

Technology Initiatives to Support Middle-Market Lending

By Mike Pennell

Middle-market lenders seek tighter integration among existing systems.

Driven primarily by a dramatic increase in competition coupled with increased regulatory pressure, today's commercial bankers are recognizing the need for better and more integrated systems. A dramatic transformation looms in commercial lending—ruled by the competitive necessity of more effective front-office processes and systems in conjunction with more efficient risk management approaches.

A recent survey of more than 100 midmarket commercial lending executives, sponsored by American Bankers Association and CapitalStream, offers practical information on the most compelling front-office issues, uncovering the critical challenges and offering solutions for banks working to be more effective at managing midmarket commercial relationships.¹ The 2004 Mid-Market Lending Survey suggests a noticeable trend by leading financial institutions to enhance processes and systems that improve customer relationships, increase profitability, reduce processing times and more effectively manage risk:

By refocusing new technology investments on the front-end functions (obviously without neglecting back-end quality), commercial lending units have gained a unique vantage point from which to pursue several strategic objectives simultaneously: in cost reduction, risk management, and customer knowledge," said Lee A. Kidder, director, Wholesale Banking, Tower Group, in a 2004 report, "Straight-Through Processing in Commercial Lending."²

Those that participated in the survey are expecting a significant ramp in business this year—with more than three-quarters (80 percent) of respondents expecting

an overall growth rate of at least 10 percent. "The economic environment is prime for increased commercial lending activity, and the midmarket is one of the fastest growing segments of the revived commercial lending market," said ABA Chief Economist James Chessen.

Greater process efficiency and front-office collaboration are key to achieving this growth without driving up costs. Yet, only 35 percent of commercial lending groups have integrated their front-office systems, leaving the majority of commercial lenders to throw more people at an already inefficient process.

Growing Focus on the Midmarket

More than 2,200 banks in the United States lend money to mid-sized businesses (defined here as businesses with revenues from \$5 million to \$75 million). This business unit or division of a bank is frequently called "midmarket lending" and operates under a very different set of conditions from its smaller sibling (small-business lending) and its larger sibling (wholesale or corporate lending). About a quarter of those surveyed have a dedicated midmarket lending group (Exhibit 1). Midmarket lending has been described as the "milk at the back of the store," as it typically generates lower margins from its credit products but is viewed as critical to selling more profitable products and services.

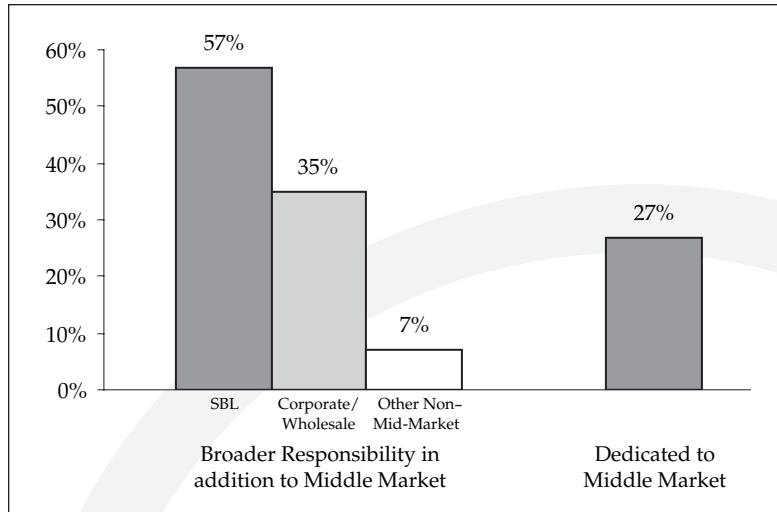
In the past, this view has frequently meant that the midmarket segment was not a focus for investment in terms of process improvement, personnel and sys-

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Exhibit 1 Organizational Structure

Comparison of midmarket groups that share broader responsibilities in small-business lending (SBL) and corporate/wholesale lending that fall outside of midmarket as opposed to a group dedicated solely to midmarket lending. Of the 73 percent that share broader responsibilities, 16 percent take on many responsibilities, so the percentages do not total 100 percent.



tems. In today’s midmarket landscape, however, this attitude appears to be changing. According to the *U.S. Bank Technology Spending and Investment Trends Report* from the ABA and Tower Group (November 2003), wholesale bankers identified their institutions’ highest priorities for 2004 as client relationship initiatives, followed by continued investments to reduce cost with straight-through processing, especially in commercial lending.

