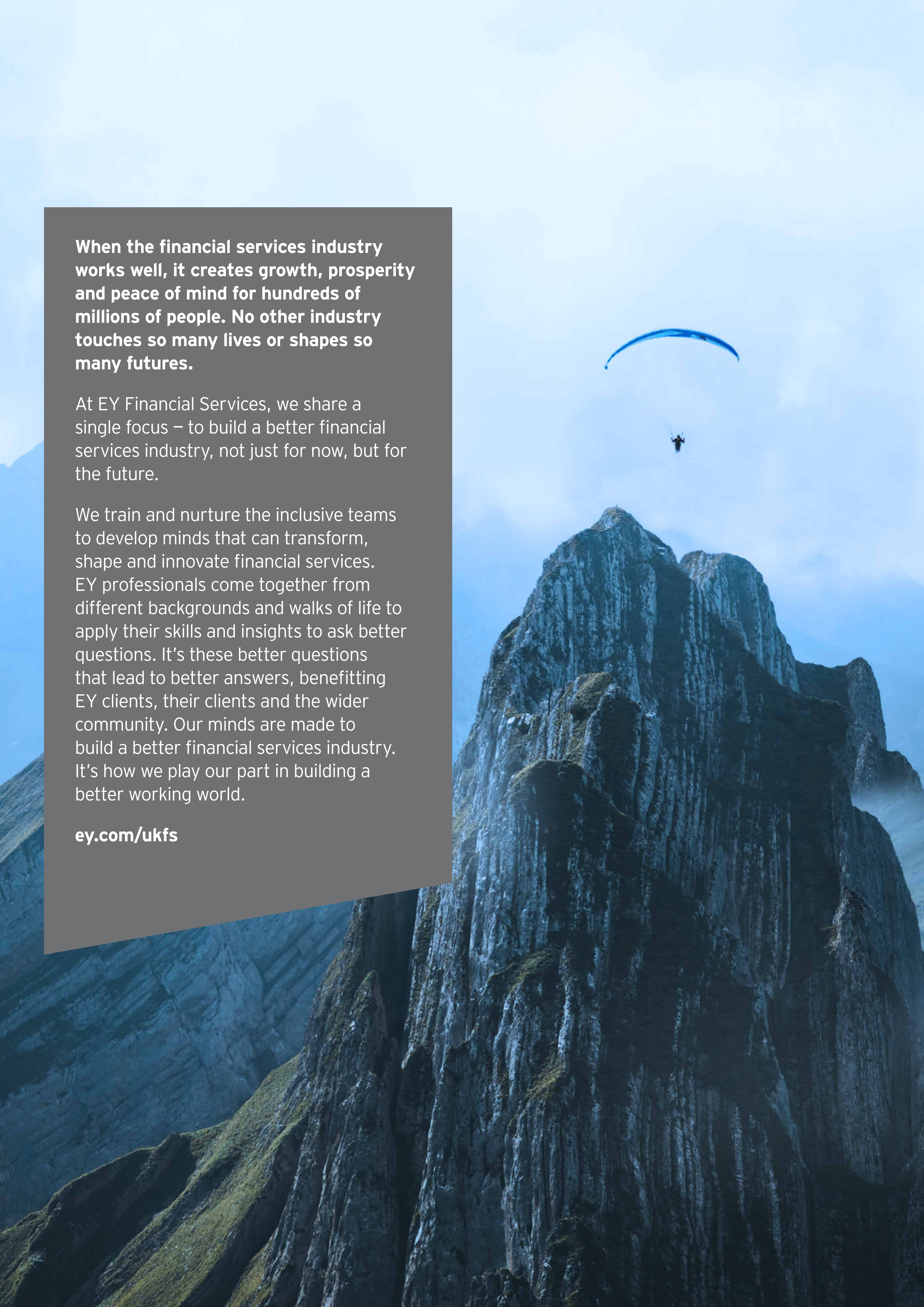
The future of SME banking

Minds made for redefining financial services

December 2018

EY

Building a better working world



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Executive summary

We have identified dynamic changes in the industry, driven by evolving SME needs and enabled by advances in technology.

