FEDERAL RESERVE BANK OF SAN FRANCISCO

Community Investments Vol. 8, Issue 4
The Business of Small Business Lending

Fall 1996

The following article is based on an interview with Terri Dial, Vice Chairman and head of the Business Banking Group at Wells Fargo Bank. We'd like to thank Ms. Dial for her candid responses to our questions and for sharing with us her views on the Wells Fargo approach to small business lending.

Before we get into the heart of this discussion, I think it's important that I be clear about what we at Wells Fargo consider to be a "small business." We don't use quantitative definitions like asset size, annual sales or number of employees. We think of a company as "small" when the owner of that business is still the day-to-day financial decision-maker. That's really important to us because our view is that we're not just banking a business entity, we're banking an individual--the small business owner. Everything we do starts with that perspective which is quite different from the wholesale side of banking. There, you are banking a business entity, and the people you're dealing with are employees of that business. It's an entirely different relationship than when you are banking the individual who, in our opinion, really is the small business.

In terms of Wells Fargo's approach to small business lending, we have been careful not to look at the marketplace as if it is a singular, homogeneous market. Rather, we approach it as though it is a number of markets. We tend to think not about the "small business market," but about a "small business segment." We might refer to the affluent segment of the marketplace, or to the mass market, or we might talk about home-based businesses or women-owned businesses. By approaching our small business lending in this way, we've been able to circumvent the deceiving game of profit averages. In other words, financial institutions who employ the holistic, homogenous approach to small business lending may be fooled by averages that are distorted by a small segment of small business customers who keep much higher average balances, or borrow in larger dollar amounts. These customers represent a disproportionate percentage of the profit contribution, which can lead to a skewed perception of overall profitability.

To some degree, cross-subsidization[1] still occurs, but by separating the market into segments, we stay on top of how profitable (or unprofitable) each segment of our small business lending program is. This kind of segmentation gives us a true picture of what's really going on, and ultimately makes us less vulnerable when niche players, usually non-banks, come along and attempt to break that cross-subsidization by attracting away the very group of customers that is cross-subsidizing the others.

The segmentation approach has also led to an opportunity to analyze the rest of the small business market and to make sound choices as to whether or not we should be lending in certain segments. There are many segments in the marketplace where it is very difficult for a commercial lender to make a profit, at least in the traditional sense. For example, there's a large small business segment that needs and wants to borrow on a commercial basis, but their needs are very small. Business owners want $10,000, $20,000 or $30,000 loan--the average is somewhere around $25,000. Traditionally, that's been a very unprofitable business for a bank. Some banks argue that they are willing to lose money on those loans because they can make it up in deposits. But what happens when the borrower has no deposits? It's a very tough balancing act.

What intrigued us about this segment of the marketplace, however, was that it was so underserved. Most banks, including our own, overlooked the borrower that needed a $25,000 - $35,000 loan and instead targeted minimum loan amounts of $100,000 and $200,000. That really limited our scope and fed the criticism regarding lack of access to small business capital and credit. Now, we offer small business loans as small as $5,000 and as large as $2,000,000.

Wells Fargo recognized the opportunity in the $20,000 - $50,000 loan market, not because this segment was profitable from an individual loan standpoint, but because there were, and are, a significant number of businesses who need this level of credit. So we said, "Well, the opportunity is there, but only if we approach this segment in a way that is different from how banks have traditionally done it." The approach we've taken is not what one would call "innovative" or "visionary"--in fact, it's really very unsexy. At the end of the day, it's about a relentless pursuit of cost reduction and expense control. That, literally, is what this business is all about.

To serve this segment, you've got to be incredibly careful about how you spend your money and how you design the business. We have re-engineered this business so many times in the last five years that I've stopped counting, but that's really what you have to do. You have to be willing to completely remake yourself to keep pace with the changing marketplace and to ensure ongoing profitability.

Wells Fargo actually started forming a small business lending group in late 1989. Back then, we decided we would target small business as a potential area of growth for Wells Fargo, because looking ahead we were concerned about new opportunities for revenue growth. Small business lending was of interest to us because it was a market segment that had not been targeted by large banks. In fact, until a few years ago, small business lending had been largely left to local community banks who primarily focused on the $100,000 and above borrower.

In terms of our profitability in the small business lending arena, I would say that we are extremely rigorous about measuring profitability--both at the business banking level and throughout Wells Fargo. We use a very precise profit-and-loss standard, and everything in this bank is fully costed-out. At times, it's a painful discipline, but it has worked well for our bank. Wells Fargo's rigorous profit standard has certainly impacted our small business outreach efforts as well as our loan-processing approach. Here's why:

Every time one of my small business customers walks into a retail branch and makes a deposit, I pay the branch; and I pay the branch based on the nature of the deposit--more if it's cash, and less if it isn't. I pay more if a customer uses a teller and less if he uses an ATM. If a customer walks into a branch looking for a loan, the branch charges me a high price for processing the loan because of the time it takes to put the application together. Therefore, I'm very motivated to get that loan business in some other, less costly, way. Many of our recent outreach efforts including direct mail campaigns and telephone marketing have been the result of our rigorous profit-and-loss standards.

Wells Fargo does not measure its small business profitability by lumping together the deposit and loan worlds. Often, if you wrap the two together, you run the risk of double-counting revenue and/or underestimating expenses. Bankers tend to overlook the costs associated with deposit accounts, for example. In our small business lending segments, we have demanded that small business loans be profitable and achieve the bank's return on equity hurdles without the benefit of corresponding deposits and other things. It's been tough, but we've achieved it.

We are a lot smarter now about our costs, our pricing and the way we manage risk. We have fundamentally changed everything about the way we do business. To me, that's a healthy dynamic and we're in a wonderful position to explore new opportunities in other small business market segments.

[1]The notion that high deposit customers who borrow large dollar amounts or don't borrow at all are "subsidizing" those customers that have low deposits and very small loan requests.

Wells Fargo currently has over 200,000 small business borrowers in the fifty states.

Terri Dial is vice chairman and head of Wells Fargo's Business Banking Group, which provides loans and banking services for small businesses across the nation. Dial began her career with Wells Fargo in 1973, advancing through a number of positions in the Retail, Commercial, and Savings and Investments Groups before assuming her current position in 1991. She has been the recipient of numerous awards this year including the California Small Business Award of Appreciation and the Financial Women's Association's Financial Woman of the Year award.