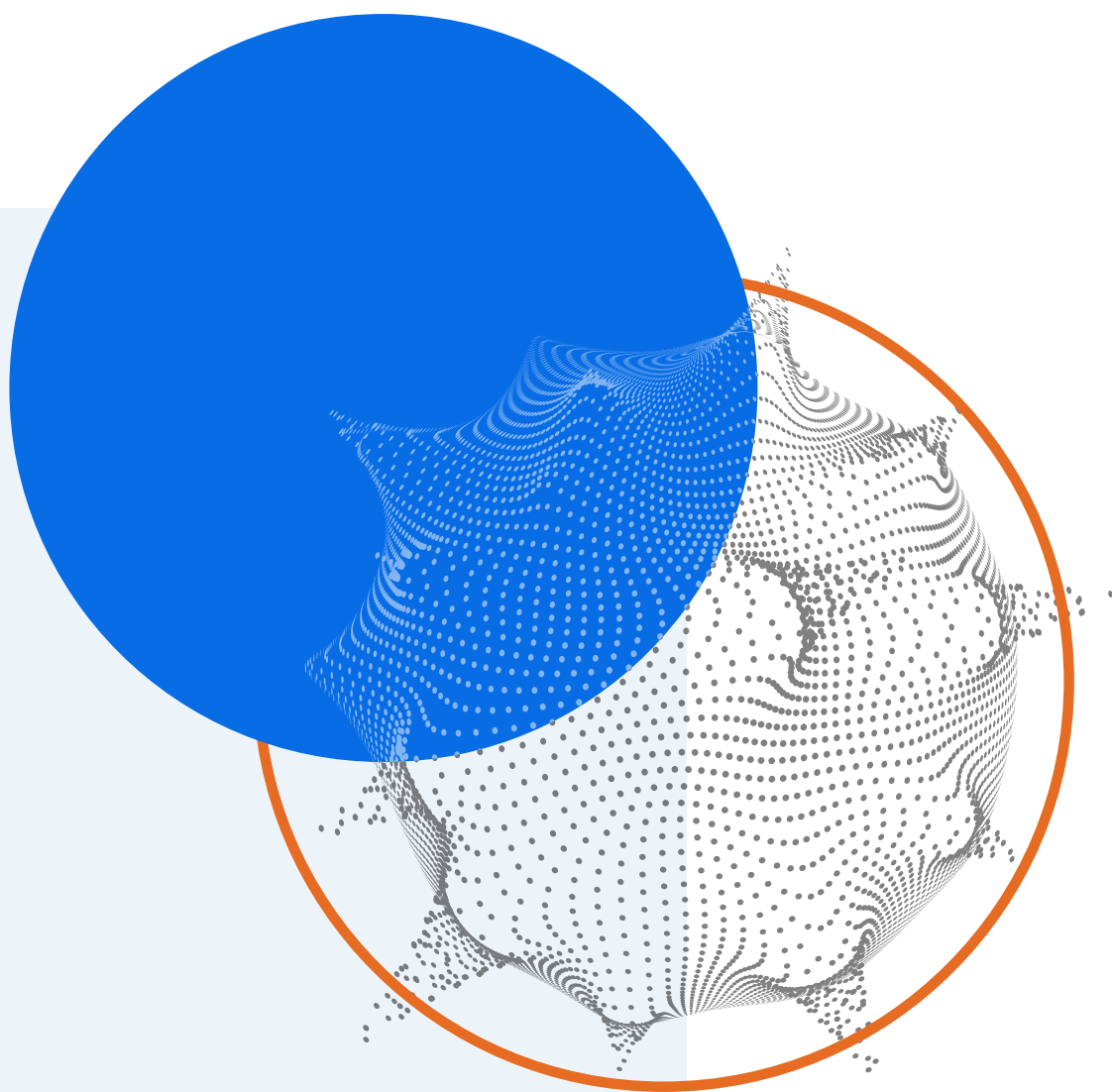


# **CATALYZING POSITIVE CHANGE:**

business lending in the  
post-pandemic era



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The COVID-19 pandemic has put businesses under immense strain. Their economic prospects, through no fault of their own, are bleak. Their cash flow runway is in many cases only a few weeks' long. And, their outlook is precarious as they depend on financial institutions to make lending a truly efficient process - urgently.

It will be some time before we understand fully the repercussions of this crisis, but two things are already clear:

First, that the **business lending infrastructure** - just about good enough in normal conditions - is **not fit for purpose** in times of profound crisis, deepening the economic emergency affecting all of us.

Second, **the speed of transition to the digital economy** has gone from gradual to **accelerating at full-speed** - and not just for customers but for the entire banking and lending sector.

As a key lever of the financial ecosystem, business lending must push into the new era at full speed, reengineering its framework to help small and medium-sized enterprises (SMEs) - and the societies that depend on them for services and employment - to survive in the post-pandemic world.

Our concern is that this change is unlikely to happen fast enough to stop thousands of preventable bankruptcies and job losses.

However, even if this is regrettably the case, the silver lining is that this will not happen again. The pandemic will catalyze an upgrade to infrastructure that will boost lending and economic growth, in good and bad times, over the longer term.

# Pre-pandemic business lending – cracks in the edifice

**c.57%**

of financing applications  
abandoned or declined;  
access to finance biggest  
barrier to growth

**30 hours**

Spent applying for credit

**90 days**

Waiting for funds, if they  
can access finance

*Average value across the EU –  
source World Bank, Trade Ledger*

The situation wasn't rosy to begin with.

While SMEs' important role in the economy has been long recognized, their business loan needs have not.

For a protracted period of time, we have seen a **persistent and growing “funding gap”** for mid-market enterprises. This funding gap represents the difference between the credit these businesses need to grow and the credit that they can actually obtain.

There are two principal reasons why this funding gap has been growing.

