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BOLSTERING BUSINESS BANKING AT YOUR CREDIT UNION

Defining market segments
Product design
Market sizing
Back-office support needs

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INTRODUCTION

- With many large banks reducing service offerings to smaller businesses and many community banks lost to merger, credit unions nationwide are striving to fill the void created by those events by augmenting business-banking products and sales efforts.
- Many credit unions claim to offer business banking services already, but an examination of their portfolios reveals an array of "pseudo-business" members: hobbyists, freelancers and gig-workers seeking a means to separate their personal and side-gig finances.
- Yet those pseudo-businesses are not the segment suffering from reduced banking options; nor does that segment offer the greater revenue potential that true "going-concern" businesses can provide.
- Accordingly, this session will present a strategic rationale for bolstering business banking efforts at your credit union; and a "how-to" guide including the key tenets of defining market segments, product design, market sizing, back-office support needs; and ultimately reaching a go / no-go decision for business banking offerings.

NOT AN INITIATIVE, BUT AN IMPERATIVE

- Business banking historically remained the province of larger regional and national banks, which offered community-based lenders and local decision authority.
- Most larger banks centralized credit decisions years ago, leaving local officers exclusively in a servicing mode.
- In recent years, larger banks have migrated the servicing function for small businesses, especially those with annual sales, into automated channels, removing the dedicated business-officer relationships that small-business owners need.
- This has left small businesses an underserved community in many markets, and worthy of the same consideration that credit unions have offered to overlooked segments of the consumer sector for generations.

AND ANOTHER REASON WHY YOU SHOULD LISTEN TO THIS SESSION!

At most financial institutions, credit unions and banks alike, the median revenue contribution of a "going-concern" small-business relationship is <u>SIX to TEN times</u> greater than the median revenue contribution of a consumer relationship.

DEFINING BUSINESS BANKING

- Per IRS tax returns, there are more than 25 million businesses in the U.S.
- But eliminating sole proprietorships with no employees reduces that total to about 6.5 million businesses; i.e., full-time firms with an address and employees, what most people would define as ‘a business.’
- This distinction, between “going concern” businesses and those sole proprietor “side gig” enterprises, should inform the architecture of a credit union’s business-banking offerings, with the former group requiring a distinct set of products and services.

THE RATIONALITY OF LARGE BANKS

- Even excluding the largest tier of institutions (i.e., the corporate-banking sector, defined by annual sales of greater than $50M), business-banking balances are still highly skewed, as shown in the nationwide distribution below.
- This dictates the focus of the large banks, but leaves more than two-thirds of going-concern businesses nationwide facing an inferior service proposition.

Tier	Annual sales	% Firms	% Deposits	% Loans
Micro	< $1M	68%	18%	26%
Small	$1M - $10M	28%	43%	40%
Middle market	$10M - $50M	4%	38%	34%

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DEFINING BUSINESS BANKING

- Businesses can be stratified in terms of industry type, sales volume, and employment count.
- There are two primary business classification systems used in the U.S., Standard Industry Classification (SIC) and the newer North American Industry Classification System (NAICS).
- Each divides the business universe into a greater number of segments than could be effectively used for targeting; thus, credit unions should consider framing their target market segments into aggregated categories.

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A POSSIBLE FRAMEWORK

- Professional services, including healthcare, legal, accounting, architecture, engineering, and most business-to-business services
- Personal services, e.g., dry cleaners, salons, auto repair, educational services; and also including hotels and movie theaters
- Retail trade, including restaurants, groceries, and auto dealers
- Manufacturing, including other industrial sectors such as wholesale trade, mining, transportation, utilities, and construction
- Agriculture, including farming, fishing, forestry, and veterinary services