Survey Specifics

The 2004 Mid-Market Lending Survey reviews the processes, systems and best practices used by leading commercial banking institutions to originate, underwrite and monitor loans, lines, commercial mortgages and other commercial credit facilities. The survey also identifies the critical challenges in front-office operations including sales, relationship management, credit and documentation and funding.

The survey participants are executive, senior or mid-level managers specializing in sales, credit or operations who work in the midmarket credit and lending group. Through personal, in-depth interviews conducted in 2004, the survey uncovers how banks are managing their midmarket lending relationships and

improving their effectiveness to grow their credit portfolios. The survey also delves into the best practices and systems implemented to address specific business challenges.

The Top Issues and Top Initiatives

As part of the survey process, respondents were asked to rate the issues and challenges facing their business using a scale from 5 (critical) to 1 (not important). The top issues indicate a need to drive business growth and profitability through more efficient, consistent and integrated origination processing and credit decisioning (Exhibit 2). Virtually all respondents touched on the need to increase business volume, grow their portfolio and effectively support this growth.

Banks are trying to increase the size and profitability of their midmarket lending portfolios, both through new relationships and by selling more products to current clients. To handle this growth efficiently, systems and processes must be well defined and better integrated. To control risk, credit decisioning processes and systems need to become more consistent and automated.

Overall, the best practices to address these issues can be summarized into five high-level initiatives:

- Ensure relationship and transaction profitability
- Integrate information for straight-through processing
- Maximize the value of each relationship
- Improve the speed and efficiency of origination process
- Ensure consistency of credit

Ensure Relationship and Transaction Profitability

The two highest-priority issues focus on the need to ensure that each transaction and the overall customer relationship are profitable to the bank. As few as three percent of respondents believe they have an effective method for identifying which products and services are most profitable. The industry is struggling to identify and sell the most profitable products yielding the most

Exhibit 2 Top 10 Issues

Top-rated issues overall based on the average ratings from 1 (not important) to 5 (critical). Percentage of respondents who have resolved the issue is indicated in the “resolved” column.

Top Issues	Rating	Resolved
1. Ensure that the overall relationship is profitable	4.18	8%
2. Ensure that the pricing and structure of a loan or product is profitable to the bank	4.11	10%
3. Eliminate duplicate data entry and errors	4.04	22%
4. Encourage cross-selling of other noncommercial products and services to the owners of the business	3.97	7%
5. Encourage cross-selling of other products and services to the business	3.93	6%
6. Improve the efficiency of documentation and operations	3.92	2%
7. Improve the speed and efficiency of the sales and origination process	3.85	6%
8. Identify the most profitable products and services to offer	3.81	3%
9. Demonstrate objective, consistent and high-quality credit underwriting and compliance to regulators	3.77	12%
10. Ensure that all required information is collected and entered correctly prior to booking	3.77	12%

profitable overall relationships. Processes and tools are inadequate in evaluating profitability. This coincides with the information technology (IT) priorities of mid-market lenders, as more than 56 percent of respondents plan to implement a relationship profitability model over the next two years, leveraging technology to help standardize and monitor profitability.

The survey results highlight the importance of expanding the analysis of profitability, viewing the relationship on an enterprise level across commercial products and services. For example, lending is frequently viewed as a loss leader generating little profitability but creating a demand for higher-margin products and services. However, without accurate profitability models that evaluate the entire relationship, the midmarket lending group has little basis for assessing the overall impact of a credit decision or financial structure. Frequent data reentry, inconsistent methodologies and a lack of integrated information limit the accuracy and completeness of profitability calculations. Increasing the availability, transparency and consistency of information helps banks identify, develop and maintain the most profitable customer relationships—again pointing to the

need for integrated, collaborative front-office systems.

Integrate Information for Straight-Through Processing

The third highest-rated issue is duplicate data entry, not surprising given that more than half of midmarket lending systems are implemented stand-alone. Lack of integration prevents the front office from getting a holistic view of the customer and credit information, affecting data accuracy and response time. Information must be reentered manually into many different systems, preventing straight-through processing and resulting in inaccuracy, inefficiency and long processing times.

