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Banks' small business imperative

New strategies for offering digital services for SMEs

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Executive summary

When it comes to the development of digital services, banks in Western Europe have neglected the needs of small and medium-sized enterprises (SMEs). Banks have successfully delivered a steady stream of new digital services to their vast retail bases. But they haven't done the same for their SME clients. And it won't be long before market pressures will compel banks to do so.

The competition for SMEs' business is coming in part from technology companies, whose innovations in the areas of financing or enhanced self-service are giving SMEs new options. Although SMEs' use of these services has been piecemeal rather than broad-based, the adoption curve is sloping up rapidly. And there is every reason to believe it will become steeper.

To keep the new competition — and faster-moving banks — from attacking this part of their customer base, banks are going to have to vastly improve the digital services they offer SMEs. This will mean developing higher levels of personalization, enhanced opportunities for SMEs to access financing online, and more cost-efficient ways for SMEs to manage their foreign exchange transactions. The banks also need to develop true multichannel offerings, so that SME customers can access the same services on a smartphone, tablet, or PC that they can get by walking into a branch office. This will require banks to make investments in the parts of their business that cater to SME customers. The good news is that banks will get substantial benefits from transforming the digital experience for their SME clients — including efficiencies that lead to lower costs and increases in customer satisfaction and loyalty.

Time for banks to up their game

Over the past decade, financial-services firms have aggressively embraced the Internet. But a crucial sector of the banking market has generally been neglected: small and medium-sized enterprises (SMEs). Their needs are often too complex to be met by retail bank services. And they don't offer banks the revenue potential of larger corporations. As a result, SMEs often suffer from a lack of attention, and they have not yet reaped the benefits of digital technology. Banks have developed some digital services focused on SMEs. But the effort has been inconsistent and the results have been uninspiring, especially in many countries in Western Europe.

Small and medium-sized enterprises are turning to nonbanks to make payments, access loans, and manage transactions.

The lack of attention to SMEs' needs has left this segment of the banking market vulnerable to asymmetrical competitors. SMEs are turning to nonbanks to make and facilitate payments, access loans, and manage foreign exchange transactions. So far, the adoption of these alternative services — including crowdfunding and peer-to-peer financing platforms — has been incremental rather than broad-based. As a result, it hasn't made a big difference in banks' bottom lines. But there is certainly a risk that a portion of banks' business will start slipping away. And as these alternative services gain traction and become more robust in the next couple of years, SMEs will have even greater incentives to start using them.

If banks are to fend off the competition — not only from new financial technology companies but also from other banks that have moved into the digital era more decisively — they need to start making a concerted effort to meet SMEs' needs. Beyond benefitting the SMEs, the push that banks make in this area should also help banks handle more transactions in an automated fashion, allowing them to lower their operating costs.

