The future of small business lending in Canada

How Canadian institutions are competing today and where they are investing

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EY
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Contents

Introduction

Small business is big in Canada. The important contribution small businesses make to the Canadian economy is well understood. They employ approximately 10.6 million people in Canada, accounting for 62.6% of the labour force in 2022, 43% of exports and approximately a third of Canada's GDP.[1]

Small businesses are also important to Canadian financial institutions (FIs), as FIs have always benefited significantly from the deposits of small businesses. **Small business lending has not been the primary focus for many Canadian financial institutions** relative to other customer segments because the loans have lower net revenue per customer. This is in part due to lending complexity, regulatory compliance and smaller loan sizes. Additionally, with some notable exceptions – such as BDC and Thinking Capital – Canada does not have the volume of small business-specific lenders that have surged in size in other geographies, though the number is growing.

The underserved nature of small business lending was revealed in an OECD study, which disclosed that Canada's small business lending relative to total business lending and GDP is one of the lowest when compared to its OECD peers.[2] Whereas Australia lends 15.45% of its GDP value to small businesses, Canada lends 4.87%.[3] There is a clear link between lending to small businesses and GDP and productivity growth – it gives firms the opportunity to invest and grow.[4]

To better serve their small business customers, Canada's FIs must improve on their abilities to effectively lend to the segment. What we are seeing now is that as small business loan origination processes become increasingly automated and the cost to lend decreases, the small business lending opportunity is growing for FIs, and change is accelerating in this market.

Given the importance to both society and FIs, in this article we investigate small business lending further by surveying a group of eight Canadian FIs diverse in size, geographic location and investment areas, and pulling insights from a recent EY Global survey of small and medium-sized enterprises. To augment this, we also analyzed leading international market players, as we found the international angle insightful to broaden horizons and assess how trends might play out over time.

The insights gleaned from the surveys and FI engagements are summarized in the following four sections:

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Part 1

EY team's insights

01

EY conducted a Global small and medium-sized enterprise (SME) banking survey to gather data on small businesses' financial needs. Respondents cited three priorities and expectations of their FI:

Doing the basics well #1

75% of Canadians

would like their FI to do the basics well before offering any value-added services.

Despite this, Canada still lags in providing SMEs with a fully automated process for new products and services – **only 28% in Canada** vs. 37% globally and 44% in the US – showing they are still on their way to mastering them.

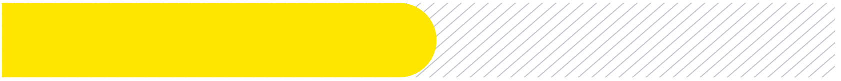
Efficient credit decisioning through auto-adjudication #2

63% of SMEs

did not agree that their FI provided them with fast access to credit when they needed it vs. 52% globally and in the US.

61% of Canadian SMEs stated speed of decisioning and the release of funding as their top two criteria when selecting a source of funding.

Offering "beyond banking" capabilities #3



52% of Canadian SMEs

believe a single integrated platform would help support their business.

57% of Canadian SMEs that believe that "business management functions" – such as legal, advice, risk management, payroll and accounting – offered by financial providers would help support their business.

Small business financial needs are broad.

The top priority for small businesses is for FIs to get the basics right, which includes investing in fast and smooth client onboarding, quick and transparent credit decision-making, and low-cost transactions that are as close to real time as possible.[5]

As a secondary priority, small businesses are seeking a fully integrated platform of "beyond banking" services – including accounting, taxes, e-commerce, HR and payroll. This provides convenience, efficiency and the simplicity of accessing several essential services in one place. Small business owners appreciate being able to log in once, complete any banking activities required and access other services in an integrated, shared platform that saves the small business owner time. There is also increasing focus and investment in auto-adjudication capabilities to enable the quick and efficient decisioning and funding that customers are seeking.

Part 2

Market participants in small business lending

02

These priorities were borne out of discussions with FIs in Canada.

While these priorities are common across the market in aggregate, we found there were three broad types of financial institutions, each with its own priorities, perspectives on the market, missions and mandates, and competitive angles.