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A POSSIBLE FRAMEWORK

- **Micro-tier**
  Annual sales < $1M
  Branch-based delivery
  - Part-time / side-gig sole proprietorships
  - Startups and other micro firms
  - Small nonprofit organizations
- **Small business**
  Sales $1M - $10M
  Business bankers service branch clusters
  - Vertical specializations, for example:
    - Professional services
    - Real estate
    - Larger nonprofit organizations and agencies
    - Other
- **Middle market**
  Sales $10M - $50M
  Serviced by centralized commercial banking group
  - Would utilize analysis product, not a standard checking product; beyond the target segments of most credit unions

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A POSSIBLE FRAMEWORK

<table>
<tr><th>Annual sales</th><th>Professional services</th><th>Personal services</th><th>Retail trade</th><th>Manufacturing</th><th>Agriculture</th></tr>
<tr><td>< $1M</td><td colspan="3" rowspan="2">Initial targets</td><td rowspan="2"></td><td rowspan="3"></td></tr>
<tr><td>$1M - $2.5M</td></tr>
<tr><td>$2.5M - $10M</td><td colspan="4">Possible long-term extension</td></tr>
<tr><td>$10M - $20M</td><td colspan="5" rowspan="3">Better suited for large banks and/or specialized providers</td></tr>
<tr><td>$20M - $50M</td></tr>
<tr><td>$50M+</td></tr>
</table>

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A TYPICAL CREDIT UNION BUSINESS PORTFOLIO

- Thousands of obligatory share accounts, 75% of which carry balances of less than $100 and remain essentially dormant.
- A single checking account product type
- Median balances in the business checking product of $400 - $600
- Around half of all accounts averaging less than one transaction of any kind (deposit, check written, electronic debit or credit…) per month, so functionally dormant or near so
- No credit side relationship with deposit accounts
- For business loans, no cross-sell of checking services
- Business loans in CRE only, with no C&I component

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KEY DECISION POINTS

- Is the credit union's focus on all of these product areas or only a subset?
  - Commercial deposits
  - Commercial real estate (CRE) lending
  - Commercial and industrial (C&I) lending, for operations and equipment
- Historically, most credit unions have focused on CRE over C&I, and with limited deposit emphasis beyond basic accounts.
- However, it is typically less challenging to cross-sell deposit services to C&I clients, which will maintain a more regular ongoing relationship with loan officers than CRE clients.
- Thus, it may be necessary for credit unions to add *lending* capabilities, including C&I capacity, to fully realize the business *deposit* potential within their markets.

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GUIDING PRINCIPLES

- Align products with segment needs
- Pricing philosophy
- Tolerance for dilutive accounts
- Functionality versus ease; breadth versus simplicity
- Accounts versus relationships, and the objective of fostering cross-sell

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DEPOSIT PRODUCT DESIGN

- The competitive audit
- Credit unions and banks
- Key parameters
  - Minimum to open
  - Monthly service charge
  - Minimum balance to waive service charge
  - Item limits, cash limits, and overage fees
  - Ancillary fees
  - Relationship pricing criteria

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DEPOSIT PRODUCT DESIGN

- The basic architecture of a business checking account:
- Monthly fee of $xx; waives with a minimum balance of $xxx
- This provides xx free items per month (deposits and withdrawals); excess items $xx per
- This provides $xx in cash deposits each month; excess amounts $xx per $100
- For example: monthly service charge of $12, waives with a minimum balance of $1,500; includes 300 free items per month, $0.40 per thereafter; and $5,000 in cash deposits per month, $0.35 per month thereafter

DEPOSIT PRODUCT DESIGN

- Six primary models:
  - Totally free offerings, with no minimum balance, no monthly fee, but minimal item allowances; for part-time / side-gig businesses
  - Low item-count offerings, with modest balance levels required to waive a monthly service fee, and with only moderate item allowances; for startup and micro-tier firms
  - High item-count offerings, with significant item-count allowances in exchange for a commitment to greater balance levels, or fees in lieu of balances; for small businesses with larger and more complex operations
  - Interest-bearing offerings, targeted toward proprietorships
  - Accounts for nonprofit organizations
  - Analysis accounts, for larger businesses