Rising expectations for digital service

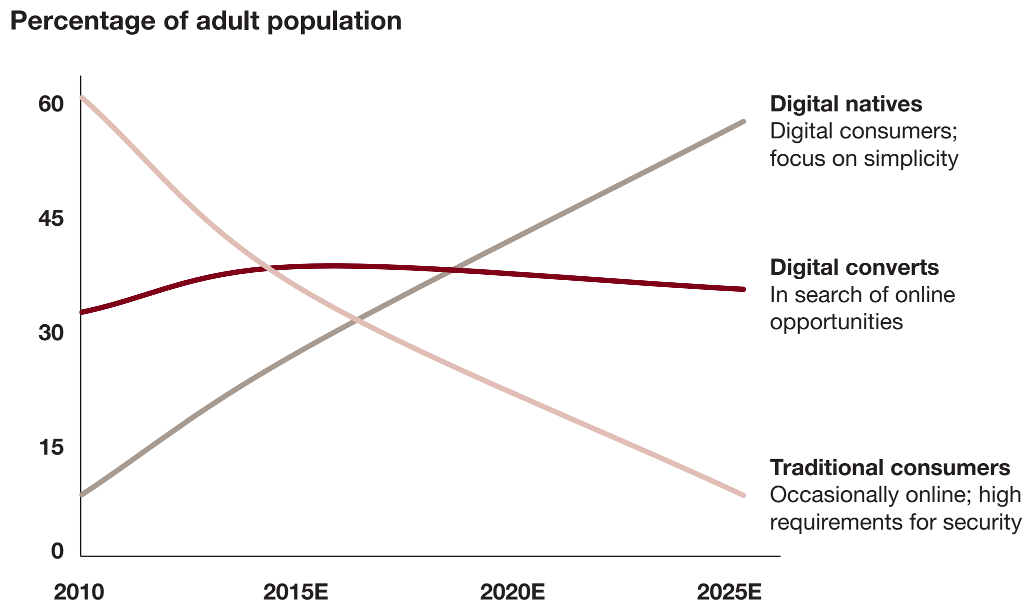
In countries where Internet access is ubiquitous, more and more people are looking to access services digitally instead of through "traditional" means. A recent PwC survey of consumers in the U.K. suggested that only about a third of them are now "traditional" — meaning they prefer offline channels — compared with the 60 percent who were traditional in 2010. The survey forecasts that by 2025 only about 10 percent of consumers will fall into the traditional category, and about 60 percent will be "digital natives" — i.e., people who grew up with the Internet (*see Exhibit 1, next page*). (The remainder — some 30 percent — will be what the survey calls "digital converts," a cohort that may have grown up with traditional services but that now prefers to transact business through a mobile or online channel.) There is every reason to believe that in developed markets, banks' SME clients will have very similar preferences.

The gap between actual and preferred online banking services was biggest in credit and financing.

In fact, a significant gap between clients' desires and expectations, on the one hand, and banks' offerings, on the other, has already opened. As of a few years ago, in a survey conducted by Strategy&, SMEs said that they would prefer to do most of their banking through online and mobile platforms. For instance, at the time, SMEs were already accepting payments electronically in about two-thirds of cases — but said they would like the share of electronic payments to be even higher. The gap between actual and preferred online banking services was biggest in the area of credit and financing. More than 30 percent of SMEs reported they would like to be able to apply for and get loans online, rather than making a trip to a bank branch. But only about 10 percent of SMEs said they were able to do so.

Advice on risk management is another area in which SMEs hunger for more online service. More than half of companies surveyed indicated they would prefer to have access to relevant risk-management-related online and mobile offerings. But only 33 percent reported they currently had such access (*see Exhibit 2, page 8*).