The importance of this issue is reinforced by the fact that integrating existing systems is the most prevalent systems initiative to be undertaken; 60 percent of community/smaller banks and 71 percent of mid-sized/larger banks plan to integrate their existing systems within the next two years.

There is a significant difference in the systems used by larger banks and smaller banks. For front-office systems, larger banks tend to build systems themselves (11 percent) or select CapitalStream solutions (seven percent). Eighteen percent choose other solutions, and 64 percent are not automated. Smaller banks tend to select BakerHill solutions (11 percent), followed by internally developed solutions (eight percent). Fifteen percent choose other solutions, and 65 percent are not automated. For back-office servicing and accounting systems, Metavante and Fiserv are the leading solutions providers regardless of bank size. However, Metavante has greater market share among larger institutions (21 percent), and Fiserv has greater market share among the smaller banks (25 percent).

Unfortunately, information housed in the back-office systems is integrated with other front-office systems less than half the time (47 percent). This

lack of integration prevents the front-office team from easily retrieving the customer, exposure, payment, balance and other critical back-office information housed within these systems. Furthermore, account and contract information must be reentered frequently.

As a best practice, information should be entered just once and flow into other systems. Accurate information should be available immediately to those who require it, in the format that they can readily use. Integrated front-office portals should link with internal and third-party systems to integrate customer, credit and other critical information into the origination process, thereby eliminating redundant data entry and providing easy access to any information directly over the Web.

“Straight-through processing is exactly what it says: the substitution of automated tasks and processes for manual ones, so that a business process or service can be entirely automated from beginning to end. In STP, all original information (*e.g.*, about new customers and loan terms) is entered only once in the process,” said Kidder.³

Maximize the Value of Each Relationship

Banks are trying to cross-sell more products to their commercial customers and striving to become a one-stop shop—even leveraging commercial relationships to sell retail products to business owners and thereby increase the value of the entire relationship.

The industry is implementing new systems and procedures to identify the products that each customer would want and qualify for. These systems include CRM (customer relationship management) systems, pricing systems and front-office collaboration systems. The key is to promote new commercial and retail products just when the customer is making a financial change. These financial changes frequently coincide with a change in the commercial lending relationship, so the commercial lending officer has a unique opportunity to sell just what and when the customer needs.

Leading institutions are introducing common platforms to manage customer accounts and to alert the front office of potential opportunities. Banks are striving to provide the integrated information and product offerings needed to develop lasting cus-

tom relationships, which in turn lead to increased credit and fee revenue.

Improve the Speed and Efficiency of Origination Process

The majority of the top issues are related to improving the speed and efficiency of front-office processing, demonstrating a huge gap between current practices and how midmarket banks believe they should be originating their loans.

Clearly, the industry is lacking the systems and processes to quickly and efficiently deliver financing. The average time to deliver documents varies from 4.2 days for deals less than \$1 million to 7.87 days for deals greater than \$5 million. However, individual responses varied from less than one day to over two months. As consolidation and competition continue, the time it takes to complete a transaction will become increasingly critical in competing for business. And the cost of delivering that transaction will directly affect the profitability of the business and the ability to provide competitive rates.

Ensure Consistency of Credit

Managing and monitoring credit decisioning and credit risk and demonstrating consistency and controls to regulators is of growing concern, especially as global mandates such as Basel II continue to evolve. Implementing processes and systems that ensure the consistency and transparency of credit decisions will be a major priority throughout the industry.

With all of the attention on high-profile losses over the last few years, survey respondents did not cite the need to reduce default rates as a high priority; of all the credit issues, it received the lowest rating. The average default rate among respondents is 0.5 percent; more than half of survey respondents indicated that the default rate had improved over the last year. The top issues focus instead on the underwriting process and information integration rather than portfolio performance.

Nearly one-third of the top issues were related to improving and standardizing the credit process to ensure better underwriting practices, improved risk management and faster credit decisioning. Information must

be current and comprehensive, incorporating the most complete and updated view of the relationship and exposure—especially true for larger institutions preparing for Basel II. According to Celent Communications, worldwide spending to support Basel II has the potential to reach almost \$12 billion by 2005.

“While only the largest U.S. financial institutions are required to comply with Basel II, there is increasing regulatory and market pressure on most commercial banks to bring their systems and procedures on par with best practices in data consistency and transparency,” said Alenka Grealish, manager of the banking group at Celent Communications. “Commercial banks that are able to integrate their systems, data and decisioning will gain a dramatic competitive edge—better managing risk while also increasing efficiency and reducing decision times.”

