executives)
2012 *BAI Research Study: Small Business Demand for Banking Services* (Survey of Small Business Owners)

While penetration of core banking products is high, there appears to be some disconnect between what banks offer and what small businesses need on loan offerings. The bank that small businesses have their primary relationship with is typically where they look to first when there is a need for additional funds. Small business owners and executives require loan products that meet their needs and most are open to education from bankers about the funding choices available. Many suggested that bankers facilitate meetings with venture capitalists that could highlight unmet lending opportunities. Others had been frustrated by past experiences with bank loans and are now inclined to borrow money from friends or family. Additionally, many banks fall short in proactively recommending products and services and helping small businesses manage cash flow.

TAKEAWAYS

Significant opportunities exist to differentiate financial institutions in the eyes of the small business owner by meeting and exceeding financial needs both with and beyond traditional products and services. Actions include:

- **Streamline and automate product origination processes.** Speed to approval as well as regular and accurate communication about the status of loan requests are important for small business customers. Consistently delivering quick "time to yes" and funding requires elimination of errors and streamlined and consistent processes, rationalized/ clear roles and responsibilities, and automation.
- **Introduce customized products and value added services.** Products that help with cash flow and risk management, and operational efficiency are in demand. Also, potential exists to charge for customized information services in the same way as some of the cards-based organizations do currently.
- **Institutionalize more focus on fee-based products.** Opportunities exist in investment/ retirement products, as well as merchant services, Point of Sale/payment related payment products. To succeed banks should:
  - Build on insights generated through application of data analytics to develop and execute targeted "next product" sales
  - Better align internal RM training
  - Closely connect bankers and specialists (e.g. cash management, wealth/ investment advisory)
  - Incentivize bankers on risk-adjusted return on capital for the relationship, which can help drive broader and deeper product penetration
  - Invest in customer education and trial efforts
- **Upgrade the skills of the sales team to move from service provider to small business partner.** Transform bankers into facilitators and advisors. Invest in your relationship bankers so they can provide industry expertise and personalized service, bringing clients relevant insights to their industry (small businesses typically find that their banker is not conversant in their industry issues).
- **Consider more of an open architecture.** Use the banking platform to integrate and deliver specialized 3rd party products and services much like wealth managers have been doing. For example, partner with online vendors providing specialized services to your small business customers, ranging from payment products to financial advisory services to business planning.

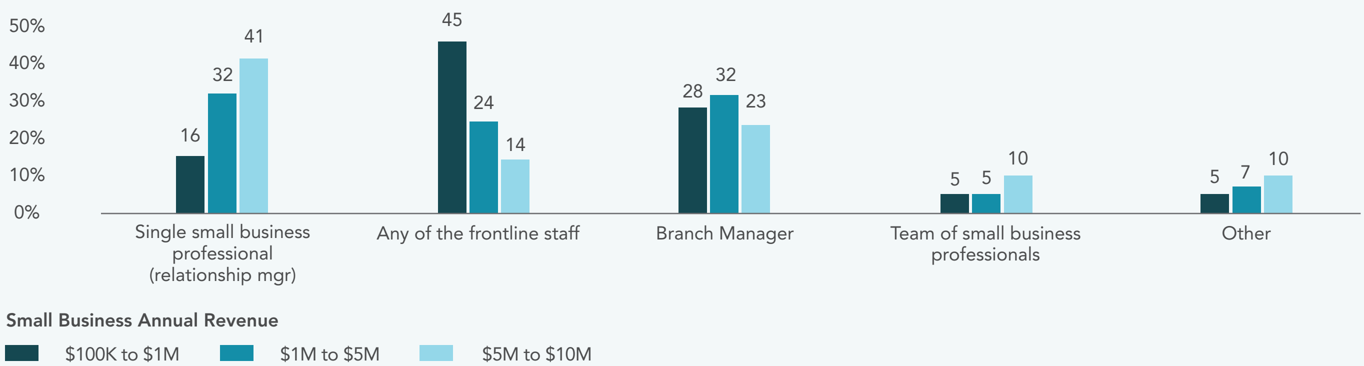
MEANS OF ENGAGEMENT AND CHANNEL USAGE

Small businesses value traditional interaction channels, such as branch and phone, with a personal touch though some are increasingly exploring online and mobile channels.

CHALLENGE: Heavy Use of Traditional Channels

Small businesses rely heavily on face-to-face channels and conduct 60% to 70% of their banking activities in the branch. These customers typically work with the frontline staff most often. However, larger businesses have a dedicated small business banker.