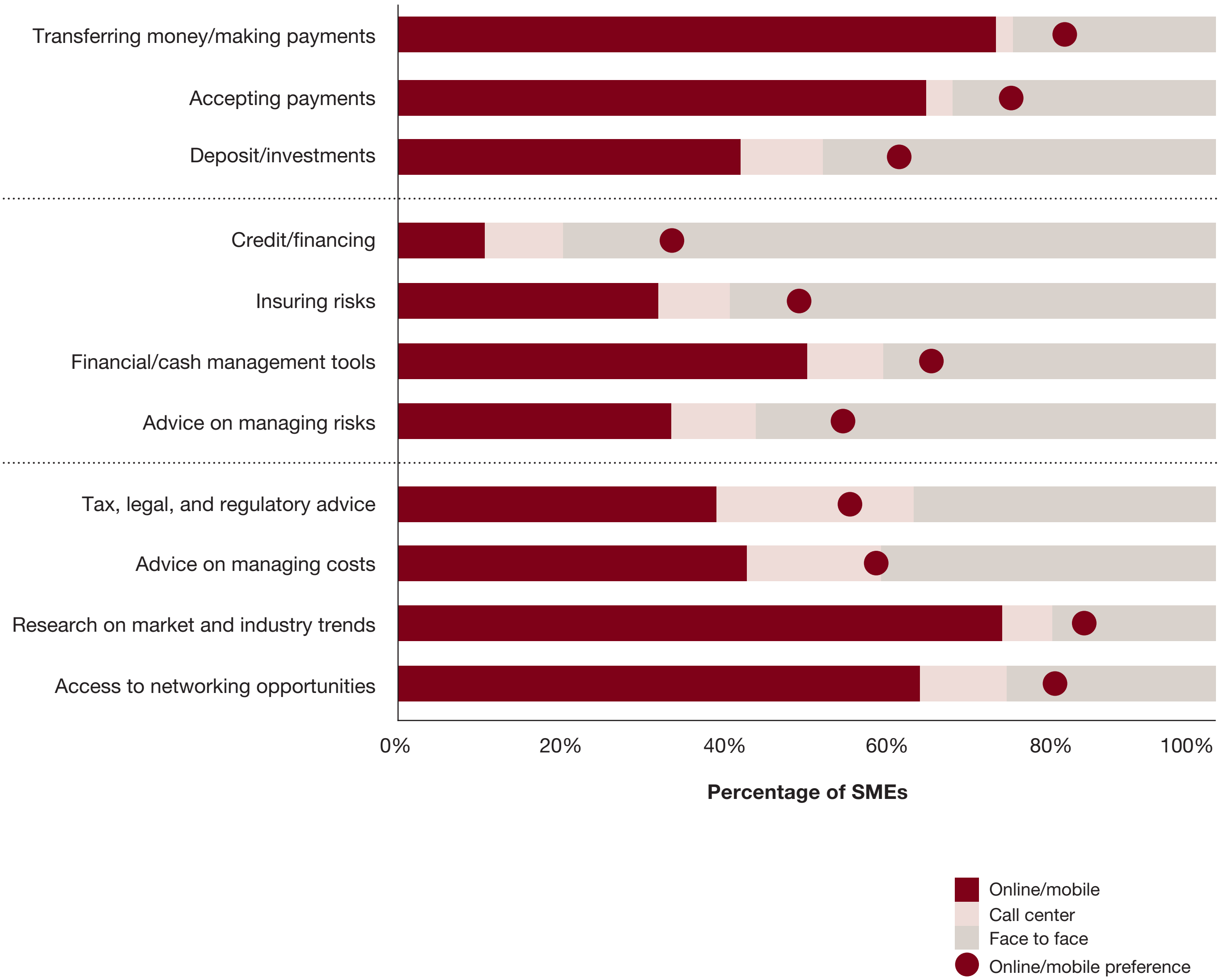
Exhibit 1
Digital natives on the rise



Source: PwC, "Profitable growth in the digital age" (2013); amended by Strategy&

Exhibit 2

Currently used channel for accessing various services (bars) vs. preference for online/mobile access (circles)



Source: Strategy& primary market research and analysis (2012)

Indeed, the more digitally inclined SMEs believe online and mobile services can replace traditional channels altogether. Of SMEs who said their main access preference was multichannel or online, the majority expect that digital channels can fully substitute for traditional channels.

The example of consumer technology. Executives and owners of SMEs are tracking the many developments in consumer technology — in particular, the conveniences brought about by Web-based services and mobile apps — and wondering why such features aren't available in their interactions with banks. Multichannel integration has become the expectation in online retail. A consumer buying, say, a shirt on his home PC knows that he can probably buy the same item for the same price on his mobile phone or iPad. But banks aren't nearly as far along when it comes to offering universal access to the services SMEs want to use. Banks' SME-directed applications are much more likely to exist in isolation than to be part of a mature, integrated system.

Multichannel integration has become the expectation in online retail, but banks aren't nearly as far along.

Besides expecting to be able to handle basic transactions in whichever channel they prefer, SMEs are starting to expect their bank experience to resemble their consumer experience in other ways. For instance, they want to be able to start a transaction in one channel and complete it in another — with maximum convenience and minimal confusion. And it probably won't be long before SMEs are looking to provide feedback through an online mechanism or to communicate with other SMEs in bank-sponsored online forums. (Fidor Bank, an online direct bank in Munich, already hosts online forums in which its users can talk to one another.) Greater personalization is another new service that makes sense for banks to provide to SMEs. This personalization might take the form of a targeted offer based on the business the SME is in, or might involve some sort of customizable interface for accessing bank services.