Top Three Challenges

Operational issues were the primary focus of the survey. However, when respondents were not prompted with specific issues but simply asked to list their top three business challenges, the results were similar to the issues uncovered above, indicating that operational issues are very much a top priority. The top challenges mentioned by respondents fall into these three categories:

- **Business and portfolio growth.** Practically all (98 percent) respondents mentioned the need to increase business volume, grow their portfolio and effectively support this growth. The most frequent growth strategies were cross-selling products and developing new relationships.
- **Processing efficiency.** Forty-one percent of respondents mentioned problems with processing efficiency and controls. Overall turnaround time and credit underwriting were expressed most frequently as the areas that needed improvement.
- **Systems integration and automation.** Thirty-one percent of respondents mentioned the need for better systems. Respondents cited improved system integration and relationship management systems most frequently.

Reality Check

In the past, speed and process were often viewed as opposites. More speed meant less defined processes

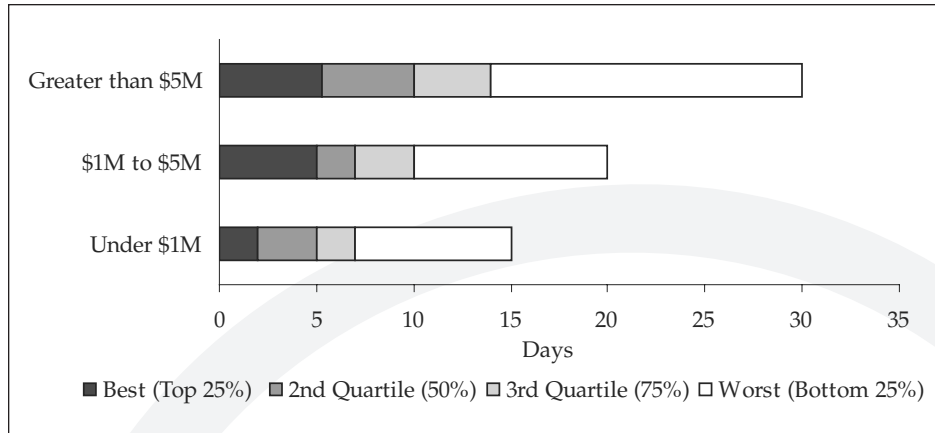
and vice versa. With modern credit analysis and work flow management systems, the opposite is true. More defined processes can now be automated for faster, more accurate decisions that manage risk more consistently. Credit analysis and work flow management systems can immediately route transactions and integrated credit information to all reviewers. More sophisticated solutions can dynamically change the review process based on the type of business, risk rating, size of commitment, type of collateral or other criteria. However, just 35 percent of survey respondents use a work flow system to manage the midmarket origination and underwriting process.

“Commercial finance overall and especially mid-market lending is on the verge of a revolution. The work flow, integration and automation technology that software vendors like us are now providing will fundamentally change how banks do business, how they compete and how they manage risk,” said Kevin Riegelsberger, CEO of CapitalStream, a provider of software and consulting services for commercial lending. “The more advanced midmarket operations will be able to make a credit decision in a couple of days or less and do so more consistently at a lower cost while easily complying with regulatory requirements. Old-style paper-based operations relying exclusively on manual processing and decisioning will simply not be able to compete.”

The survey uncovered significant disparity between the timeliness of credit decisioning among midmarket lenders (Exhibit 3). As expected, review times increase with transaction size, reflecting the additional complexity associated with reviewing larger transactions. However, the differences among responses from banks competing in the same size range indicate that some banks are significantly more effective. For example, credit approval time for transactions under \$1 million ranged from just a few hours to two days for the top 25 percent of respondents, whereas the slowest 25 percent of respondents require seven days to three weeks. Similarly, for transactions between \$1 million to \$5 million, decision times range from one to five days for the top 25 percent of respondents, while the slowest 25 percent of respondents require two to four weeks. Businesses looking for funding frequently give preference to the bank that can deliver the fastest. As a result, those on the right side of Exhibit 3 are at a significant disadvantage.