Entrepreneurs come in all shapes and sizes, from the funky FinTech start-up or family business on the high street to the home-based manufacturer using 3D printers and the power of the internet to reach new markets. The path from start-up to corporate is no longer linear. The banking needs of small and medium enterprises (SMEs) are changing dramatically, and the banks' responses need to evolve accordingly. The UK Government and regulators are applying increased scrutiny to the segment to ensure that there is both innovation and competition in the market.

There can be no doubt that increased access to debt finance and supporting services is required. There are now some 5.5mn SMEs in the UK (representing phenomenal growth in recent years). These SMEs have a turnover of £1.9tn, covering 51% of all private sector turnover in the UK. We are seeing a growing market with many diverse and complex needs; a market that needs better products, more tailored to financial services.

A tangible example of regulatory action is the recent formation of the Banking Competition Remedies Ltd, an independent body which will administer access to £775mn of funding for those that can demonstrate they will address SME needs. The intent is clear: to increase access to capital and supporting services to the SME lending market and support the lifeblood of the economy.

At EY, we believe this is a great opportunity for the market – not only those bidding for funding but everyone involved – to re-examine and re-imagine their propositions, putting the needs of SMEs first.

We think that it's vital that traditional banks, challengers and FinTechs all look at how they can do things better. This is not just about tweaking existing products; it's about having the right propositions and the right support and services. Digital is at the heart of the next wave of SME banking services. SMEs use digital platforms for their businesses and have every right to expect to have their financial services on these platforms too.

This is even more important with the advent of open banking changing the traditional competitor landscape. Firms need to make sure they can combine innovative digital and data offerings, alongside human advice.

In this report, we have outlined a number of questions that we believe firms need to ask themselves with respect to how they can really help the SME community, considering how they can provide additional insight, tools and services that will best serve their customers. Firms that answer these questions the best are likely to come out on top, not just in this funding contest, but in the ongoing battle of attracting and retaining SME customers.

Dan Cooper
UK Banking & Capital Markets Leader
EY

1 What is the status quo?

UK SMEs are a growing and demanding segment accounting for approximately 99% of the private companies in the UK.

1.1 UK SMEs: a growing market

UK SMEs are a large and growing market with turnover of £1.9tn and account for approximately 99% of private companies.

SMEs account for the majority of registered businesses in the UK and are traditionally categorised by headcount and turnover. For the purpose of this publication, we have grouped SMEs into four categories: sole proprietors, micro-businesses, small enterprises and medium enterprises.

Sole proprietors are companies with zero employees. Micro-businesses are companies with a turnover of less than £1mn and fewer than 10 employees. Small enterprises have between 10 and 49 members of staff and a turnover between £2mn and £5mn. Lastly, medium enterprises make up the final segment of the SME market, with 50 to 249 employees and turnover between £5mn and £25mn.

SMEs are the lifeblood of the UK economy. Despite the financial crisis, the total number of SMEs has grown over the previous decade. They have been instrumental to job creation, with approximately 16.1mn employees in 2017, representing 60% of all private sector employment.

They are equally important to UK plc, with a combined annual turnover of £1.9tn, covering 51% of all private sector turnover in the UK. In times of austerity, the Government has relied heavily on the growth of SMEs to help fuel the economy and, in uncertain economic times, further emphasis will be placed on this key sector.

Resilience in times of austerity

We have seen an explosion in the number of new start-ups over the past five years, each with the same basic need to fuel their growth: working capital finance. The number of small and micro-businesses in the UK grew by 1.8% in 2016 to 5.5mn, representing 99% of the UK private sector by volume.

