eBOOK

The High Cost of Lending Uncovered

Foreword

Snehal Fulzele
SVP and General Manager, Lending, Q2

To retail banking consumers with mobile phones, it looks like banks have done a good job taking their operations online. Many of us are now able to use an app to do a lot of our day-to-day, less complicated banking. But peek behind the curtain and you'll find that many traditional banks are struggling, particularly in small and mid-ticket SME and commercial lending. The interface that customers see is typically a thin veneer of technology applied to a handful of tacked-together legacy systems, straining under the pressures of excessive costs, high demand, and emerging competition from tech-savvy fintechs. To keep pace, traditional lenders need to change the systems that operate the core of their business. And they must allow their customers to manage it all online, or on their mobile phone, in a way that is intuitive and elegant. Customers will not tolerate bad digital experiences.

Small ticket lending is a great place to start. It's expensive for financial institutions to do, much slower than commercial and consumer customers want, and run by clunky systems with way too much human involvement. However, competition is emerging from fintechs and challenger banks. Serious competition from the tech giants also is only around the corner. This eBook is about Straight Through Processing (STP), a solution that can, all at once, reduce the cost of small ticket lending, enhance customer service, reduce risk, and create opportunities for upselling and cross-selling banking products and services. STP is not rocket science, it's for regular banks, and it can be implemented quickly. There are people in this industry – and I'm one of them – who think those FIs without digital solutions will disappear in short order. The demise of even the very largest companies in their sector is not unimaginable. With that in mind, it doesn't seem like the tallest order to make a few changes to the way you work. We hope you enjoy this eBook, and we'd love to hear from you if you have any questions.

Chapter 1

Lenders: Move money to make money

Despite "smaller" values the small ticket lending market represents just as big an opportunity as full-on commercial lending. Around 99% of firms in industrialised countries are small to medium-sized enterprises.[1] Together, they provide about 60% of jobs and produce around the same proportion of gross domestic product.[1] They need a lot of loans and leases. Yet, approximately 53% of SMEs complain that they struggle to access finance for growth.[1] And the retail lending market, worth trillions of dollars globally, has been described by TSB Bank in the UK as "stacked against consumers".[2] In North America the U.S Federal Reserve in the recent past has reported 52% of small businesses encounter funding issues with 23% of small businesses facing lending shortfalls, and another 29% potentially having unmet funding needs.[3] It's a high-volume market, and there's a lot of unfulfilled opportunity.

The primary reason? Cost. Small ticket lending is expensive. It's a low-margin job. Since it doesn't make much for the bank in the first place, the logic follows that banks can't commit a lot more cash to do it only slightly better. As well as cost, the systems that sit behind the lending process, from origination to delivery, require high levels of human touch, are complex, siloed, and worse – old. Archaic legacy systems create much of the cost problem.

Traditional systems tend to only look at past data for credit assessment and as a result, are responsible for turning down some good borrowers and putting off many more. If you could fix both those things – the cost of lending and the systems for approving and delivering loans – a lot of hay could be made.

53%

of SMEs complain that they struggle to access finance for growth.[1]

[1] https://www.oxfordeconomics.com/recent-releases/the-big-business-of-small-business
[2] TSB, Consumers Matter: Loans, p.3
[3] Fed Small Business, 2018 Small Business Credit Survey

"The fast-moving COVID-19 pandemic has brought this all into focus. In a short space of time, small businesses in every sector, in almost every market, have required immediate loans to remain even partially operational. Governments asked banks to move that money, and to do it very quickly.

We know that the average 'time to cash' for commercial lending is nearly three months – in many cases because of worthwhile anti-money laundering and know-your-customer processes. But a lot of businesses don't have the reserves to wait that long anymore. Very suddenly, big banks are struggling to do something fundamental to their purpose: to get money to their customers, when they need it most."

– Snehal Fulzele
SVP and General Manager, Lending, Q2

But this is only one chapter in a story that has been building for some time. Despite endless change management, traditional banking looks old. It's a digital laggard, currently unable to deliver on the experience that other sectors have managed to develop at speed. And these sectors do not limit themselves. Google, Apple, Facebook, and Amazon all have the skills and most importantly, the data to step into this space if they wish.