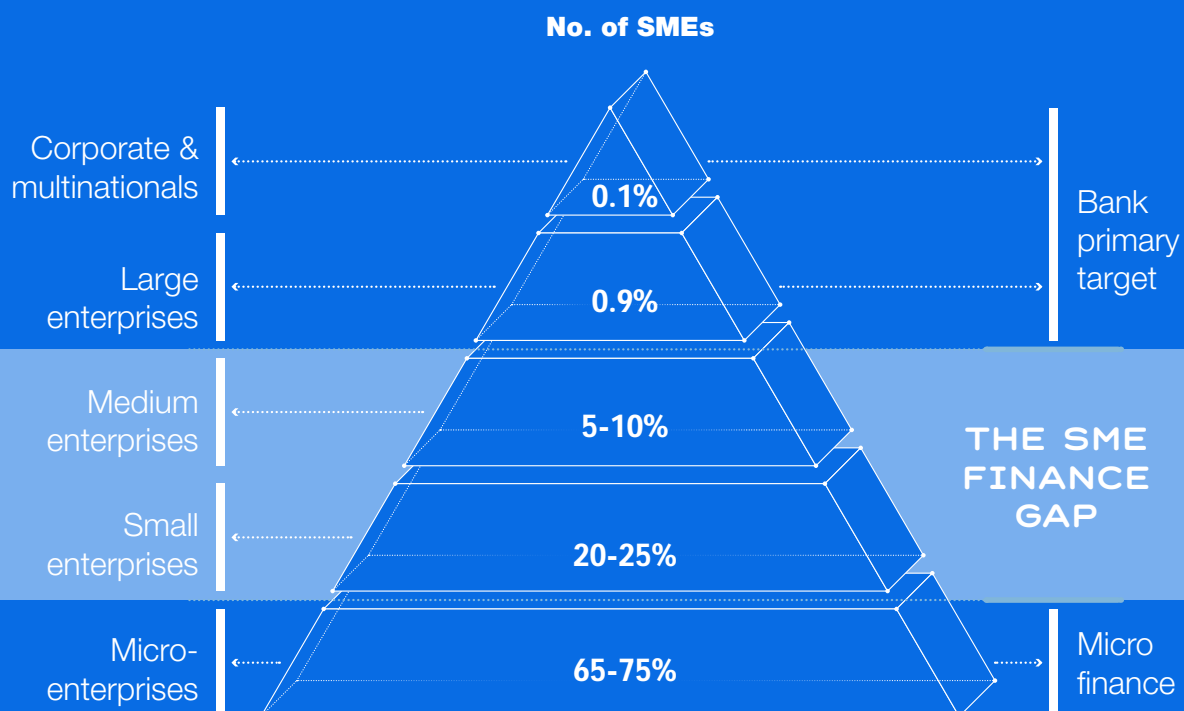
First, **high operating and servicing costs make it uneconomical** for many banks to lend to SMEs. Burdened with legacy IT systems and manual, paper-based processes, banks find it hard to assess applications quickly or cost effectively enough to make good margins on this lending. And so they don't lend. Moreover, this situation has been compounded by regulatory changes that have pushed up administrative costs further as well as increased the risk weighted capital that banks to set aside, reducing return on assets.

Second, **banks have struggled to lend against intangible assets**. For the banks that do lend to SMEs, they favour those who can collateralize physical assets, such as buildings. The reason is that banks aren't able – in a timely and efficient manner – to get data to verify intangible assets, gauge counterparty risks nor understand the changing status of these assets as they move through the value chain. So, they don't lend against intangible assets. The issue is that this excludes an increasing number of SMEs whose businesses are intangible – both in the services they provide and the assets they hold.



The adverse consequences of credit constraints are particularly severe for firms specialising in digital and other ‘intangible’ activities.

In essence, many small and mid-sized companies are too small to qualify for microfinance lending and too large to meet the requirements of the corporate lending provided by most large financial institutions. There are in the underserved mid market.



SMEs are too large for micro finance institutions and too small for corporate banking.

World bank<sup>1</sup>

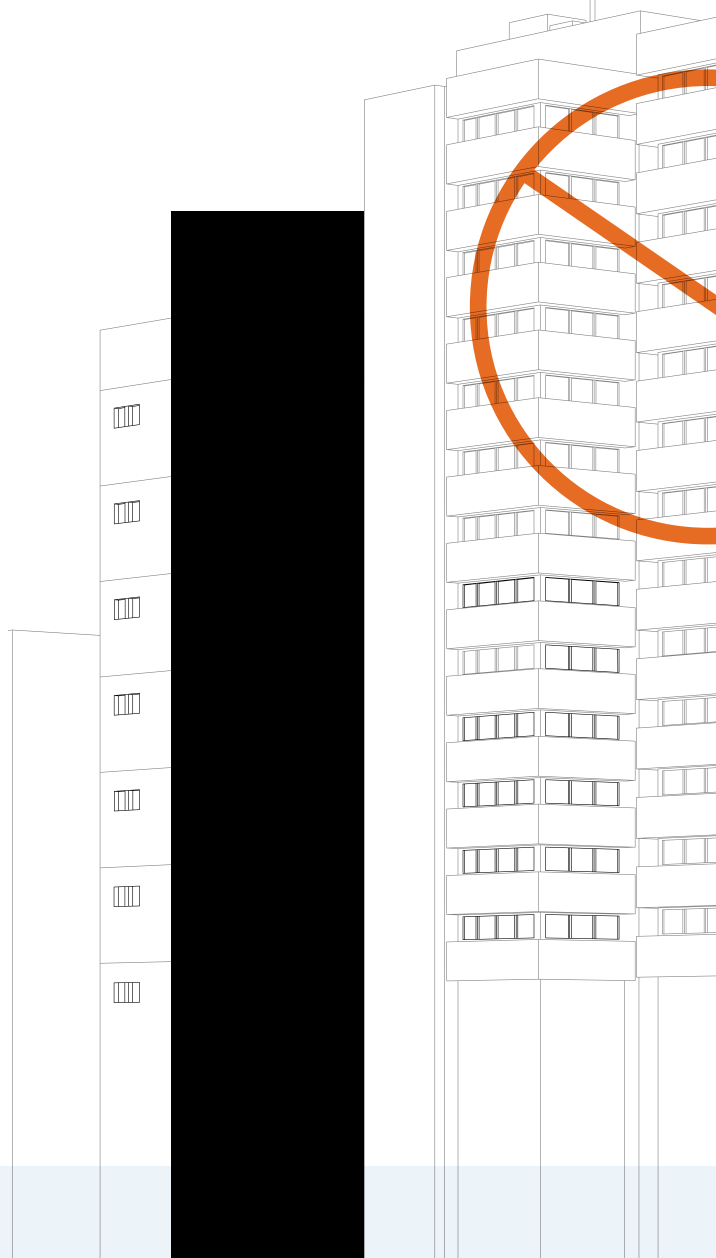
For companies operating internationally, they also face the additional challenge of **capital tied up in slow, manual trade financial arrangements**. Documents verifying that goods have been shipped and received are still sent by mail. Literally, the document flows related to shipping often travel slower than the ships themselves. And until these documents have been received and processed, money remains tied in guarantees and escrow accounts and not where it should be: on the balance sheets on the firms that need it grow.



