Business Lending: Third Party Origination

Banks must have clear strategy to deal with the broker channel

Despite business customers indicating that they view their primary banking relationship as being with their transaction banker as opposed to their lender, the obsession most commercial banks have with protecting and growing their lending market share shows no sign of abating. And if the incredible shrinking margins were not bad enough, the amount of business lending that is being originated by third party channels continues to grow steadily. Put simply, if a lender is not engaging with the broker channel they are not participating in a large and rapidly growing chunk of the business lending market. East & Partners' Business Lending Report 2006, released this week, shows that almost 40 percent of Micro Businesses (sub A$5 million turnover); close to a third of all SMEs (A$5 to 20 million); and more than 20 percent of the Commercial (A$20 to 340 million) enterprise segment use brokers to source plain vanilla debt. It is worth remembering that back in 2001 third party origination accounted for less than six percent of all business lending. The broker channel has traditionally provided a vital channel for banks in regions where they don't have a physical presence, but given the volume now passing through this channel, it is imperative that lenders have a clear strategy for third party originators.

So why are growing numbers of businesses turning to brokers to source their debt? For the most part to secure better and more flexible terms and collateral than these businesses perceive they will get from their banks. In June's Research Note, we discussed how three quarters of SMEs, for example, described the experience of applying for a loan from their primary business bank as "negative", and that four out of ten had their application rejected due primarily to "inadequate security". If they can hand over the "hassle factor" to someone else AND be more likely to achieve the desired outcome, why wouldn't they go to a broker? Interestingly, for a product as relatively straightforward and commoditised as vanilla term debt, many enterprises are taking their business to a broker rather than their incumbent bank because they see brokers taking the time to understand their business. Given this it is not surprising that accountants and financial planners are increasingly employed to source debt. Vendor/product financiers, many of which have alliances with accounting groups, still constitute the largest broker segment. What is most worrying for mainstream commercial banks is that the third party channel is increasingly being regarded as "what good banks used to be". This sentiment is spreading quickly via "word of mouth" as time poor businesses, preferring not to shop around to compare the expanding number of products on offer, act on the recommendations of colleagues and associates.

Another dynamic contributing to businesses turning to brokers rather than banks is that businesses, particularly in the Micro Business segment, have been forced to deal remotely with banks (as last month's Research Note on the fragile role of today's branch in business banking explored) to the extent that almost half of these businesses say their favoured means of interacting with their bank is via the Internet, as banks themselves have been promoting for several years. This is another reflection of the shallowing of the bank to customer relationship, and one which should be viewed as a worrying development for mainstream commercial banks in Australia. Even if banks are delivering the levels of relationship banking to small business customers they say they are, these Micro Businesses are clearly not responding to their overtures, hence the propensity to turn to brokers. And once a business has entered into a relationship with a broker, who then owns the customer? On this evidence, the answer would have to be the broker. It is no surprise that banks are responding to these indirect relationships with customers by deploying strategies focussing on "relationship managing" the broker channel as much as the end customer.

Businesses prefer to purchase Equipment Finance from their banks

East & Partners recently completed the largest study of the Equipment Finance markets ever carried out in Australia. Equipment finance has long been a "classic" broker originated product line with almost 70 percent of Micro Businesses and more than 50 percent of SMEs currently making their purchases through brokers. One of the many key findings of this Equipment Finance study, relating to this issue of Research Note has been that, "all things being equal" the vast majority of these businesses would prefer to source equipment finance through their principal relationship bank, rather than through third parties (see exhibit).

Why? The most commonly cited reasons were: "it generally makes better sense", "simplifies relationship issues", and "achieves further overall cost savings". Given these responses coupled with the high rates of third party origination utilisation, it is evident that customers are not happy with their principal banks in relation to equipment finance.

But it's not all doom and gloom for commercial banks. "All things being equal" can be read as "if my bank gave me the service I wanted". In other words, there are huge gains to be made for those banks that do step up to the plate and deliver the service that customers are demanding, filling the void that brokers are currently stepping in to and leveraging the "native" preference business customers are clearly expressing they have to deal with their bankers.

Figure 1

Preference to purchase Equipment Finance through Principal Bank — by Segment

N: 2,507	% of Customers — August 2006		
	Yes	**No**	**Don't Care**
Micro Businesses	88.7	5.1	6.2
SMEs	80.9	7.0	12.1
Commercial Markets	70.0	8.5	21.5
Top 500 Corporates	46.5	44.7	8.8
TOTAL	74.4	12.6	13.0

East & Partners Equipment Finance Markets — August 2006

Figure 2

Micro Businesses: Product Sourcing Behaviour
(A$ 1-5 million Turnover Enterprises)

	% of Enterprises Using Brokers		
	Term Lending	**Leasing**	**Liquidity**
2005	29.3	56.6	1.6
2006	38.2	74.8	2.7