Primary Bank Contact for Small Businesses



How Small Businesses Interact with Their Bank

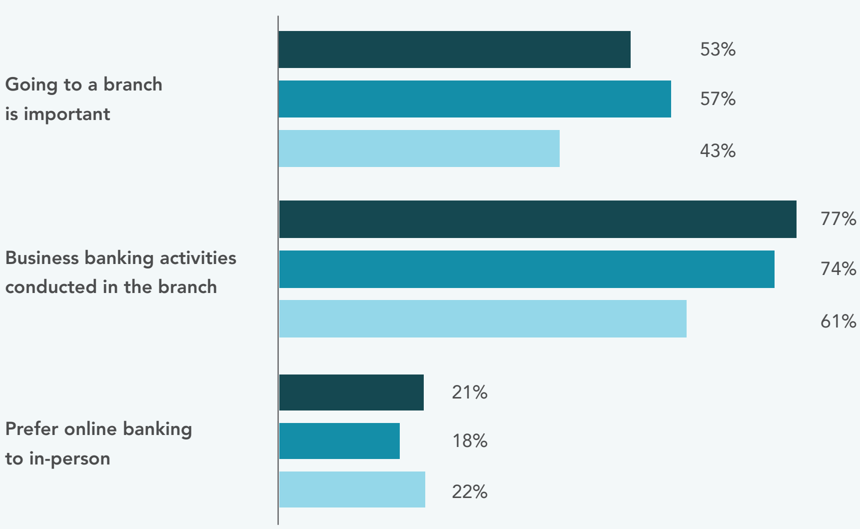


Chart indicates the percentage of respondents who completely or strongly agreed with the statements to the left.

Small Business Annual Revenue

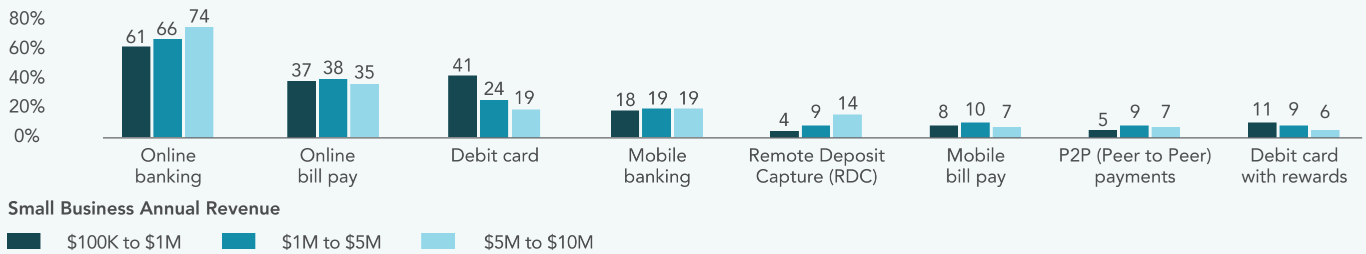
$100K to $1M $1M to $5M $5M to $10M

In comparison to consumer banking, where branch transaction volume is gradually dropping, small business banking remains centered on the branch, which accounts for two-thirds of all business transactions. Half of small businesses report that going to the branch is important and only one-quarter are comfortable conducting banking transactions on a mobile device. Very few prefer online to in-person banking. These findings align with this segment's preference for personal engagement to have their questions answered and any issues or concerns addressed.

OPPORTUNITY: Extend Beyond the Branch

While small businesses show a strong preference for traditional channels, such as visiting the branch, their actual technology usage indicates some adoption. Initial use of online and mobile may indicate a trend toward these channels as small businesses gain familiarity and confidence. Study findings show that 68% of the small businesses use online banking and 36% use online bill pay at their primary financial institution.

Technology Product Usage at Primary Financial Institution



Extending service to customers beyond the branch channel is likely to have a positive dual effect — better meeting the needs of small businesses while improving the cost effectiveness of serving them. While this segment is generally reluctant to switch from their traditional banking services, they may consider other alternatives when they can clearly see the value, such as greater accessibility or time-saving. The efficiency of more innovative payment methods, such as remote deposit capture, could be an entry point for higher adoption of online and mobile channels more broadly.

Increased adoption of RDC and online bill pay are two examples where small businesses could potentially benefit from greater cost effectiveness of these channels versus the traditional branch and check-based environment.

The larger, more established small businesses in the study do tend to use RDC and conduct a smaller percentage of their transactions in a branch by 15-20%. Extending this trend to the much larger population of smaller (<$1M) small businesses indicates a significant opportunity for changing the way those business interact with their bank.