Consumers increasingly used to a seamless digital experience will welcome it. In fact, a viable digital process is a must-have in order to compete. Certainly, some fintechs have made inroads on the market lately, but serious competition for bigger banks is relatively nominal at the moment. However, in a heartbeat, the competition could be fierce. Banks should feel threatened. So how can banks lend small amounts quickly and cheaply but with lower levels of risk? We don't think that the answer is simply "technology". Yes, systems need upgrading, but the right technology alone won't deliver the change that's needed. Instead, banks need to approach lending as an information problem.

In fact, a viable digital process is a must-have in order to compete

An approach that checks all the boxes

That's where straight-through-processing (STP) comes in. STP checks all the boxes: it's a quick and effective digital process. It delivers money to customers in hours, not weeks or months. It increases the profit margin on small-ticket lending. And it means banks can do more deals. But it also does a lot more than just shift money quicker. Because STP is built around infrastructure that collects, stores, and uses so much more information about customers, it means that lenders can provide them with more personalized experiences – experiences traditionally reserved for high-net-worth customers or companies with large credit facilities.

Financial Institutions (FIs) can advise customers better because they have more time and more customer-centric knowledge. They can sell them more useful products, more cheaply. They can spot and address risk in a much more targeted way and provide a detailed audit trail for regulators. And they can connect STP to other third-party applications both in and outside the bank to provide their customers with seamless financial experiences that meet their needs and exceed their expectations.

This eBook is about solving the high cost of lending with STP. In it, we'll explain how the technology works and how it can deliver all kinds of benefits to FIs and their customers. And we'll explain how FIs can make the transition. But if you come away with one thing from reading this, it should be that STP is really an outcome. If you have commonality in technology, if you have the information on your customers, if you have the economic context, then you can have a quick decision about lending. That's STP.

STP is more than a process, it's an outcome

To understand why STP is such a compelling solution for small ticket lending, it helps to have a better grasp of the problem – from both perspectives, the institution's and the customer's.

When a person walks into an FI or leasing organization wanting a small ticket business loan or needing to lease equipment (such as office equipment), the FI or lessor will treat them in most cases as a new customer. Twenty years ago, that would have been fine, if not a little irritating for the customer and the bank employee moving all the paperwork. Today, it's a problem.

On requesting a loan, a chain of events is set off that today looks utterly different from most other buying experiences. The customer's experience isn't a good one, and neither is the bank's.

One U.S. lender captures the realization that many lenders are coming to:

> "We're not a technology company, but we understood how technology investments could improve the customer experience and enhance our impact in helping small business owners access the financing and support they need to thrive."

Typically, the information about the loan would be recorded initially by phone or fax – only sometimes by software. Then it would go through a series of confirmation processes at both ends, reviewed, counter-reviewed, and either kicked into an exceptions queue or punched into the payment system manually. Each person in this series of events would be operating in a different environment. And the disunity of each stage requires high levels of human interaction with the system. Humans, errors, delays. That's expensive.

– Darpan Saini
SVP Product and Engineering, Lending, Q2

How the loan process actually works – or doesn't

Let's start with the FI. To begin with, institutions providing small ticket loans to good businesses can charge between 4%-13% interest.[3,4] But they're borrowing between 5%-7%. And the cost of originating and servicing that loan – from initiation to payment, and even securing repayment – can also be high. The margin on these deals is wafer thin. The size of the margins does help to explain why small ticket lending isn't a change priority for FIs. That's the macro picture.

Then there's the chain of events. At a lot of FIs, different loan requests get different treatment – a lasting outcome of the golden era of commercial lending, when semi-independent lending departments bought different IT systems to run their respective portfolios. These siloed systems don't work together, and the technology they use only works across part, not all, of the lending cycle. Put simply, they're built on 30-year-old technology and operate using 30-year-old rules. The market looked very different in 1990.