Click on each type below for more information:

Big 5 banks

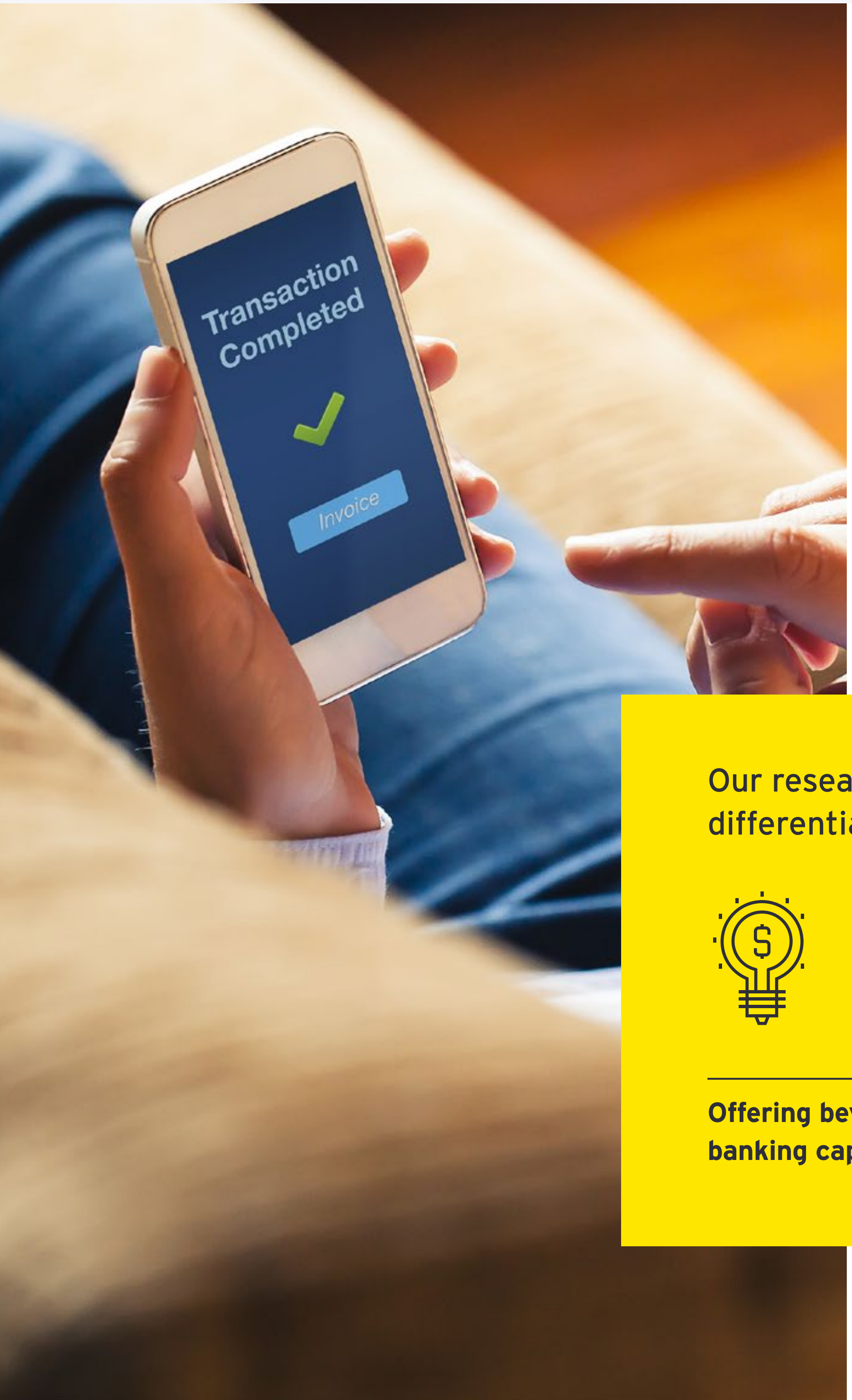
Regional financial institutions and Credit Unions

Fintechs

Part 3

Competitive dynamic in small business lending

03



We have seen how the priorities of SMB clients – getting the basics right, efficient auto-adjudication, beyond banking capabilities – are met by three broad groups of lenders that approach these needs with a different focus.