One way for banks to determine where they are in their SME product development cycle is to take inventory of all the services they offer to retail clients, and see how many of these services are also available to SMEs. Already, many banks are giving individual customers online options for personal financial management. These retail clients can see at a glance what their spending trends and debt balances are, and can categorize transactions with the push of a key. In a particularly popular option being offered more by financial technology companies than by banks, retail customers can access aggregate account data. They can see not just what assets they hold at one financial institution but also what they have across all the institutions with which they have relationships.

There is no reason banks can't offer many of these same services to SMEs. To date, however, very few banks have done so, and the number and quantity of services available to retail customers continues to far outpace what's available to SMEs.

A greater sense of urgency. Pressure is building for banks to bridge the gap between what SMEs expect and what they are getting — thanks in part to outsiders bent on disruption. In the area of payment transactions, a bank that doesn't have a state-of-the-art payment method is already vulnerable to services like Apple Pay and Google Wallet, which can be used in lieu of debit or credit cards in many environments. PayPal offers SMEs an alternative to traditional payment systems such as debit and credit cards. iZettle makes point-of-sale card readers that can be connected to mobile devices, and that offer transaction fees lower than those of traditional banks. By exploiting weaknesses in banks' value chains, these newer, more innovative services are chipping away at banks' hold on SMEs and forcing them to respond.

In financing, SMEs likewise have some new options that, although still not pervasive, could come to represent real alternatives to bank loans. Lendico, which operates in five European countries and South Africa, uses a peer-to-peer model to provide loans to borrowers. EquityNet, based in the U.S., raises equity stakes for SMEs through a crowdfunding model. Peer-to-peer foreign exchange services such as Kantox, CurrencyFair, and Transferwise offer competitive exchange rates and transfer fees to SMEs. (Transferwise is very direct in what it is trying to accomplish; on its home page, it calls itself "the clever new way to beat bank fees.") Compeon, a comparison engine based in Germany, allows small businesses to search for the best terms on credit and lease financing.

Eager not to be left behind, some forward-thinking banks are partnering with, or investing in, these innovative startups. Doing so can be a good way of adding capabilities that the banks themselves lack and of shortening product development cycles. BBVA in Spain, Commerzbank in Germany, Barclays in the U.K., and Westpac in Australia are among the banks that have some sort of partnership with financial technology firms.

The initial rollout of digital services, whether developed in-house or through a partnership, is just the first step in banks' transformation challenge. To make progress toward their digital destinations, banks are going to have to realign their internal organizations, and they will have to overcome some of their own technological limitations. This means creating services that can be accessed from anywhere, at any time. It means enabling end-to-end digital processes, so that a transaction or an activity that is initiated online can be completed online. Making such goals a reality will require the commitment of top management and a strategy for modernizing and reworking the legacy systems that in some cases are holding banks back. Effective change management, the right incentives, new compensation structures, and a plan for communication are all part of a successful transformation.

Critical success factors

For bank executives, the challenge is to simultaneously understand the emerging expectations of their SME customers and implement strategies to meet those expectations. Five strategic shifts are necessary.