Customers must typically complete a lot of paperwork – even if they're already an account holder. Then, it can be three to five weeks before they receive a decision, and nearly three months for the cash to reach their account. For small businesses in need of money, waiting three months for funds (or around a month to get turned down) is only going to cause reputational problems and a potential loss of business.

[3] https://www.valuepenguin.com/average-small-business-loan-interest-rates
[4] https://apps.newyorkfed.org/markets/autorates/obfr

Macro trends are finally forcing change

This process, characterized by rigid and iterative manual processes, legacy systems, and a largely monolithic approach, is increasingly ineffective today. On a technical level, the process could perhaps survive if it wasn't under today's more significant macro-level pressures. To be straightforward, the process can't deliver the experiences that customers – both commercial and consumer – now demand.

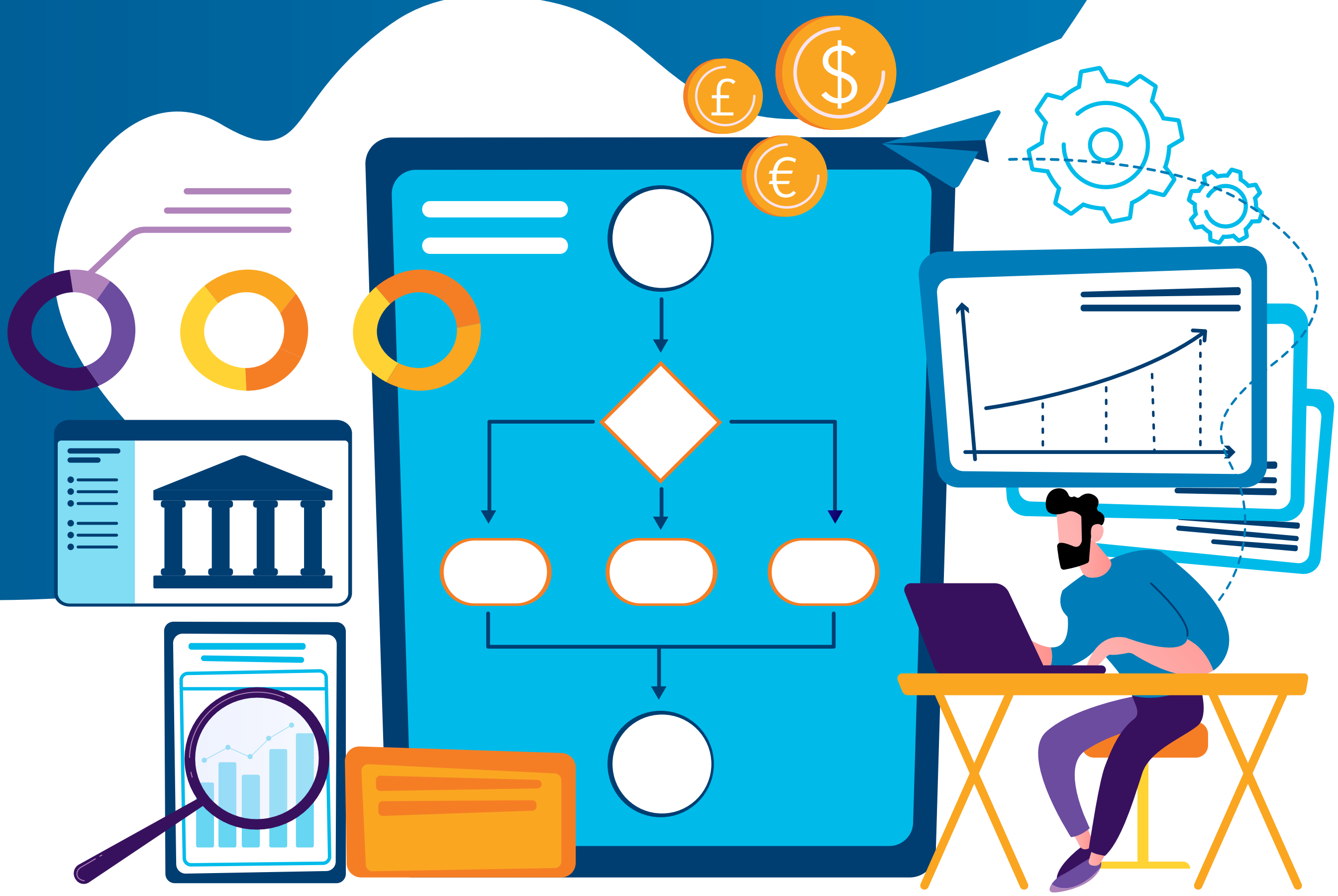
Today, most people expect seamless digital experiences when it comes to retail and communications. And they expect it in most areas of their lives. In an attempt to bring more speed and ease to banking, both fintechs and challenger banks have entered the lending market, meaning that many customers are acutely aware of, and increasingly prefer, online options for banking. Not wanting to be caught out, many of the big banks have gotten involved in some small way too. But so far, most of their focus has been on smarter-looking front-end interfaces, with the processing technology at the bank remaining untouched.