As outlined in Figure 1, the number of active SMEs, defined as those with either turnover or employment over the course of any given year, has grown steadily at 3.8% CAGR. Critically, as well as growing in number, they have also been growing in size, with SME turnover increasing by 5% CAGR from 2013 to 2017 as indicated in Figure 2.

Figure 1: Number of SMEs by size, 2013-17, (000s)

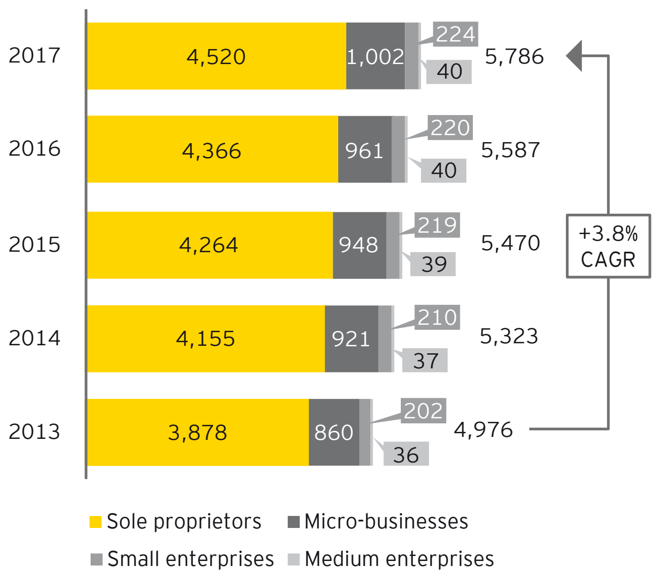
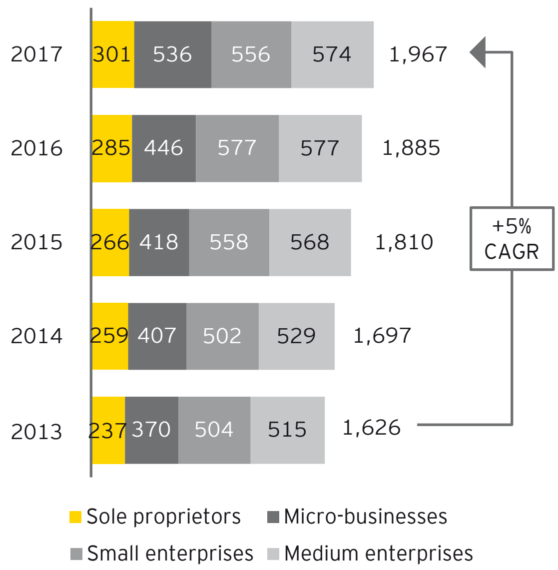


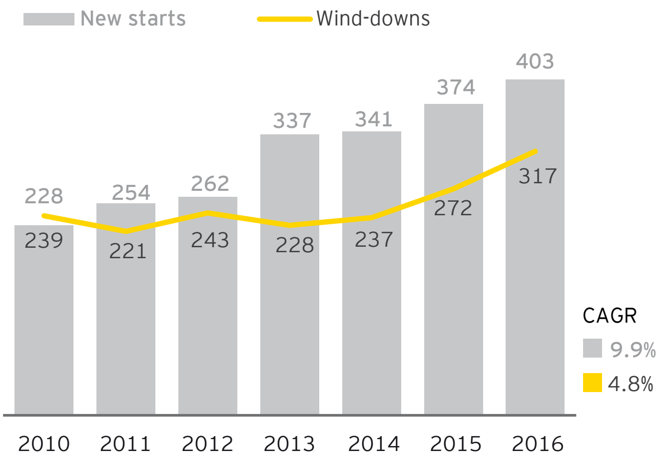
Figure 2: SME turnover by size, 2013-17, (£000s)



Since 2010, each year there have typically been more micro-SME creations (the number of new active companies) than wind-downs (the number of micro-SMEs that ceased to be active). The exception to this was 2010, when wind-downs exceeded new starts, reflecting the impact of the financial crisis which led to the failure of a number of small businesses:

- As illustrated in Figure 3, since 2010, with the increasing health of the economy, there has been an increase in the net number of new companies (9.9% CAGR).
- The spike in new starts in 2013 (year-on-year growth of 28.5%) reflects the UK Government's focus on promoting and protecting small companies following the financial crisis.
- A number of new initiatives were established as part of the business enterprise policy, such as start-up loans (2012) and the Business Finance Partnership (BFP, 2013). Start-up loans have so far provided over £400mn in government-backed loans to young entrepreneurs.
- The BFP aimed to increase lending to SMEs from sources other than banks. It invested over £800mn in 2013 in companies offering finance to SMEs.

Figure 3: Number of micro-SME businesses: new starts and wind-downs



SMEs are not only instrumental for job creation and UK plc but are also an important customer segment for the banking industry.

Whilst attention in recent years has been on serving the consumer market, the SME market generates c.£14bn in banking revenue and 10%–15% return on equity (ROE)* — representing a significant opportunity for existing and emerging financial institutions.

We have provided a view below of the revenue generated by each category of SME.

	Segment	Definition	Total no. of SMEs	Revenue pool[1] (£)
1	Sole proprietors	0 FTE	4.3mn	5.3bn
2	Micro-businesses	1-9 FTE or £0mn-£2mn turnover	1.2mn	2.2bn
3	Small enterprises	10-49 FTE or £2mn-£5mn turnover	208,000	2.2bn
4	Medium enterprises	50-249 FTE or £2mn-£5mn turnover	38,000	6.5bn
5	Corporates	>250 FTE or >£25mn turnover	72,000	16bn

Source: EY analysis, Mintel Small Business Banking — UK — September 2017.

1.2 Dominant incumbents have led to a drive for greater competition

Though business banking is positioned differently amongst high street banks, they have dominated market share.

The major high street banks retain a substantial stronghold of the SME banking market, particularly business current accounts (BCAs), where the top five banks account for around 75% of the market. Whilst their market share is being eroded by the rise of challenger banks and FinTechs, the incumbent players continue to hold affinity with their customers. SMEs continue to trust the brand and reputation of their bank, though they have experienced challenges in meeting their evolving service expectations.

Each of the major high street banks is set up differently to serve the SME segment: at Lloyds Bank, for example, SME customers are grouped into their 'community banking' population, with middle- and back-office operations supported by the retail and commercial banking divisions. The table below provides a comparison of the five major high street banks and provides a view of where the segment sits within their organisation.

SMEs can find themselves dealing with a retail bank for their personal needs and then, depending on their choice of bank for business banking needs, they could be dealing with separate community, commercial, personal or wealth divisions. Data is often not shared across the key business divisions, leading to a lack of detailed understanding and personalisation of the SME user's needs.

Traditional banks look at the UK SME market in different ways, but are united in the challenge to leverage digital and redevelop their products

		Lloyds Bank	HSBC	RBS	Barclays	Santander
Business banking	**Position of business banking**	Between retail and commercial banking	Separate commercial banking catering for all business customers	UK Personal Banking and Commercial & Private	Wealth, Entrepreneurs & Business Banking (Barclays UK)	Retail Banking (Santander UK)
Business banking	**Market commentary**	▶ Lloyds became the first provider to integrate with a third party (Yolt) under Open Banking this year	▶ HSBC increased their SME Fund 2018 to £12bn this year	▶ RBS has announced that they will be launching a standalone Digital SME bank (Mettle) ▶ Separately, it is funding the Alternative Remedies Package to increase competition	▶ Barclays has taken a stake in MarketInvoice and launched SME funds for groups such as UK housebuilders, and Northern Powerhouse	▶ Building an open digital financial services platform for SMEs ▶ Santander are eligible to apply for the Alternative Remedies Package

With increased competition and technological advances, SMEs have a greater appetite for better service and provision of products tailored to their needs. The major high street banks are aware of the dynamic forces at play and are trying to reposition their propositions to the SME market, whether this be in the form of improving the existing products and services on offer, or through the creation of new greenfield digital banks in the hope they can rival their new, legacy-free competition.