However, to some degree, all categories of lenders are now striving to meet the basics, and while achieving them is by no means easy, significant progress is being made. This means that the bar for competition is now higher, and that winning strategies are no longer centred on the basics. All lenders are also focused on the customer experience; the ways in which these lenders achieve this customer-centricity depends on the way in which they choose to differentiate in the market.

Our research and survey results found that there are several differentiation strategies in the market today, which include:

- **Offering beyond banking capabilities**
- **Serving a specific customer segment**
- **Offering best-in-class digital experiences**

Across the institution types, there are several distinct and viable pathways for Canadian FIs to succeed in their small business loan origination offerings. These strategies are not mutually exclusive, and financial institutions with the capacity may decide to operate across multiple differentiation pathways. While these strategies do not perfectly correlate with one specific type of institution, broadly speaking, it was found that the big 5 banks were focused on offering beyond banking capabilities, regional banks and credit unions on serving specific customer segments, and FinTechs on offering advanced and best-in-class digital capabilities to their customers.

Offer beyond banking capabilities

FIs can offer a beyond banking approach to stand out from the competition.

This involves developing a single, integrated platform for all small business needs. This approach focuses on holistically serving the customer while providing the best of a wide array of services and filling gaps where needed by customers. In the EY Canadian Small Business Loan Origination Survey, it was revealed that the big 5 banks have widely rolled out and operationalized beyond banking, while smaller institutions and credit unions are either in the proof-of-concept stage or have yet to and have this as a longer-term objective.[8]

Within the beyond banking approach, there is variety in the depth of the partner relationships, with some banks opting to fully integrate the partner into their banking platforms for an embedded experience, and others opting to redirect their customers to a partnered third party. There is, of course, significant complexity, time and investment required to create an embedded integration, and generally the institutions that choose this route have fewer partnerships due to the effort to integrate each partner.

The pricing models vary too, with some institutions bundling the fees in a subscription model (e.g., DBS), and others offering discounts for their partners' offerings and making the customer responsible for payment at each partner (e.g., RBC). Irrespective of the beyond banking model, and propelled by the expected introduction of open banking in the Canadian market, FIs benefit by accessing new sets of data and corresponding insights, creating cross-sell opportunities and providing a superior customer experience.[14]

All eight of the Canadian financial institutions we surveyed stated that sharing small business clients' data with trusted partners was a longer-term objective, or that they were only in the proof-of-concept stage.[8] As the Canadian Government continues to take steps towards establishing Canada's open banking system, small businesses can expect its introduction to assist them in streamlining operations and giving them faster access to credit.[15]