DEPOSIT PRODUCT DESIGN

- The totally free option can remain a legitimate part of a credit union's portfolio, but should be used judiciously
- Minimal item allowances
- No amenities or ancillary options
- Consider restricting to personal members only
- Goal is to minimize the dilution from inherently unprofitable accounts

ANCILLARY SERVICES

- There are many additional optional services credit unions can attach to business checking products, in addition to the primary noninterest revenue source of the debit card:

Informational	Basic paying and receiving	Advanced paying and receiving
Dashboards	Online bill pay	Real-time payments
Combined statements	Remote deposit capture	ACH origination
QuickBooks download	Wire transfer	Lockbox
		Cash collection / vault services
Cash optimization	**Fraud prevention**	**Card services**
Sweep accounts	Positive pay	Corporate card
Overdraft from savings	ACH positive pay	Purchase card
From line of credit		Merchant processing
Deposit consolidation / overnight funds / ZBA		
For deposit insurance		

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NSF / OVERDRAFT CONSIDERATIONS

- Many of the largest banks followed the lead of Capital One in late 2021 in greatly reducing or eliminating nonsufficient funds and overdraft fees, placing pressure on institutions throughout the industry to follow.
- Minimal NSF / OD fees can be a core tenet of a credit union's consumer-friendly pricing model, providing tolerance for the accidental marginal error.
- However, a business is unlikely to overdraw accidentally. Rather, a check written against insufficient balances likely represents a conscious effort to secure the short-term loan an overdraft represents; and this service carries a value that credit unions should strive to capture.

A KEY SEGMENT: NONPROFITS

- An alliance of shared values – we're nonprofits too, with the same goals of elevating our communities!
- As with traditional business accounts, it is essential to parse going-concern nonprofits from small, part-time associations.
- When designing account features and parameters, keep in mind the distinct seasonal activity levels of many nonprofit organizations.
- Use as an entrée to the centers of influence who typically serve on nonprofit boards of directors, as a means toward pursuit of their personal relationships.
- Consider preferred pricing for nonprofits with personal-member sponsor board members.

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BUNDLED PRODUCTS VERSUS CROSS-SELLING

- Ancillary services can be viewed as cross-sell items that business members can layer onto their primary checking account. A bundle-based approach can frame the most frequently sold items in the context of logical add-ons to help member service representatives in the sales process, for example:
  - Retail / service: merchant services; payroll services
  - Utility / property association: lockbox and cash management
  - Professional services (e.g., legal, accounting, healthcare): remote capture; debit/credit card; this offering could also house the partner consumer accounts defined in the SEG-type workplace-banking programs
  - Construction: asset based; leasing; ACH payments

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BUNDLED PRODUCTS VERSUS CROSS-SELLING

- Of course, members would be welcome to purchase whatever products they needed on an à la carte basis.

- However, the predefinition of logical cross-sell groupings for various business types can help sales staff uncover needs during initial interviews and give prospective business members the perception of benefit from one-stop shopping.

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INTEGRATING CONSUMER RELATIONSHIPS

- Two primary channels for converting business relationships into consumer relationships:

  - Traditional cross-sell, to the owners and partners of the member businesses

  - Group banking programs, presented as bundled, discounted offerings available to the employees of member firms, in a return to the industry's SEG-driven roots

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A POSSIBLE ORGANIZATIONAL FRAMEWORK

- Branch managers directly address firms with annual sales < \$1M, as needs in this segment are less complex, and potential members are likely to be firms based in close proximity to the branch, in areas where branch managers are (or should be) community leaders.
- Circuit-rider business bankers address larger firms from a team context.
- Each team includes a business banker, a cash management / treasury services specialist, and a loan assistant / sales support MSR.
- Each team addresses a cluster of branches in relative close geographic proximity (likely around 6 - 8 branches per team).
- The business banker leads all loan discussions, and enlists the relevant branch manager as needed for deposit discussions.