Some progress has been made in recent years to address these issues, but the revolution has not yet arrived.

**Alternatives began to appear** before the pandemic. Specialist lenders such as Scottish Pacific Business Finance, iwoca, MarketFinance and Funding Circle appeared which opened up new funding sources to SMEs, but not at the scale needed to make a material dent in the funding gap. SME-focused digital banks also emerged, but these were more focused on taking the headache out of cash management & accounting than on giving SMEs the capital to realise their potential. There was also a massive expansion in VC activity globally in the run-up to the pandemic, which has benefitted thousands of SMEs globally, but typically only those with the potential for large IPO or trade sale – and not the 99% of SMEs who need more funding but can't get it.

So, in short, compared to what mid-market firms need, the range of financial products and services they could choose from was inadequate and incomplete even before the world plunged into a socio-economic crisis.





# Pre-pandemic business lending – the building is declared unfit

From one day to the next, through no fault of their own, SMEs all over the world saw business activity collapse. Government-imposed shutdowns made it impossible for many businesses to operate at all, while limiting the general level of activity for most.

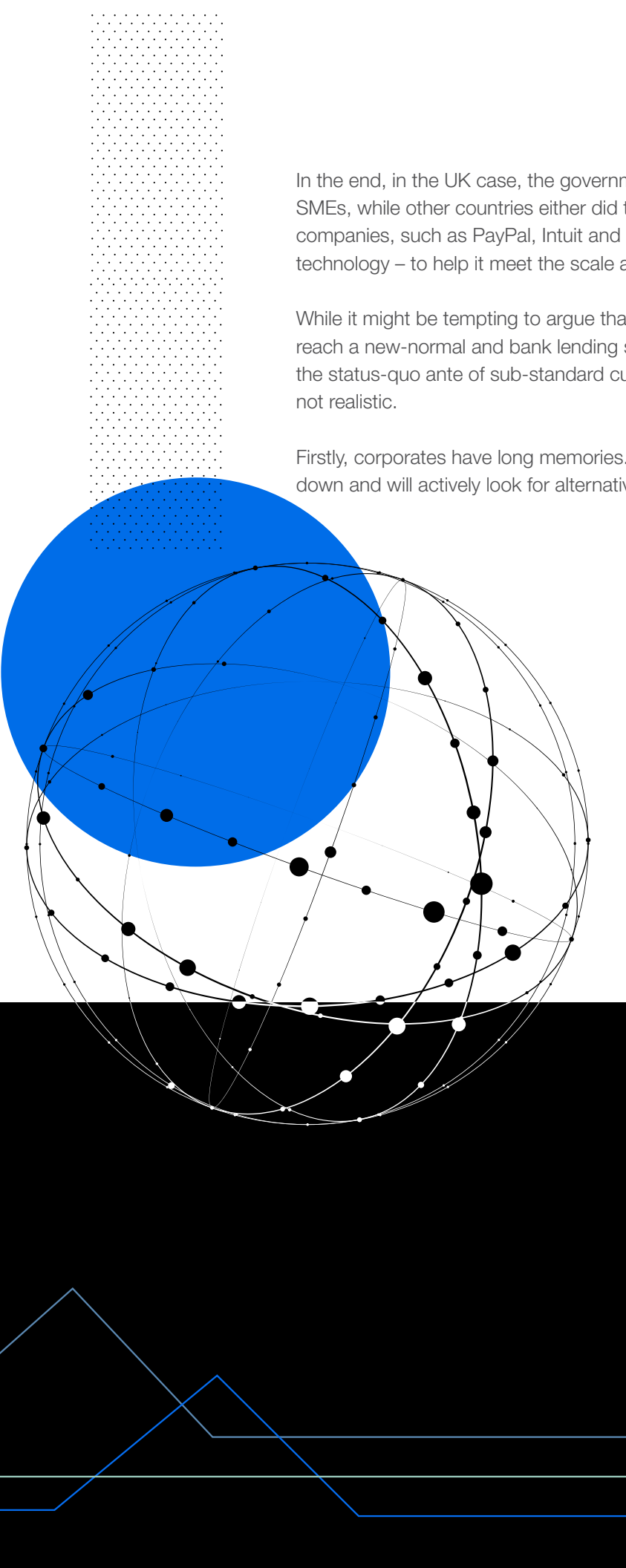
Against this backdrop, SMEs needed an immediate cash injection, but the imperfections of the bank lending system - highlighted in the previous section - meant that this hasn't been possible. When the world needed emergency cashflow the most, the banking sector couldn't deliver on the scale or at the speed required. And, at the same time, the boring and esoteric conversation about modernizing bank systems suddenly went mainstream.