Meanwhile, small-ticket commercial and consumer lending and even leasing in most cases needs to be fully available online, and it needs to be quick and easy. To deliver this, traditional FIs should partner with third parties offering fully integrated single platform solutions that provide lenders with a complete view of the customer – including their assets, activities, and risks. It also should be possible to upgrade the platform while it's in use and release new functionalities without interrupting business. STP can achieve these requirements.

Small-ticket commercial and consumer lending and even leasing need to be fully available online

Chapter 2

Straight-Through Processing – the value proposition



STP: the value proposition

STP brings great value to commercial lending and asset finance. The proposition varies between asset classes, countries, and business contexts too — STP isn't a hermetically sealed system you drop into your bank. It's more flexible than that. But we're getting ahead of ourselves a little.

Let's pick up where we left off in Chapter 1. Banks need a digital small ticket lending infrastructure. How does STP provide that?

We said earlier that STP checks all the boxes. And there's one main reason it's able to do that, and thankfully, it's straightforward: STP is designed to reduce – and ideally, eliminate – the need for human touch.

With STP, the information about new customers and loan specifications only needs to be registered once. If that customer interacts with the bank again at any point, the system calls up the information from the central database. Siloes, gone. Tons of paperwork, gone.

And that information is available to everyone in the process of lending. Not just the customer and the lender, but the relationship manager at the bank, credit rating agencies, the bank's lawyers, investors, regulators, and so on.

It's all customizable too. As mentioned, it's not hermetically sealed. The workflow arrangements, the approval pyramids, how the sequence is managed – everything that's defined by your internal business logic rules – can be custom-built, reorganized, and updated.

> **Human touch is the industry's way of saying that there's an actual person handling deals and making decisions. In small ticket lending, where the amounts of money are pretty minimal (in the wider context of banking), human touch can create a whole lot of cost and error. On a deal-by-deal basis, human touch is just a drag.**
>
> **– Mukul Mittal**
> Vice President of Industry Solutions, Lending, Q2

> All your levels of tolerance can be set in a way that suits the institution. Just because it's automated doesn't mean it's rigid. If it were strict, there would be a depreciating level of return: it would cost you more in complexity because you make fewer loans. STP helps banks to strike the balance they can bear. And these deals are designed not to be touched by humans. This is functional efficiency.
>
> **– Mukul Mittal**
> Vice President of Industry Solutions, Lending, Q2

STP allows you to:

- **Build custom lending sequences**
- **Organize and update sequences**
- **Set risk tolerance**
- **Funnel 'marginal' customers to a different part of the system for more scrutiny, rather than lose them completely**

Some of the banks we talk to are afraid that STP will make things more impersonal, but the truth is that it gives them the information and the time to be insightful, personable, and generally the kind of banker only the high-rollers get to have. Speed and convenience will be the new brand loyalty. The banks that have the technology to meet the expectations of the digital demographic (now the largest income-producing demographic in the world) will go big.

– Darpan Saini
SVP Product and Engineering, Lending, Q2

STP is also great for risk management. In the wake of Basel IV, banks must provide a huge amount of information on their loans. They must pull it all together and analyse it, make estimates, and build policies. Having STP in place means that you have coherent data. You haven't entered one customer three times into your system. You're not analysing data from loads of different sources. You have a data lake, you pull from it, you present your information, and you can cut it any which way the regulator wants with confidence.