Global Case Study: DBS Bank

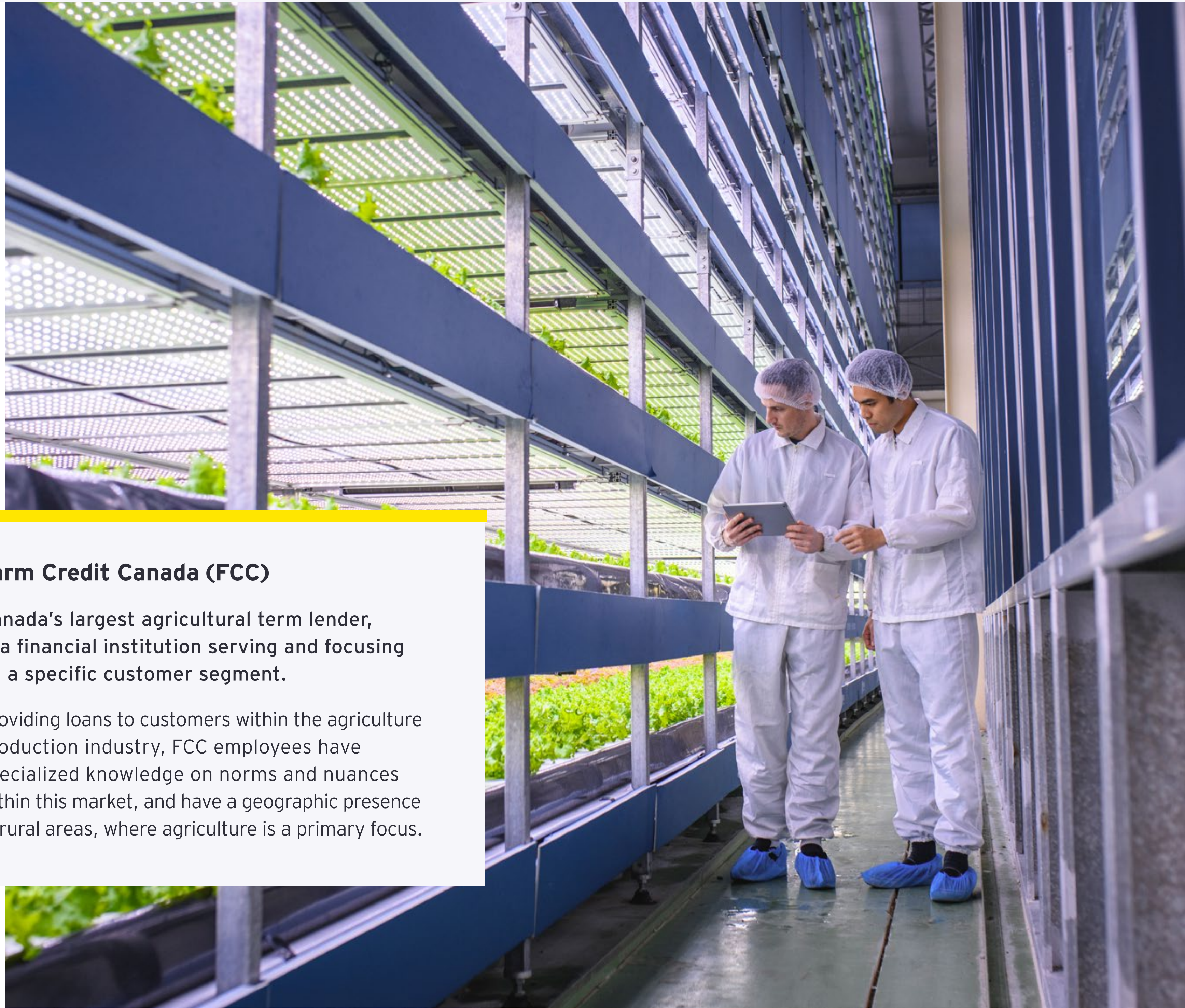
A leading global example of a full-ervice, digital forward small business offering is DBS bank based in Singapore.

DBS Start Digital Programme, is a beyond banking platform where small business customers have access to services that span HR, e-commerce, cybersecurity, accounting and more. A noteworthy offering is DBS Quick Finance, which allows the bank to proactively reach out to identified customers to extend working capital and cashflow support, enabling customers with access to financing of up to SGD300,000 (approximately CDN$300,000) through a one-minute application, one-second adjudication and instant disbursement.[16] The bank's focus on small businesses in Singapore is paying off: revenue from DBS's small business bank now accounts for 28% of all DBS revenue.[17] The different elements of the bank's digital transformation have allowed the bank to provide its customers with a more seamless and customized experience,[18] which is expected to increase satisfaction levels of existing clients over the long term, and to attract new clients.[19]

Focus on specific customer segments

Another approach to differentiation is to serve a specific customer segment, whether it be a specific industry or geographical region.

We have traditionally seen credit unions and regional players employ this approach, but are now also seeing larger national banks begin to invest more heavily in specific segments, such as agriculture. In doing so, these financial institutions must seek to develop a deep understanding of their chosen customer segment and develop products and services that cater to their unique needs and wants. Institutions that have chosen this approach also tend to invest in relationship managers with deep expertise in the target customer segment.



Farm Credit Canada (FCC)

Canada's largest agricultural term lender, is a financial institution serving and focusing on a specific customer segment.

Providing loans to customers within the agriculture production industry, FCC employees have specialized knowledge on norms and nuances within this market, and have a geographic presence in rural areas, where agriculture is a primary focus.

Offer best-in-class digital experiences

FinTechs differentiate themselves in the market with advanced digital capabilities.