In our [open letter to the Banking Competition Remedies \(BCR\)](#), we tried to raise the alarm about the situation



Millions of SMEs only have weeks before they run out of cash. After this time, irreparable damage will have occurred, both to the UK economy, and to the millions of whose livelihoods depend on these businesses. However, the relief funding, being channelled using legacy bank infrastructure, is not getting there fast enough.

If we take the case of the United Kingdom, a country where SMEs employ over 23 million people, the government made available £330bn to support the country's 5.8m SMEs to bridge through the crisis. Initially, it chose to guarantee up to 80% of these loans and use banking intermediaries to disperse the money. However, by the 23 April, two months into the crisis, banks had only approved 16,000 loans and issued £2.8bn in lending. The scheme had fallen foul to the same issues we described in section one: slow, bureaucratic processes for loan application and assessment had resulted in significant backlogs and high rejections. The only difference from pre-pandemic was that SMEs' funding gap had ballooned – and the world was watching.



In the end, in the UK case, the government moved to guarantee 100% of loans to smaller SMEs, while other countries either did the same or, like the US, enlisted the help of fintech companies, such as PayPal, Intuit and Square – companies with much more modern technology – to help it meet the scale and urgency of the challenge.

While it might be tempting to argue that, post-pandemic, when loan application volumes reach a new-normal and bank lending systems are under less pressure, banks can return to the status-quo ante of sub-standard customer experiences and inadequate products, this is not realistic.

Firstly, corporates have long memories. They will remember the institutions that let them down and will actively look for alternatives post-pandemic.

But, secondly,  
and much more  
importantly, the  
pandemic has been  
an acid test of system  
readiness for the digital  
age that awaits us.

In the digital age, finance is about to be upgraded, augmented and embedded into other services. That lending systems weren't able to rise to the demands of the pandemic only underlines how unfit they are for the future of finance. As one senior banker commented to us 'in the future, we could see the FCA stress-testing digital resilience alongside capital adequacy'.



# Post-pandemic business lending – tuned to the digital age

The popular prediction is that post-pandemic finance will be more digital. The problem with that statement is that, firstly, it's vague – what is digital finance? - and, second, it understates the broader shift that is taking place to embedded or open finance.

In this section, we try to be more concrete about what digitization means for corporate lending as well as to set these changes across the broader context of embedded finance.

## Digitization means more than digital channels

Our economy is undergoing a fundamental shift from industrial to digital. To be able to originate a loan over digital channels, without any paperwork, is a big step forward. But it is by no means the end goal.

### Commercial Lending for Digital Age



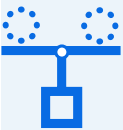
If we were to just make existing products available over digital channels, we would only be exploiting one small facet of digitization. What digitization really means is that everything becomes connected thanks to ubiquitous computing. What digitization gives rise to, as a consequence, is an immense stream of valuable data, which can be used to make better informed decisions and better personalize products and services.

In the context of commercial lending, we foresee several major shifts:



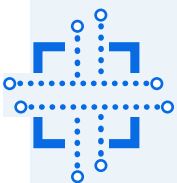
### A shift to Virtual – not just digital

One thing this pandemic has really brought home to banks is that digitalization cannot just apply to customers. Banks have been investing for over a decade in customer innovation, but have spent comparatively little time and money on true digital innovation in the middle and back-office. In their new guise as virtual banks, with hundreds of thousands of support and operational staff working remotely, the underinvestment in banks' own systems has been laid bare as critical functions competed for wifi bandwidth with kids streaming videos and as important calls were punctuated with barking dogs.



### A rebalancing of convenience vs trust argument

To stop the flow of the virus as life goes back to some kind of new normal, we are being asked to consider downloading a new pandemic track & trace app with the rhetoric from some governments that the sacrifice of our privacy is the key to unlocking our freedom. When you look at South Korea's response to the pandemic, it's hard not to argue that by putting their trust into a program that allowed the government to track every case of the Covid-19, the country has not benefited since the adverse impact has been so relatively minor. As the troubles deepen for many SMEs, could this be an opportunity for banks to ask for more trust in return for a more convenient service?