STP reduces errors, speeds up the decision, reduces time to fund for small businesses and consumers, and has an impressive impact on customer satisfaction. It's a pretty common gripe among small to mid-sized loan customers that they receive a sub-standard quality of service. STP automates all the generally draining and time-consuming origination and servicing steps in the current system that require human touch and frees up an employee to 'touch' the loan in a way that benefits the customer.

STP reduces errors, speeds up the decision, and reduces time to funds for small businesses and consumers. It has an impressive impact on customer satisfaction.

Cross-selling and more

Besides doing a better job of servicing that one small loan, the relationship manager has information about their customer to offer other products and solutions that are more targeted, and much more likely to elicit response.

And having this valuable information about customers, the bank can develop entirely new products based on what their customers actually need, rather than what they think they need. Opportunities will quickly open to build more relationships, leading to cross-selling, customer retention, enhanced customer lifetime value – and ultimately, increased revenue. STP augments your ability to do good deals. That's hard to argue against.

STP does a couple of other things, too. The data it generates allows for more detailed reporting. It creates an incredible information trail for auditors, particularly on risk, and allows for improved accounting, since it speeds up and tracks the exchange of money between lender and customer.

One of the most impressive capabilities is STP's ability to facilitate API connectivity. It has the infrastructure to integrate with third-party solutions seamlessly. Over the last several years, FIs have made many acquisitions. The depth of integration that can be required is just enormous. Fortunately, STP connects with all that legacy infrastructure in the places where it makes sense. Q2, for example, allows multiple integrations per implementation, and this list is continuously growing. And never mind the legacy infrastructure, it will connect with most of what FIs acquire in the future, meaning that they can continue to upgrade to deliver a broader suite of online products for their customers.

A Case Study: How Q2 supported a leading global FI with SBA CARES Package automation

The challenge

As the "stay-in-place" requirements of COVID-19 began to shutter businesses everywhere, the U.S. Government acted to provide swift financial support for struggling companies. The resulting SBA CARES Act called on FIs to funnel government-backed loans to the companies that applied for them – and to do all the background work first on eligibility, as well as the standard know-your-customer and anti-money laundering checks.

This was an enormous task, to be completed at unprecedented speed. Tens of millions of businesses quickly applied. Some banks threw people and paper at the problem, upscaling their staff, and requiring applicants to complete paper or PDF forms. Other banks are using technology to scale and automate the loan process.

Many businesses have suffered as they haven't received their loans quickly, and many more didn't even hear back from their bank. Much of this comes down to the exact processes we described: the slow movement of information through legacy systems. The winners have been those banks with a digital interface and automated processes.

The Solution

We were approached by a leading global FI to help them quickly build a solution to support their clients. It was clear to Q2 that an STP approach would pave the way to success.

A scalable solution wasn't in place, and our client didn't have a two-way digital channel for self-service.

Six to 12 months for a significant implementation is a typical timeframe. This time, it took only 10 days. Q2 rapidly delivered and deployed a scalable, commercial-grade solution, with an entirely digital back-office workflow and review and approval process.

STP came through in shining colors, proving its ability to handle complex, large data projects.

In a short space of time, the collaboration between Q2 and our client achieved great things. The results speak for themselves:

The application process is fast
The eligibility application process takes borrowers less than five minutes to complete. We were able to automate the eligible and permissible amounts, and for the complex cases, we created a notification system that alerted teams to take a closer look.

API integrations are built in
We built the system with four other major integrations, including DocuSign.

A superior experience
The digital interface for loan applicants was intuitive and elegant.

5 days

13,000
loan applications processed

20-30
applications per minute

$2-3B
loans deployed

Chapter 3

The STP fear factor – and how to overcome it

The fear factor – and how to overcome it

This is the final chapter in our eBook focused on the high cost of lending. Previous chapters outlined the cost challenge FIs face in delivering small and mid-ticket lending and leasing and uncover how the concept of Straight Through Processing (STP) can resolve many issues related to the challenge. In this chapter, we discuss how a fully transformative digital approach like STP requires a culture shift that transcends an organization.