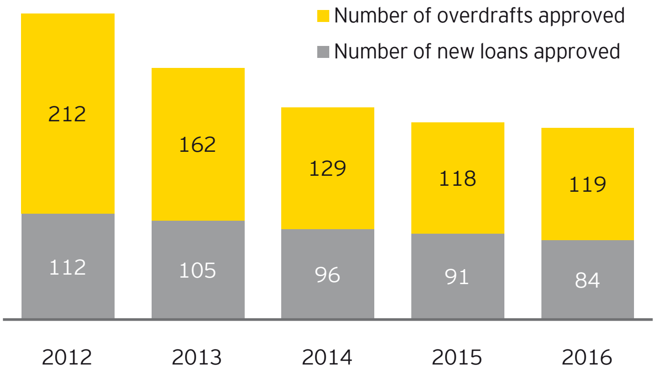
Source: Mintel Small Business Banking – UK – September 2017.

1.3 SMEs are increasingly turning towards alternative sources for finance

Whilst banks have traditionally dominated SME finance, in the years following the financial crisis, we have seen SMEs turn to a broader range of suppliers for their finance needs.

Following the financial crisis and the subsequent increase in regulation, banks have implemented stricter lending requirements, deterring many SMEs from applying for funding and leading to a year-on-year reduction in the number of approved loans (Figure 4).

Figure 4: SME bank loans and overdrafts approved (000s) 2012–16



SMEs have also become increasingly frustrated with what they perceive to be poor customer service through the continued deployment of legacy processes coupled with restrictive finance requirements. This has resulted in SMEs seeking finance via alternative sources (Figure 5).

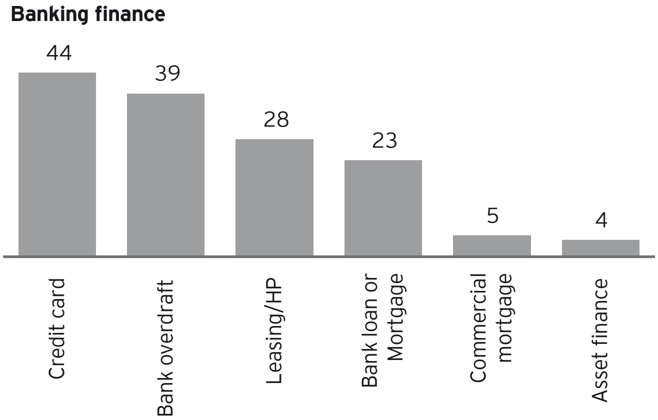
In a recent survey conducted by Ipsos MORI, 36% of SMEs claimed to be seeking finance using loans from personal sources (18% directors in the business and 18% family and friends). Half of those that injected 'personal funds' did so by choice and half felt they had to.

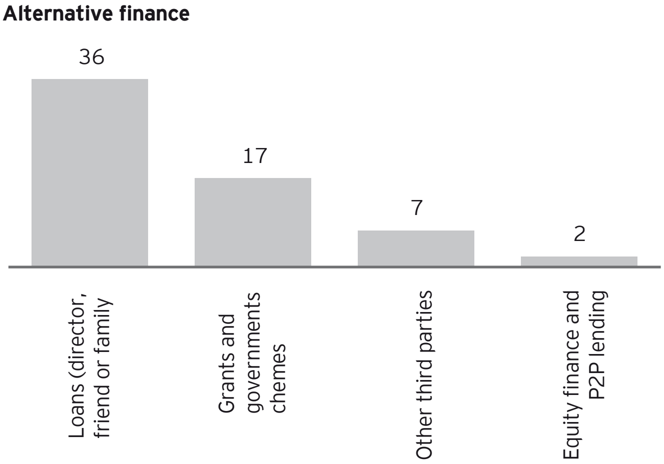
The top barriers to bank finance for 'would-be borrowers' are:

- Discouragement (47%) (put off by bank)
- Assumed they would be turned down and so did not apply (30%)
- Process of borrowing (typically the hassle or expense) (29%)

If banks want to protect a crucial market from being further eroded, they need to address the root causes of SMEs turning towards alternative sources of finance.