### Embedded lending

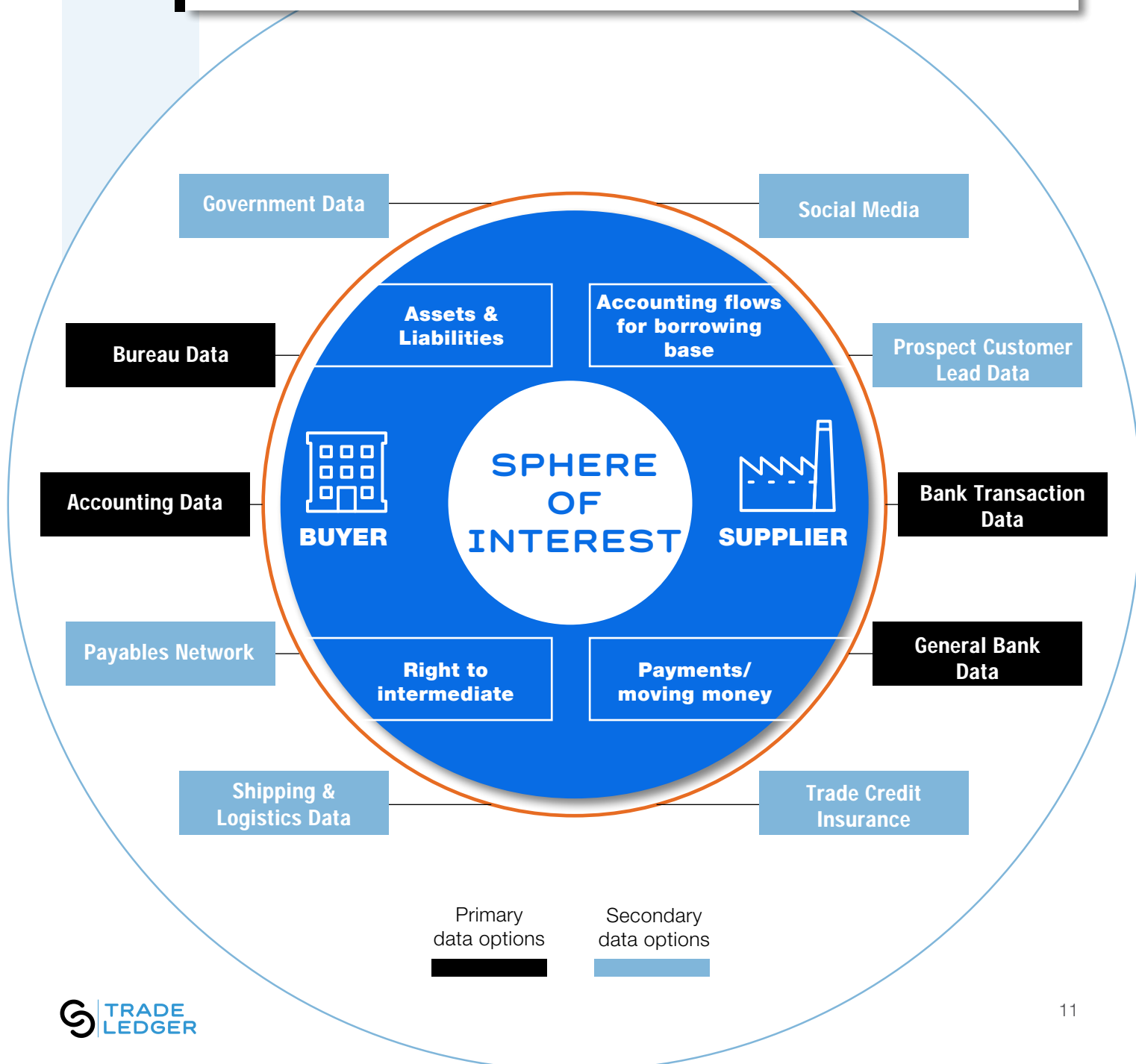
The ultimate destination for digital lending won't be that we can apply for loans through our mobile phones. Instead, once lending has been digitized it will become akin to an infrastructure layer that can be embedded into other services. That means that lending will be available seamlessly when we need it, such as at the point of buying inventory on the Amazon Marketplace, or when we're reconciling our monthly accounts on Xero.



## Data-driven – fostering a new level of personalization and value-add

There is no excuse for banks using historical accounting information when their customers have moved to real-time cloud accounting systems. Similarly, there is no excuse for using bills of lading and other anachronistic tools when their customers are moving to real-time supply chains based on smart inventory tracking.

Not only are data sources becoming real-time, but they are proliferating and becoming easier to access through API, system to system connectivity. Now it is up to lenders to bring together these multiple data sets - structured and unstructured, financial and contextual, internal and external - into a unified data model that is capable of delivering a completely new level of value-add to customers.

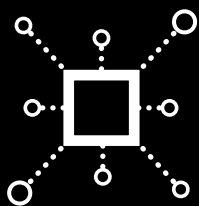


Lending against intangible assets will become routine when banks can access the real-time information to understand and track these assets. Tying up needlessly liquidity in trade finance arrangements will also cease to be a problem once banks have real-time information to shipping information and the progress of manufacturing processes. And, with a deeper reach and understanding into firms' operating metrics (win rates, conversion, churn, LTV and so on) it will be easier for lenders to engage in regular lending to digital age companies.

In essence, with the right data insights, lenders will be in a position to move from standard products based on standard terms to completely flexible services based on the exact context of every customer – giving them the funding they need at the time they need it.

And as lenders demonstrate the value they create as well as their careful consent management, customers will readily share more data. The more data they share, the better lending services can be tailored to them. But also, conversely, where they choose not to share data, customers face not just less customized services, but also likely higher rates. That is, an information asymmetry will grow up between companies that share data and those that do not, where the latter will be subject to adverse selection penalized with higher rates. So, in effect, data will be compelled by both the carrot of better services and the stick of higher rates.