The value proposition for STP is clear. But there are speedbumps. And those speedbumps illustrate how a change in philosophy is the only thing that will deliver a change in technology.

The first speedbump is that FIs typically take a deliberate approach to change. They're shackled to cumbersome processes and, to be fair, have a set of ideas that have served them well over time. They're often hesitant to change—and the old adage is true, change is hard. However, change can be accomplished effectively from process and timing standpoints with the right partner and technology.

> "It takes around three years to roll out a new implementation for average-sized banks – that's just a fraction of their landscape. Banks are already undergoing a virtually never-ending process of legacy change. The internal exhaustion is real."
>
> **– Darpan Saini**
> SVP Product and Engineering, Lending, Q2

Feel the fear – but do it anyway

I'll make fewer loans overall

"It's possible but unlikely. You get to build the system that makes the decisions. It isn't harsher just because it's automated."

– COO
Leading Asset Finance Independent

Automation might erode my workforce

"Actually, it frees them up to work in more complex areas of the business that require human interaction."

– VP Operations
Leading Community Bank

I'll lose the opportunity to build relationships

"You'll actually end up improving it—because instead of spending time on small, manual processing tasks, you'll be able to talk to them about their business, and maybe even recommend products and services that are useful to them."

– Head of Customer Engagement
Leading Fintech Lender

Four major myths associated with implementing STP

1. "It erodes the workforce."

The first myth is that the automation STP delivers will end up eroding your workforce. We've found that it doesn't. Instead, it frees up staff to accomplish other work, better care for customers, develop new products, reskill, and more.

2. "We'll end up lending less."

Some fear that they'll make fewer loans because of the notion that removing the humans removes the nuance. The argument goes that if you take humans out of the picture, the people who are close to (but not quite) eligible for a business loan or plant lease will get kicked out of the queue by the strict controls built into your system. However, as we've pointed out, you can develop your own controls. You can finesse your decision-making to the point that certain applicants can enter a queue where they'll receive closer inspection. Ultimately, you can address this concern with much less stress.

3. "We'll lose the relationship."

The third myth is the idea that automating everything will result in lost customer relationships. This is common, and rightly so; FIs should be scared to lose their account holder relationships. But do they really have deep relationships with their small-ticket segment? Wouldn't FIs much rather build relationships where they could share specific, personalized advice? That's what STP enables.

4. "The gains from digital aren't big enough for us to make the switch."

It's been said the uptake of digital processes and solutions for FIs is in the area of 40%. In part, this is because it's not always seen as sufficiently beneficial compared to the standard way of doing things. This isn't correct. Not only is the online channel far more developed for small ticket lending, participants can lend with a minimum of fuss, a minimum of meetings, far fewer phone calls, and so on. With reduced friction, you don't just keep a relationship with your customer, you make it better—because you deliver what they want, sooner.

What's happening in 2020 is a titanic shift. Everyone expects a digital solution. So, among FIs there's going to be a divide between the digital have and have-nots. And the have-nots won't just do badly, they'll disappear. Banks are now going to see digital as more valuable, rather than a challenge to the value of their relationships. Digital banks are absolutely going to be the beneficiaries of bad experiences at other banks—and after COVID-19 there will be no shortage of bad experiences with your lender. It's not the end of a way of life, it's an extension—a highly personalized and on-demand one. It just requires a few changes to the way banks do business.

– Taylor Adkins
VP Products, Lending, Q2

Fear of the competition

The typical fears FIs express about STP (as described earlier in the chapter) are so often unfounded. But there is a bigger, more immediate, and pervasive fear that FIs shouldn't ignore: the fear of the competition. Competitors will eat your business – and small ticket lending is a competitive environment. Challenger banks are innovative, technology-led, and employ highly capable teams. They can launch new systems in a few days. And they're not the only ones to fear; Google, Amazon, Apple, Facebook, and others are beginning to investigate this space. And if there's a profit to be had, their presence won't be small.