Exhibit 3 Credit Review Times

This figure shows the wide variance in credit review times among respondents by size of commitment. Each shaded area shows the number of days required from customer request to credit approval segmented from the best/shortest times to the worst/longest times broken down in quartiles. The best quartile shows the time required for the fastest 25 percent of respondents; the worst shows required time for the slowest 25 percent.



What Next?

Commercial lenders are now planning the systems and process improvement projects that will make them more effective and competitive. The top priority is to get access to all the necessary information without having to reenter it time after time. Lack of integration between systems means data must be reentered into different systems with different procedures. Information is incomplete and incorrect, and it becomes extremely difficult to access all the information that is necessary to determine what the customer needs, whether the customer is creditworthy and which product and structure would be most profitable to the bank.

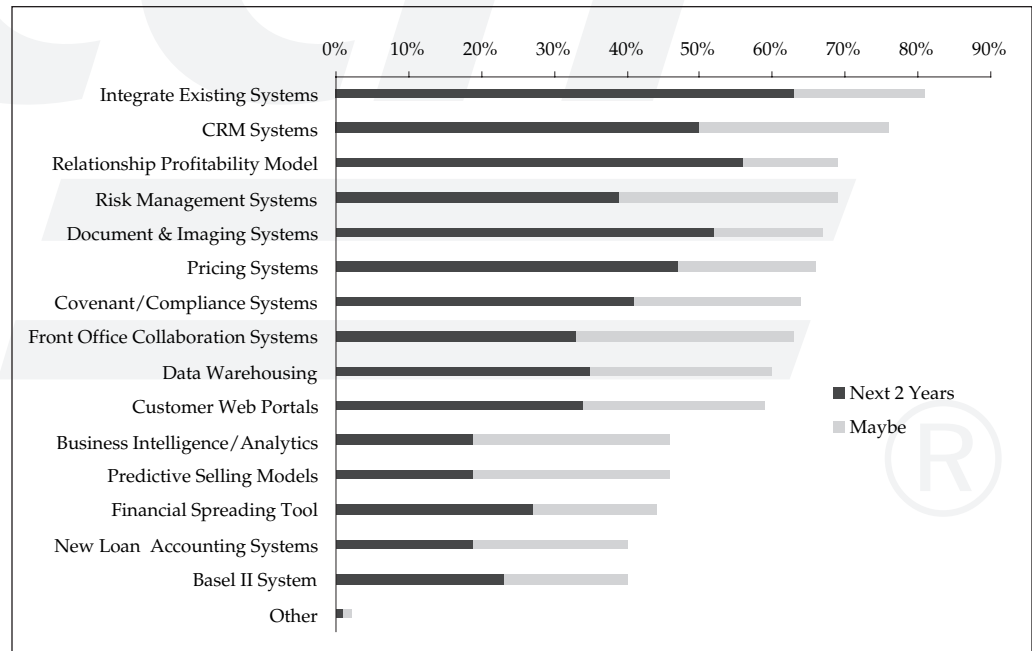
Not surprisingly, the most popular IT initiative over the next two

years is to integrate existing systems (Exhibit 4). In fact, four out of five survey respondents indicate that they either will or might be undertaking an integration initiative. CRM systems, relationship profitability models and risk management systems are next in priority. These IT priorities are consistent with the overall findings from the survey: Midmarket lenders are integrating and automating to better understand the customer, improve relationship profitability, enforce consistency and better manage risk.

One of the most noticeable changes uncovered by the survey is simply the emphasis on midmarket lending. The sheer number and cost of IT initiatives focusing on a business unit typically ignored by IT indicates a significant shift in strategy. The old way of doing business using paper and people

Exhibit 4 IT Initiatives

Percentage of respondents implementing various IT projects in the next two years. The black bar indicates that a project is planned during the next two years. The gray bar indicates that a project may occur in the next two years.



is no longer viable. The technology and process improvement methodologies previously applied to retail and other high-volume products must now be applied to commercial lending. The leaders are making the investment, the followers will be forced to and the stragglers will be forced out of the market.

Endnotes

- ¹ The full survey report is available at www.capitalstream.com. The survey drills into systems, priorities, issues and best practices in a broad range of commercial lending disciplines, such as sales and relationship management, credit, documentation and operations.
- ² Lee A. Kidder, *Straight-Through Processing in Commercial Lending: A Solution Waiting for Awareness of the Problem*, COMMERCIAL LENDING REVIEW, Nov. 2004, at 11.
- ³ *Id.*

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