### Intelligent ecosystems

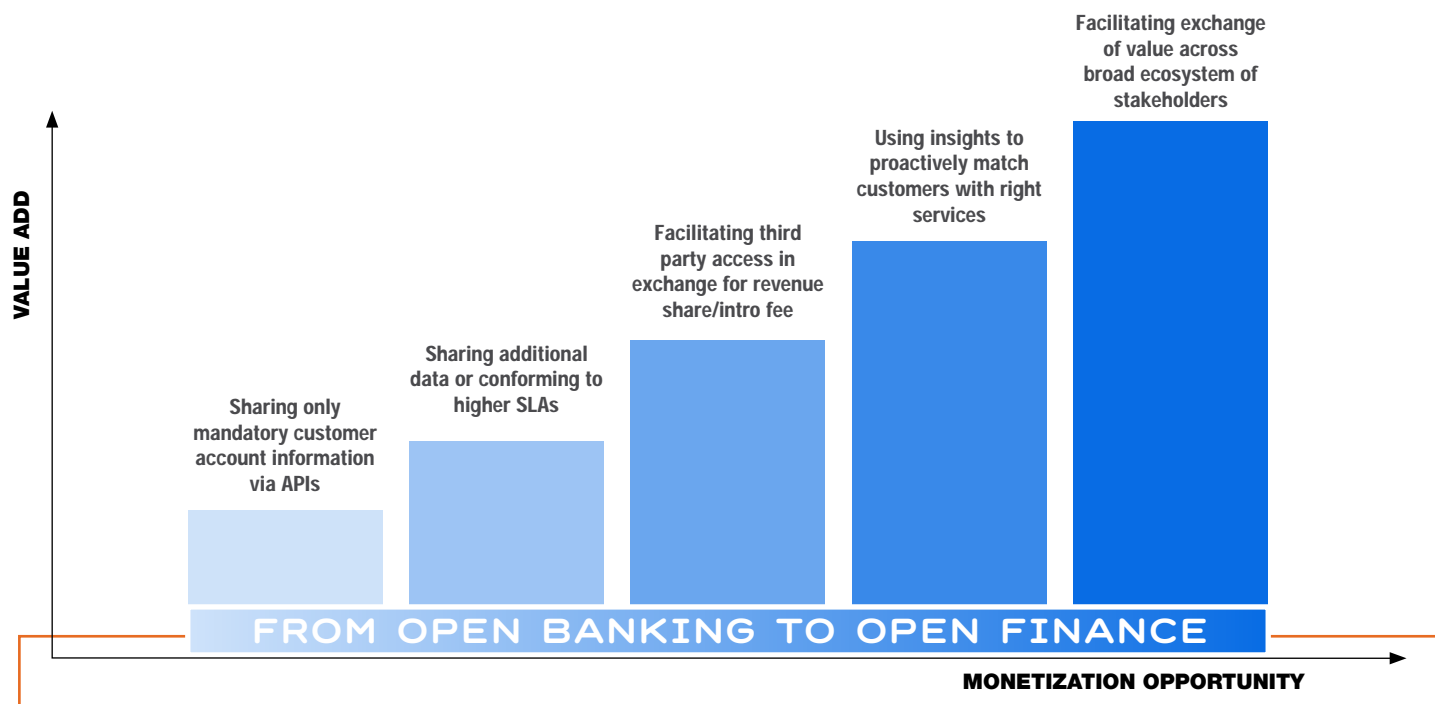


The proliferation of data will not only improve personalization, but will also facilitate new lending ecosystems.

Open banking legislation has been helpful, but it is merely the first step on a road created by the internet, not regulation, towards something much bigger – what we term Open Finance.

Open Finance refers to the free exchange of all customer data that can be used to deliver better outcomes for that consumer. It is happening already with real-time accounting information, but it will soon extend to areas like goods in transit and inventory – after all, it's all data that belongs to the customer.

The important point is that is only with the advent of Open Finance that lending can be truly intelligent and exactly match risk and return and do so in real-time – delivering correctly priced credit at the right place and time.



Once lending has become intelligent in making individual lending decisions, the next step will be to use the information generated from Open Finance to link together the different stakeholders in the value chain – banks with fintechs, consumers with fintechs, banks with banks and so on - to create intelligent ecosystems that deliver even more value by creating optimized, meta services.



To quote [Babak Nivi](#), co-founder of Angel List, there is no longer a trade-off between scale, on the one hand, and quality, on the other; instead, digitization is about pursuing “quality and scale, simultaneously”.

Corporate lending has, until now, been ruled by this trade-off. Financial institutions took the time to make high-quality credit decisions, but this couldn't be done at the scale needed – leading to a \$1 trillion+ funding gap for SMEs pre-pandemic and the bankruptcy of thousands of SMEs during the pandemic.

But with digitization, the trade-off has disappeared. Lending technology can be scaled to meet the demands of SMEs – even in crisis – at the same time as it can be used to make that lending ever more tailored to individual context and delivered at the time of need.

The next section makes the case for why this technology upgrade needs to happen now.

# The imperative to act now

We understand management reluctance to kick off new projects during a crisis, but this crisis won't just "blow over"; instead, it will accelerate secular trends towards greater digitization. It is management's responsibility not to just see out the storm, but to ready its organization for the future that is coming – and time to act is short.

## Digital businesses are winning now

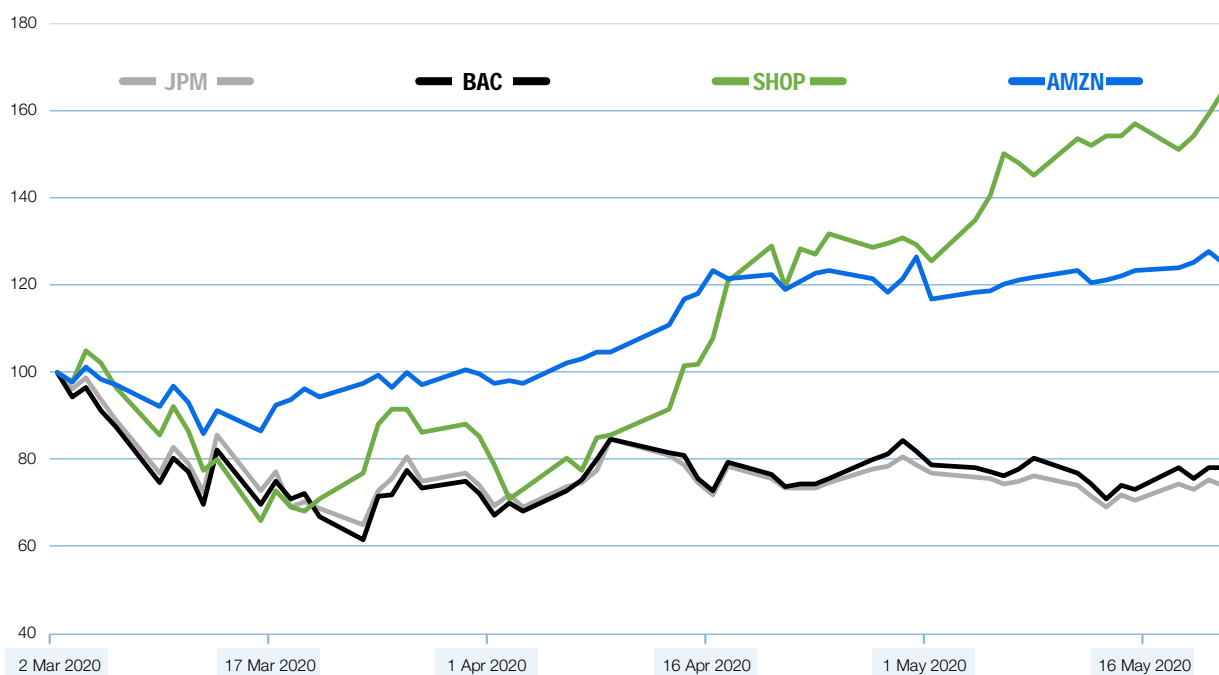
Whenever there is a crisis, the default reaction of many leadership teams is to stop all new investments, hunker down and ride things out. After all, its fiduciary duty is to protect shareholders' money. But is it in the best interest of shareholders – and any other stakeholders for that matter – for a business to be strategically inactive during a period of profound change in its business environment?