You can, of course, go digital without implementing STP, mixing digital processes with human intervention. But STP delivers the relational 'stickiness' that drives value. The STP approach immediately increases the margin in the small ticket sector and provides overarching context for multi-product FIs.

Culture is the greatest barrier to change

Since it encompasses the entire lending lifecycle, STP is a fully transformative process. Companies considering undergoing a completely transformative process can experience unease. To overcome this, lenders and lessors can get comfortable with the process first, eliminate teething problems, and gain their employees' trust, without every part of the business having to undergo change.

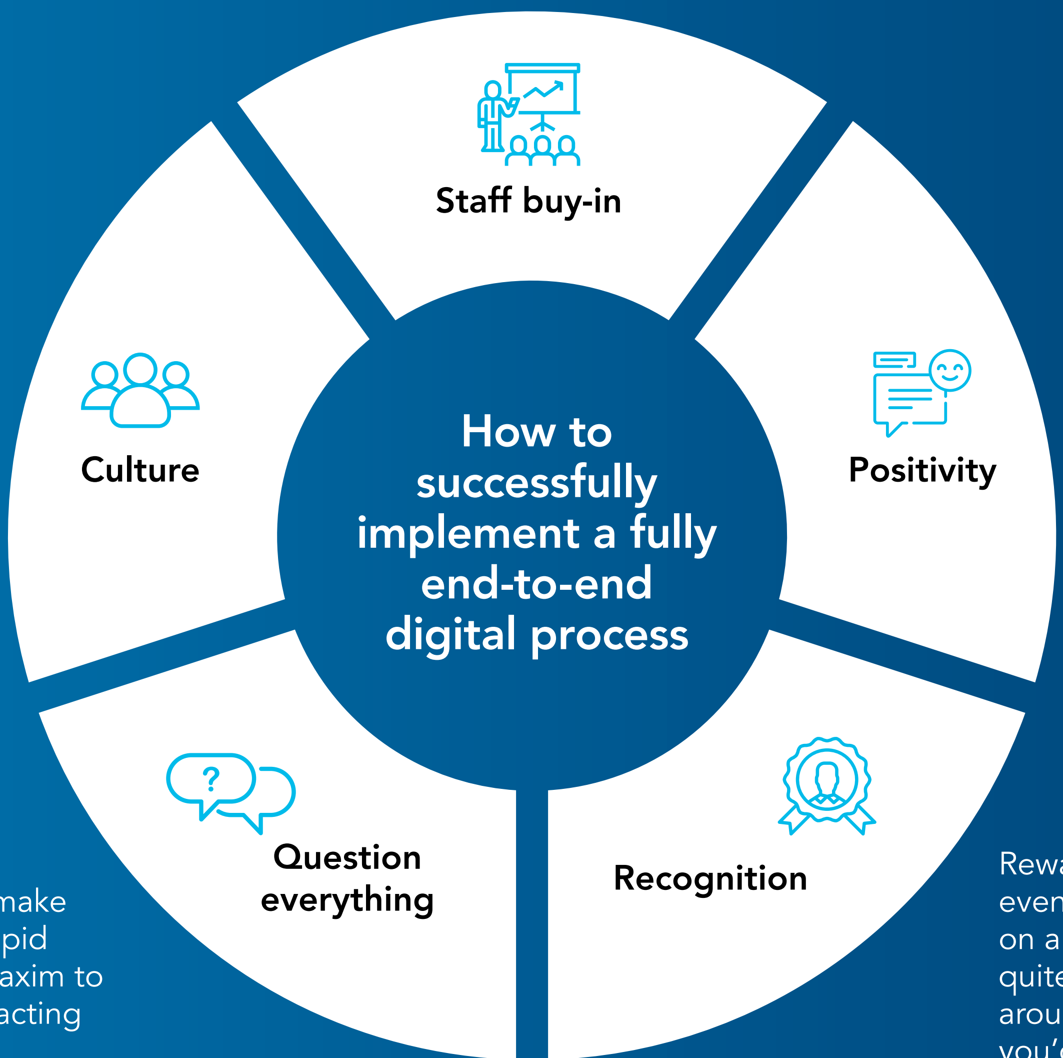
> One of the biggest cultural challenges for financial institutions will be their internal sense that 'procedure is king'. There's a lot of people involved in the lending process who'd say that if their standard of procedure says 'x' then they need to do 'y'. For example, if every application requires a credit manager to sign it off, then there's no way we can automate that. True. If you're operating in the old system, that is. Banks need to remember that small ticket lending is small beer. If you're giving someone $50,000, do you need to refuse automation? Or do you need to change your policy and build the kind of automation that meets your risk appetite?
>
> **– Mukul Mittal**
> VP Industry Solutions, Leasing, Q2