Figure 5: SME finance obtained in past three years (% of SMEs using products) 2017





Source: EY analysis, Mintel Small Business Banking – UK – September 2017 and EY analysis (Federation of Small Businesses (FSB) – Verve 'Voice of the Small Business' Panel Survey), 2017 Business Finance Survey: SMEs, Ipsos MORI, February 2017. 'Forms of Finance Obtained within the past three years' (2017). Based on SME sample: 1,535.

1.4 There remains a sizeable market to be served

Despite the rise of challenger banks and FinTechs, there continues to be a significant market opportunity for institutions to grow their footprint.

Whilst consumers continue to be a key focus, the industry has recognised a significant unfulfilled opportunity within the SME market.

There are sizeable areas to grow market share across a number of products that are targeted at the SME sector. The table below provides a breakdown of the growth opportunities with respect to traditional banking products and the current demand by the SME sector.

<table>
<tr><th colspan="2"></th><th colspan="4">Demand for SME banking services – 2017 (£bn)</th></tr>
<tr><th colspan="2"></th><th>Sole proprietor and micro-business</th><th>Small enterprise</th><th>Medium enterprise</th><th>UK total</th></tr>
<tr><td rowspan="5">Lending</td><td>Asset finance</td><td>12.2</td><td>5.1</td><td>1.3</td><td>18.6</td></tr>
<tr><td>Invoice finance (net lending)</td><td>1.1</td><td>4.2</td><td>5</td><td>10.4</td></tr>
<tr><td>Credit cards</td><td colspan="2">10.1</td><td>22.7</td><td>32.8</td></tr>
<tr><td>Business loans</td><td colspan="2">7</td><td>15.9</td><td>22.9</td></tr>
<tr><td>Commercial mortgages and property development</td><td>11.2</td><td>3.3</td><td>1.4</td><td>15.9</td></tr>
<tr><td rowspan="3">Other</td><td>Business current accounts</td><td colspan="2">29.3</td><td>34.9</td><td>64.3</td></tr>
<tr><td>Foreign exchange</td><td>141.5</td><td>178.1</td><td>67.8</td><td>387.4</td></tr>
<tr><td>Savings (balances)</td><td colspan="2">14.5</td><td>17.3</td><td>31.8</td></tr>
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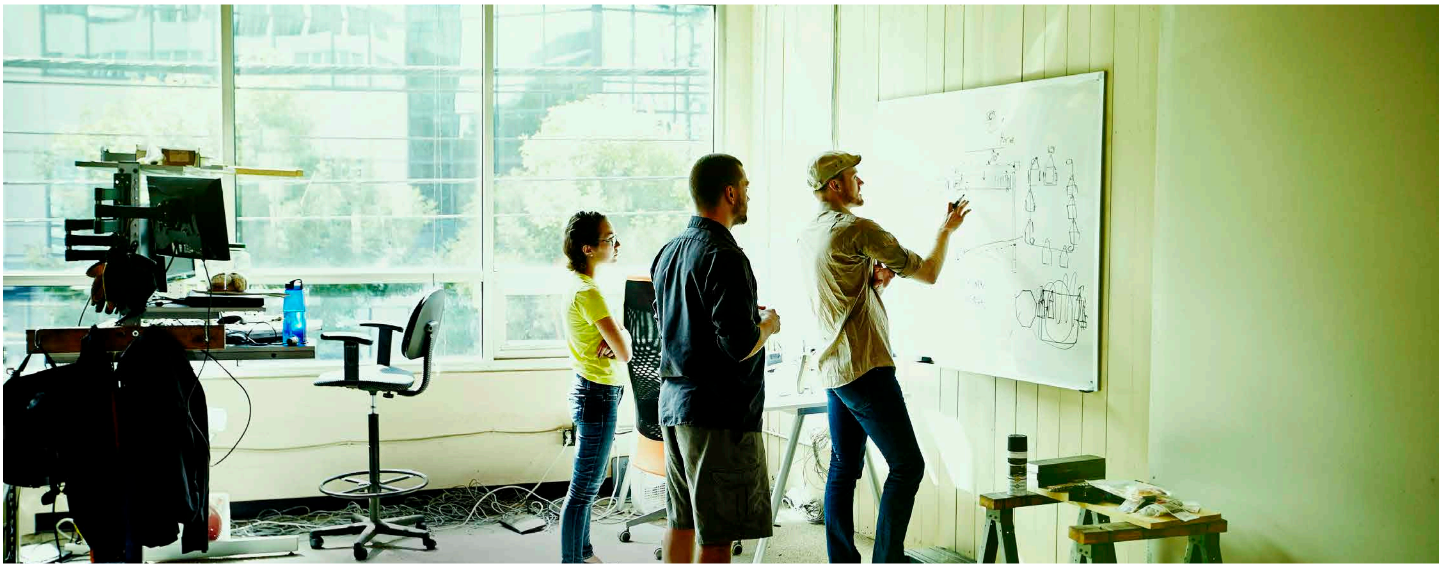
As the number of SMEs continues to grow, we will see demand increasing for products traditionally provided by a financial institution. As well as traditional lending products, there is opportunity for growth in other key product areas such as BCAs and foreign exchange (FX).