We would argue that, even in a time of crisis, leadership teams should be investing for the future. That is not to say that they should be increasing costs during a crisis, but instead they should reappraise existing spending in the light of the new world that awaits us. We estimate that half or more of financial services firms' existing technology projects are no longer fit for purpose – because they are too incremental or because they are too slow to deliver.

The fact is that the post-pandemic world is introducing such a rupture in operating and services models that many businesses' established product/market fit may no longer hold. The crisis has already brutally separated the winners from the losers - Hertz filed for bankruptcy while Zoom went from 10m daily users to 200m daily users in a month – and the characteristic of the winners is that they are either digitally-native or they have made a major digital transformation.

If we look at corporate lending, we should extend our focus to the competitive arena rather than just the industry. As we note above, we are moving to a world of ecosystems and embedded finance. On that basis, the potential disrupters are not just formal lenders but any entity capable of distributing digital services and any entity with excess capital to lend to others. And with that wider prism, we see that the threat is as likely to come from Amazon or Shopify as it is from OnDeck or Wells Fargo and incumbents should be alive to this and act fast to counter it.

Share prices: JP Morgan and Bank of America vs Shopify and Amazon  
– 1 March 2020 to 22 May 2020 (rebased to 100)



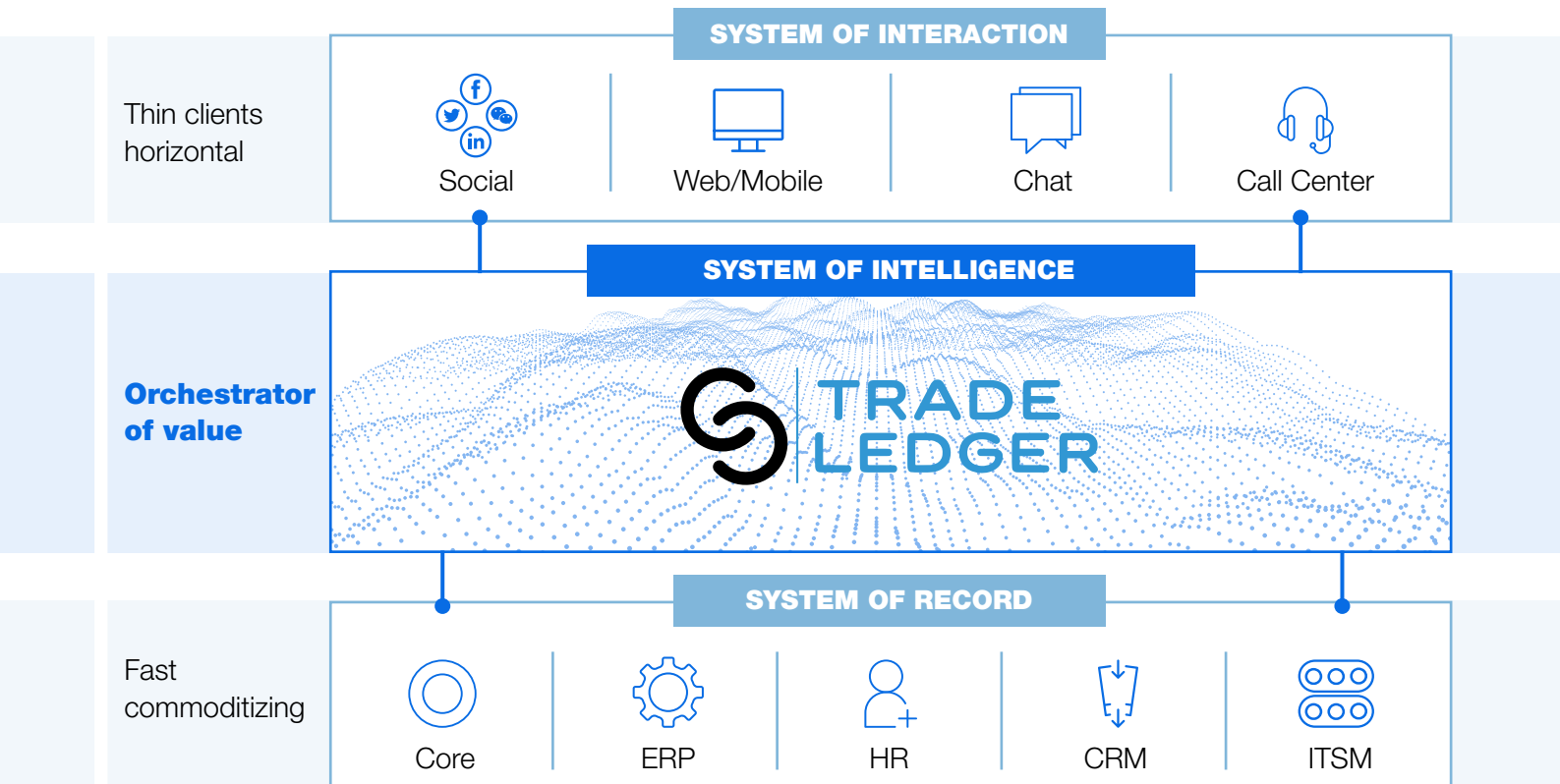
## Getting there fast

The good news is that digitizing your business has very different connotations now than it had even just a few years back.