With STP, you can create a system that provides control and manages risk to the degree with which you're comfortable. And technically speaking, the digital 'scrape' that STP undertakes provides more information than you'd get using your old system. Your customer information will be far more detailed and reliable.

The most difficult part of the process lies in understanding that STP isn't something you can tack onto your existing processes to create deal flow. That approach doesn't provide the lift required to increase speed and increase margins. Business processes must be entirely re-engineered. That is the nature of software-as-a-service (SaaS). But if FIs embrace a vision and are flexible, STP will provide everything they need.

All of this must be led from the top - the CEO, CTO, management - the entire lot. Change management requires heavy lifting, and that's most effectively accomplished when it's championed from the top. Leaving change in the hands of the operators can result in replicating the systems they already know. STP must be implemented on a strategic as well as functional level. As always, the human element of the change is the biggest variable in the success of the process.

The message is key. Get your staff excited and invest in training. Remember to always start with leadership—they're best placed to sell the change.



Leverage successful aspects of your current culture to drive the change you want. Don't try and change the culture by changing the technology first.

Change is a discipline, not an end in itself, especially with STP. Since it can always be updated you can always expect to be making changes. Staying positive about change helps it become the status quo.

Don't be afraid to talk about risks that could make the project fail. 'No stupid questions' is a good maxim to live by when you're enacting fundamental change…

Reward your team's efforts, even if they have worked hard on a change project that hasn't quite worked the first-time around or is taking longer than you'd hoped.

> **Straight-through processing is a means of automating the decision and delivery process for small ticket lending and leasing. On a very basic level it means small businesses and consumers get their money faster.**
>
> **– Snehal Fulzele**
> SVP and General Manager, Lending, Q2

Conclusion

The financial sector has been slow to change, especially when it comes to rolling out digital solutions. But the drive to take small ticket borrowing online—to reduce cost, increase deals, and improve customer experience—means that even the most traditional of FIs will need to get on board.

STP delivers further opportunities for lenders. Not only will it help break down siloes throughout institutions by forcing commonality in IT structure, it will open a pool of extremely valuable data. Lenders can use their collective imagination. The data gives them essential context on their customers. Lenders can make meaningful recommendations to customers, sharing useful products and solutions that meet their particular needs.

And lenders can report to investors and regulators with a great deal more confidence, detail, relevance, and speed. STP brings so many benefits.

STP is not without challenges, but it is completely transformative. Without it, FIs will see their market share steadily erode by smaller fintech and challenger banks. In the worst-case scenario, it will be gobbled up by technology natives like Google, Amazon, Facebook, and Apple. The time to choose a strategy is shrinking—events in 2020 have made this obvious. Small businesses and consumers need funding. Will you deliver?

About Q2

Q2 is a financial experience company dedicated to providing digital banking, lending and asset finance solutions to banks, credit unions, alternative finance, and fintech companies in the U.S. and internationally. With comprehensive end-to-end solution sets, Q2 enables its partners to provide cohesive, secure, data-driven experiences to every account holder – from consumer to small business and corporate. Headquartered in Austin, Texas, Q2 has offices throughout the world and is publicly traded on the NYSE under the stock symbol QTWO. To learn more, please visit Q2.com.

Interested in find out more about the tackling high cost lending and how you can solve it? Speak to an expert today.

For more information go to Q2.com