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A POSSIBLE ORGANIZATIONAL FRAMEWORK

- Decision point: do the business banking teams report to their local market executive; do they all report to some central business banking function at headquarters; or is there a matrix-management model?
- For credit unions just launching full business banking, the teams should report to a centralized business banking executive, overseeing all activities in that segment, as this will concentrate authority in a tenured officer with the specialized knowledge required to succeed in the segment.
- That noted, the structure should also maintain "dotted line" accountability of the business banking teams to their respective market-level leaders, to ensure coordination with local sales and marketing efforts, and with local branch staff as needed to deliver the most efficient service experience to the member businesses.

PREREQUISITES

- Confirmation of systems capabilities: if we design a new business checking product, can current processing systems support that design?
- For example, can our systems tally and charge for excess cash handling; and assess other fees beyond basic service charges? Can we implement relationship-based fee waivers?
- What capabilities will our credit union need to add in terms of credit analysis, collections / workout, training, sales support, dedicated business call center agents, and executive oversight, among others; and what are the costs of these, one-time and recurrent?

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BARRIERS TO SUCCESS

- No/limited preexisting brand presence as a business banking provider
- Perceptual hurdles as a credit union versus commercial bank
- Ability to find qualified officers and cost of hiring
- Member acceptance, and whether consumer members would consider the expansion a sign of growth, or a distraction that could potentially dilute their dividends
- Fully loaded costs could expand well beyond staffing, if systems upgrades are required for the launch of advanced product and treasury services
- Any new line-of-business initiative requires internal resources and executive attention, and could crowd out focus from other worthy initiatives at the organization

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MARKET SIZING

- Recall our example segmentation framework:

Annual sales	Professional services	Personal services	Retail trade	Manufacturing	Agriculture
< $1M	Initial targets				
$1M - $2.5M					
$2.5M - $10M	Possible long-term extension				
$10M - $20M	Better suited for large banks and/or specialized providers				
$20M - $50M					
$50M+					

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MARKET SIZING

- Quantifying balance expectations within those target market segments:
  - Define trade areas around our branches
  - Business trade areas in the Micro sales-tier tend to mirror consumer trade areas, but trade areas grow larger in the Small-Business tier
  - For each product type:
    - Average balance for firms in the segment
    - Multiplied by number of businesses
  - Divided by a factor of the number of competing branches; i.e., a ‘fair share’ expectation

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BUILDING THE BUSINESS CASE

- Fair-share balance expectations x spread
- Include factors for estimated fees / noninterest revenue
- Ongoing salaries of business bankers, cash management specialists, loan assistants, and other member-facing employees
- Ongoing salaries of permanent back-office additions, e.g., credit analysts and collections staff
- One-time costs for systems upgrades, recruitment, marketing, training, etc.

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LAUNCH!

- The addition of augmented business banking services can bring multiple benefits to a credit union, including diversification of revenue sources, the ability to accrue balances in greater increments compared to consumer members, and likely a lower cost of funds than the consumer portfolio offers.

- However, business owners often seek holistic relationships, where a credit product drives the selection of the deposit provider; and accordingly, your credit union will need to consider its abilities to offer CRE and C&I lending if it wishes to maximize its gains in business deposits.

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LAUNCH!

- Further, it is imperative to confirm that your credit union holds the operational and systems capabilities to add augmented business-deposit and treasury-management services; and any efforts toward implementation must include early consultation with your credit union's information technology department.

- Finally, as your credit union strives to augment business banking offerings, understand that there is no substitute for experienced leadership. Thus, if you do not already hold such capabilities within the current management group, seek an experienced business banking executive, skilled in both the sales and operational sides of the discipline, whether from the bank or credit union side of the industry, to lead the business banking effort.

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LAUNCH!

- Good luck in those efforts!
- Any questions?

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QUESTIONS, COMMENTS OR MORE INFORMATION?

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