Source: Finance and Leasing Association (FLA), UK Finance, The UK Commercial Property Lending Report, Cass Business School, Mintel, Office for National Statistics, HM Land Registry, L.E.K. Consulting Analysis HiFX, Bank of England (BoE), The UK Cards Association, CreditCards.com, EY analysis.

2 Changes in the SME banking landscape

New entrants to the market are capitalising on the previously unmet needs of SMEs

2.1 The market is awakening to the opportunity

Pre-crisis, the market was served primarily by traditional banks and specialists; post-crisis, a number of new entrants such as FinTechs and challenger banks have emerged.

There is now stronger competition in the UK SME banking landscape. A decade ago, an SME would turn to the traditional banks or to niche specialists for sources of finance. Today, there is a much broader range of options, with each provider striving for critical market share.

Figure 6: New entrants targeting SMEs

Market Landscape in 2007

Traditional banks

- Lloyds Banking Group*
- Santander*
- HSBC
- Royal Bank of Scotland
- Nationwide
- The Co-operative Bank
- Clydesdale Bank
- Dankse Bank

Specialists

- American Express
- Close Brothers
- Bibby Financial Services

*Entities renamed post-acquisitions since 2007

A sample of new entrants, products and brands launched to the SME Market (2008-2017)

2008	Capify						
2009	Aldermore						
2010	Funding Circle			Metro Bank			
2011	Ezbob	TradeRiver	ThinCats	Funding Knight	Nucleus Commercial	MarketInvoice	Shawbrook Bank
2012	Capital on Tap	365	Start up Loans	Iwoca			
2013	Merchant Money	FOLK2FOLK	Pay 4	PayPal – SME Lending			
2014	Spotcap	Lending Crowd	Fleximize	Amazon Lending			
2015	Oak North	Growth Street					
2016	Newable	Esme					
2017	Redwood	Tide					