While FinTechs don't typically provide a full one-stop-shop banking offering, they offer a customer experience that is so seamless, fast, transparent and fully digital that customers sign up despite having a primary banking relationship elsewhere.

FinTechs found significant success in the payments space, where they started to compete with FIs. However, since that time, FinTech offerings have developed far beyond payments. In fact, large FIs are increasingly developing partnerships with FinTechs, an indication of the potential and modularity of the offerings.

Three out of four Canadians intend to keep up the increasingly digital banking habits they developed during the pandemic. With this increase in comfort in digital banking, financial institutions have begun incorporating FinTech solutions as part of their service offerings to their customers who were now more digitally savvy and open to being served without a physical institutional presence.[20]

Part 4

Where financial institutions are investing

04

Traditionally, investment has been a challenge for small business banks because of the size of the portfolio relative to the size of the retail bank.

Irrespective of this, banks are increasingly investing in continuing to get the basics right, as well as to support the differentiation strategies. The emerging priority areas for investment around small business lending are linked to the type of financial institution.

There are three primary change areas around small business lending:

- **Auto-adjudication**
- **Investment areas** (through loan origination systems)
- **Personalization**

Broadly speaking, the big 5 banks are focused, to some degree, on all three of the listed investment areas. Regional players and credit unions typically need to choose between investment areas and often first look at auto-adjudication to further their digitization journey and improve cycle times. Fintechs, which also need to choose between investment areas, vary in focus but many look to integrate data and personalize experiences for their customers.

Auto-adjudication

While financial institutions are at varying places in their auto adjudication modernization journey, all surveyed institutions are actively investing in and seeking to expand their auto-adjudication limits, since their SME customers want them to prioritize the speed of decisioning and quick release of funding.

Business benefits: it contributes to a reduced turnaround time, reduced adjudicator labour hours focused on small business credit, and improved customer experience. On average, larger institutions are further along their credit risk modelling journey; to enable auto-adjudication, they have completed assessments of their business rules.

One big 5 Canadian bank leapfrogged all the others in its auto-adjudication limit by carefully reviewing its auto-adjudication process as a whole, including assessing the business rules to determine which ones were truly required. This was completed as a collaboration between risk and the business and balanced risk management with the customer experience. This overall process took more time, which meant this institution was not the first to market with an auto-adjudication offering. In the end, however, this institution was able to auto-adjudicate at a higher threshold than its competitors.

The next frontier is tapping into the wealth of data available to FIs, internal and external to the institution, to enhance risk assessment.

DBS Bank

DBS, a digital- forward bank based in Singapore, introduced above, has integrated external data into its operations.

Xero, a leading global cloud accounting platform for small businesses, is one of the partner institutions on DBS's beyond banking platform. More recently, DBS deepened this partnership by establishing Xero as an external data source. Xero customers can now opt into securely sharing their transaction data with DBS. This enables DBS to offer tailored banking solutions, including credit terms and working capital limits, and more accurately and easily assessing customers' creditworthiness.[21]

Loan origination journeys

(through loan origination systems)

Many Canadian FIs are challenged by legacy technology loan origination system platforms. There are clear and significant benefits to upgrading to a modern platform.

First, systems need to meet the experience expectations of clients who have been influenced by interactions with competitors either within banking or leading digital interfaces outside banking (e.g., e-commerce, travel and hospitality. The transparency of information and richness of functionality to submit and adjust requests set the bar high. Client expectations have risen such that clients expect an intuitive, efficient process with self-serve tools provided by a modern platform.

Second, loan servicing and collateral management has typically been manual and frustrating, manifesting in delays retrieving information, manual calculations, limited templates, and paper trails. Modern loan origination platforms can also make loan servicing and collateral management easier by providing, or integrating with, features including automated workflow and intelligent capture (e.g., OCR optical character recognition).

Third, loan origination system modernization helps decrease both cost and operational risk, with an overall workflow, embedded tasks and automation, controls, role access and authority levels all set in the system, resulting in fewer errors.

While the benefits of a modern loan origination system are clear, a full analysis also needs to take a step back to acknowledge that, driven by advances in technology, the capabilities and platforms available to an FI are always evolving.