TAKEAWAYS

While small businesses value traditional interaction channels, financial institutions can extend services to customers beyond the branch. Banks can differentiate themselves by delivering a seamless omni-channel experience that ensures value and consistency within channels. Opportunities also exist to use physical locations to serve business customers in new ways. Actions to consider include:

- **Take advantage of mobile for payments-related services.** Enhance mobile offerings to provide small business users with real-time access to funds, cash flow management tools, the ability to accept payments/deposits, and the ability to authorize payments.
- **Adopt an omni-channel approach to cash management services.** Develop and deliver a small business solution that integrates all cash flow needs, including inbound, outbound, and management of cash in one location and available through an omni-channel experience. Related, re-examine and strengthen remote deposit capture offerings, including associated customer adoption strategies.
- **Deliver more integrated online experience for financial accounting and planning.** By partnering with non-bank specialized service providers to deliver an integrated experience (e.g., financial management and business planning tools integrated into an online banking portal).
- **Orient branches to better support small business customers.** For branches with significant small business customer bases, consider options for how they can be enhanced through integration with mobile devices and self-service at kiosks. As some banks both domestically and internationally have evidenced, there are also opportunities to design and designate selected branches to provide for small businesses meeting spaces and also showcase areas to display local business services and products.

CONCLUSION

Small business banking would appear to be a profitable segment with strong competition among banks, particularly when it comes to increasing their loan portfolio. Financial institutions that can clearly demonstrate superior service and solution delivery capabilities are likely to differentiate themselves in the eyes of small business owners and win in this market.

A challenge for banks is likely to be the development of a better understanding of this segment's banking needs and preferences and cost-effectively meeting those needs through more customized product offerings and personalized assistance. These customers tend be loyal to their primary financial institution and based on the survey results, are willing to consolidate with one bank if their needs are met. Therefore, banks should consider making an attempt to ensure a high level of customer satisfaction and become a one-stop-shop to customers for all of their financial needs. This is likely to be achieved through proactively understanding the needs of small business customers and being knowledgeable about their business, offering innovative products, increasing sales of fee-based services through cross-sell/up-sell, and providing value added solutions via online, mobile and tablet devices.

STUDY METHODOLOGY

BAI Small Business Demand for Banking Services Research Study
In the Fall of 2012, BAI collected and analyzed over 1,500 U.S. small business owner/decision maker responses utilizing a panel maintained by Barlow Research Associates, Inc. (www.barlowreasearch.com). These U.S. small businesses represented broad industries and were fairly evenly geographically distributed across the U.S. as shown on page 5 of this paper. The over 1,500 responses were collected in each of the following annual revenue categories:

- $100K to $1M: 546 respondents
- $1M to $5M: 536 respondents
- $5M to $10M: 457 respondents

The study consisted of two parts:

- 20 minute, 3-page paper and pencil quantitative survey, mailed out to U.S. small businesses from the Barlow Research Associates, Inc. database.
- Online qualitative discussion board comprised of 36 participants of the paper and pencil qualitative survey – 12 from each of the three revenue categories shown above.

Participants were asked three to four open-ended questions every two weeks over a period of eight weeks and were able to interact with each other throughout that time frame.

2012 BAI Solutions Demand Pulse Study
BAI's *Solutions Demand Pulse* Study captures insights from U.S. financial institutions on a tri-annual basis. The online surveys garner information from bank and credit union executives on:

- Key business challenges and opportunities
- Investment and resource priorities, near and long-term
- Solutions provider characteristics that may or may not influence selection of a partner to help address specific challenges and business issues
- Overall investment priorities & 'drill downs' on specific topics across various business and functional domains:
  - Executive Business/Strategy
  - Retail Marketing & Product Management
  - Retail Distribution Channels (Branch, Online, ATM, Mobile, Other)
  - Payments
  - Operations
  - Sales & Service Effectiveness
  - Technology
  - Risk & Regulatory Compliance

The online survey was conducted three times in 2012 – April, July and October. The survey was deployed to BAI's database of bank and credit union executives from all asset categories. Each iteration of the survey produced between 500 and 600 responses.

RESEARCH

BAI is the financial services industry's partner for breakthrough information and intelligence needed to innovate and stay relevant in an evolving marketplace. For more than 80 years, we have focused on advancing the industry by offering unbiased education and research. Our offerings are as diverse as the industry, and include premier events such as BAI Retail Delivery Conference & Expo, ground-breaking research and performance metrics, professional learning and development programs, and in-depth editorial coverage through *BAI Banking Strategies.* Visit www.BAI.org for more information.

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