- **Know what's happening in the market.** Banks need to have a clear picture of what their SME clients want and of what SMEs' options are for getting those services. This may require conducting a comprehensive assessment of the competitive landscape, looking at the services being offered by rival banks and by financial technology players from the well established to the newly funded.
- **Understand the digital future.** Banks that anticipate the next wave — or that react quickly to technological opportunities — can create a competitive advantage. Banks must take a systematic approach to determining what will matter to SMEs; they should build scenarios but also test those scenarios regularly to see if they are still valid.
- **Look beyond the limits of traditional banking.** To date, when serving SMEs, banks have mostly focused on their traditional areas of strength, such as cash management and financing. But they should be thinking of providing adjacent services, such as creating e-shops, undertaking payroll processing, and offering access to networking opportunities and communities.
- **Define a multichannel strategy.** A true multichannel offering, which is easy to conceptualize but hard to implement, requires digital capabilities that many banks may not have and a sophisticated approach to IT systems, especially in the areas of user interface and integration. The benefits of executing such a strategy well include increased levels of customer satisfaction and reduced expenses. After implementation, any freed-up resources can be invested in other parts of the operation.
- **Find effective ways to manage the new measures and initiatives.** The strategies banks formulate and the changes they target will, by their nature, require some stretching and risk taking. To maximize their chances of success, banks will need to translate their vision into a road map, think through any issues related to organizational structure, and devise governance plans.

Developing the digital SME offering

Developing more effective and comprehensive digital offerings can be a bewildering and daunting prospect. To help, we have identified 10 possible routes banks can pursue. All of them take into account SMEs' current and future needs, the services competitors might be offering, and what technology currently allows. Banks don't necessarily have to introduce all these services or move in all these directions; they should be taken as examples. Sooner or later, though, some of them will undoubtedly be on the priority list.

1. Setting up digital secure mail inboxes using robust encryption and authorization and identification mechanisms so SME customers can communicate securely.

2. Extending self-service offerings so SMEs can get more detailed information about bank transactions without having to come into the branch or speak with a bank representative on the phone.

3. Strengthening after-sales service through data analytics so that SMEs can obtain tailored advice on new products and services, identify emerging risks, and access timely new market data and research.

4. Introducing co-browsing, which would allow bank representatives to view and steer the SME's screen (for instance, when demonstrating a Web application), and video advice. The latter would allow for expert consultation and would permit SMEs to finalize legally binding transactions without having to visit a branch.

5. Introducing other advanced digital tools, including those that help SMEs do financial analysis and planning, or value their receivables.

6. Developing new fully digitized products for SME clients, including credit guarantees and credit lines.

7. Using the aggregate data that banks have on SMEs to show how individual SMEs compare to their peers or to industry benchmarks, possibly through numerical ratings that would allow SMEs to make operational improvements.

8. Creating microsites with tailored offerings for SMEs of specific types — for instance, founders or those in specific industries such as hospitality, manufacturing, or healthcare.

9. Rolling out new kinds of security verification, such as fingerprinting and photoTAN (in which devices read encrypted authentication messages in QR code images) that make the authorization process more robust and increase the security of online transactions.

10. Introducing auto-recognition technology for SME clients and personalizing the Web content they see, especially when it comes to products and services. An example would be delivering custom information on a welcome page, such as hedging services for SMEs doing business abroad in different currencies.

Conclusion: Digitization offers benefits for both SMEs and banks

As banks start meeting SME customers' expectations for digital service, both the SMEs and the banks will benefit. The SMEs will gain 24/7 digital access to tools and processes they need to run effectively — a significant improvement on its own. Of course, this won't prevent them from visiting bank branches when they have something complex to discuss. Rather, they will simply be able to conduct more transactions (and components of transactions) online, including finalizing loans or credit lines and other contracts. Potentially, SMEs will also have the option of using services that banks traditionally haven't offered — such as accounting and analytics services. Finally, better digital service should also mean that SMEs won't have to struggle to figure out what they are paying banks — and what they are getting in return for those fees.

For the banks, the payoff will come partly in the form of reduced operating costs. To be sure, an investment will be needed if banks are to build the digital end-to-end execution of transactions that is at the heart of digital banking. But once these processes become automated, banks will be able to get by with fewer employees and fewer in-person services — freeing up resources that will either lower their cost basis or allow banks to add higher-value advisory services. Indeed, in the end, the digitization of SME banking should provide much broader benefits than those related to cost — including higher customer satisfaction, higher rates of customer retention, and higher revenues per customer. Not to make the transformation may leave banks unable to hold on to SMEs, which increasingly have other options and may soon have a leg, an arm, or their whole body out the door.

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