To futureproof any investment in loan origination systems, technology strategies are incorporating two factors. The first is the availability of cloud software, so the actual chosen provider's tools can evolve. Loan origination systems can now deal with multiple workflows, have multiple modern integration patterns available, aren't hard to configure, don't require extensive customization on the majority of installations, and aren't tied to expensive and resource-heavy upgrade cycles.

Prior to the introduction of modern loan origination platforms, many organizations were left with significant technical debt, perhaps with multiple instances of the same software, or separate systems for different segments (e.g., small business vs. real estate.

In addition to moving to cloud platforms that continue to evolve over time with new capabilities, today the mindset at financial institutions has shifted somewhat towards a modular architecture approach. A lending origination system is central to the lending technology ecosystem, but we often see this being treated as a technology of centre of gravity, rather than needing to do everything itself.

A loan origination system doesn't need to do everything, but the combination of systems covering related capabilities within CRM or digital marketing or analytics does need to integrate easily with it. Vendors have progressed all platforms and tools to the extent that these are more easily configured and use modern integration patterns. We are moving to a more "plug and play" lending ecosystem where new vendors and best-in-class capabilities can be switched in to the technology ecosystem without significant investment in integration or rework.

These systems have rules engines in isolation of one another, meaning that changes can be made more easily without significant disruption. As well, there is less reliance on coding and development to set up and maintain these systems, which enables IT teams to focus on activities that help differentiate the FI in the market and reduces their reliance on vendors. With technology and systems evolving so rapidly, leading to a host of significant benefits for FIs, the loan origination system modernization journey is undoubtably compelling.

Personalization

Personalization is an emerging investment area for Canadian FIs. EY's Global SME Banking Survey showed that Canadian small businesses were more interested (74%) in sharing their business data with their primary FI in exchange for richer insights about their business and tailored, more personalized services than their global peers (72%), but less than their US peers (84%).[13] These personalized services are so enticing to Canadian SMEs that the survey revealed they have a high willingness to pay for tailored advice based on their business data (40%), yet this is still less than their global and US peers (50% and 52%, respectively).[13]

One way to provide personalization is to offer services based on where small businesses are in their lifecycle, from conception, growth and maturity to decline and exit. Another tactic is to tap into small business customer behaviours to predict customer needs. Many FIs are doing this, but in one example of an institution using internal customer data to provide value, if a customer is searching for a loan with this market institution, the bank uses this information to develop a tailored understanding of the customer's business and displays relevant products and services through its apps and online portals to help the customer find a product that best meets their needs.

Small businesses are even willing to pay for services based on their business data.[13] With the onset of open banking, there is increasing opportunity to use external data sources to support personalization.

Malaysian bank UOB

In August 2022, the Malaysian bank UOB launched the UOB SME app, an all-in-one digital banking platform, to meet the needs and requirements of small and medium-sized enterprises.[22]

With the application being built off customer insights, users are not only able to view their cashflow data within an interactive dashboard and apply for loans, but the platform uses this data to generate curated solutions such as loan financing options and suggestions on how they can improve their performance and make better decisions based on their banking patterns.[23] Customers can also use the platform to set personalized foreign currency watchlists, access customized insights and find events relevant to their industry.[24]

Conclusion

Small business growth is important to Canada's future, and this growth needs to be enabled by FIs lending which, due to new technological capabilities, is becoming an increasingly exciting space.

Based on the insights from surveying a group of eight Canadian FIs and the Global SME survey, we have examined the three types of FIs in the small business lending space: the big 5 banks, regional financial institutions and credit unions, and FinTechs. Each type of FI is looking to differentiate itself in the market in a different way, such as offering beyond banking capabilities, serving a specific customer segment, and offering best-in-class digital experiences.

We have reflected on the fact that over the last few years, some of the "basics" of small business lending have been largely addressed and/or organizations are already on their journeys towards mastering them. The type of FI also determines what areas they are investing in, which include auto-adjudication, loan origination journeys through loan origination systems, and personalization.

While we do not intend to predict the future, we have seen how leading international players can bring together capabilities to offer a more compelling offering, and the increasing of prioritization in the investment areas mentioned can only improve options and the experience for small businesses when investigating and choosing funding for their business needs.

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