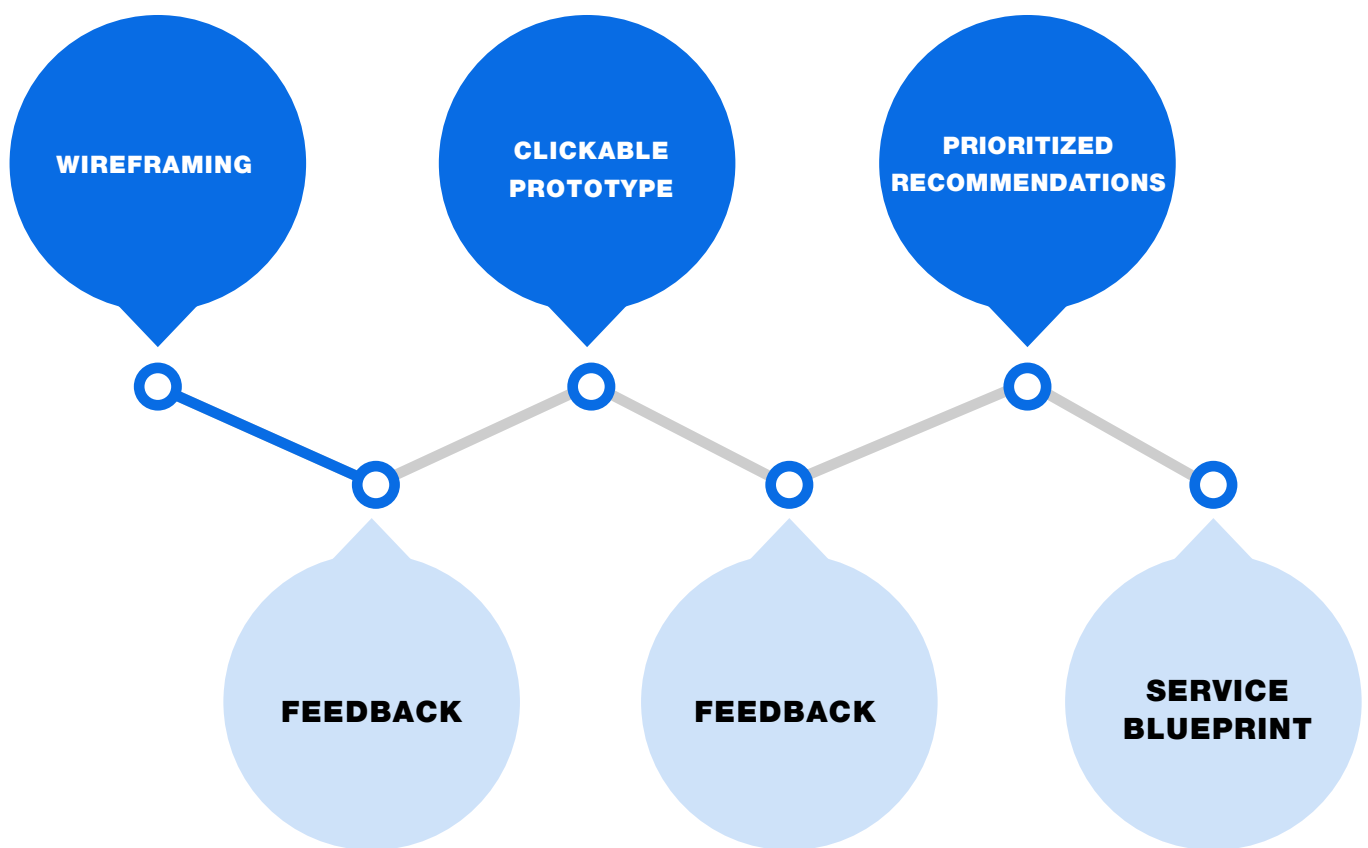
In the past, digitization for banks meant long, risky replacements of legacy core banking, lending and payments systems or investments in digital channels that cost a lot, but didn't deliver much.

What we have learnt in the meantime is that there is a much faster, less risky and less expensive approach to digitization that extends the life of legacy systems (and/or makes them simpler to replace) and increases the return on investment for channel spending.

This new approach involves creating, over time, an orchestration layer that sits between (legacy) record-keeping systems and thin-client interaction channels. We call this layer the System of Intelligence and it is this system that mashes up all of the different data sets – internal and external, structured and unstructured, financial and contextual – to be able to offer up the right engagement and deliver the right lending solutions tailored to the customer's individual context, sourced – or augmented with services – from third parties and delivered over the right channel.



Furthermore, because these Systems of Intelligence are microservices-based, they can be delivered truly in a progressive fashion, use case by use case. Allied with this, many of the providers of these systems – ourselves included, have developed [robust, agile frameworks](#) that can deliver projects fully remotely if necessary (as now) and that provide high impact, low risk returns on investment in a highly predictable manner. In fact, at Trade Ledger™, we won't take on a project that we can't deliver in under six months. The reason that in, the digital world, the pace of change is such that if you're not moving forward, you're going backwards and 6 months is too slow for a project. We need to deliver, learn and enhance.



So while it is imperative to digitize fast, the technology exists to facilitate such a rapid response.



## Summary

For a long time, mid-market companies have suffered from a large, persistent funding gap. This stems chiefly from the fact that existing technology and processes prevent banks from making the right kind of lending products available at the necessary scale.

The pandemic has shone a light on this deficiency. When businesses were unable to function as normal, and even though many governments came forward with emergency credit, the funding gap ballooned as the same systems created a massive bottleneck for this credit.

Post-pandemic, change is inevitable. Companies will demand it. Society will demand it. And digitally-native companies stand ready to provide it.

This change will entail an acceleration to digital business models. As a consequence, companies will be better served with more personalized products made available on better terms and seamlessly through the right channels. **In short, the trade-off between quality and scale is over.**

Corporate lenders do not have much time to react. The pandemic has brought forward the moment where change is both inevitable and urgent.

For lenders that let down their customers during the pandemic, all is not lost, but they must act soon and they might only get one chance to get it right.

The good news is that new

## SYSTEMS OF INTELLIGENCE

for lending have emerged that make the transition to digital models much easier and cheaper. Much better than that, they can be licensed and implemented in a matter of months and act as a catalyst for true operational change.



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