Legend – competitive segments

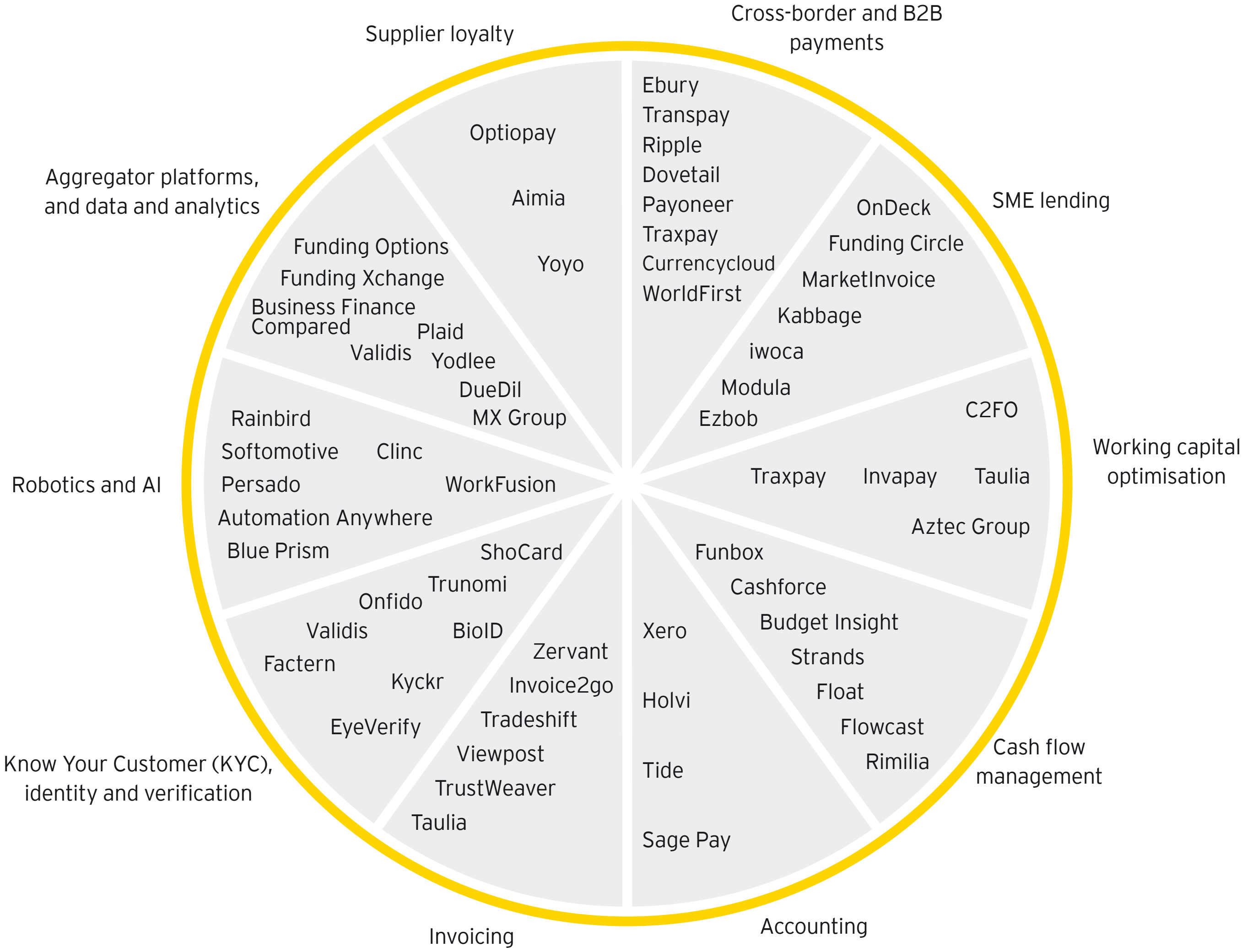
- Traditional banks: incumbents offering a comprehensive range of products to SMEs and large corporates
- Specialists: specialised, product-led players offering a narrow range of products to specified customer segments
- Challengers: specialised banks targeting particular customer segments, including non-bank brands and digital-only banks that have emerged post-crisis
- FinTechs: new entrants leveraging tech-enabled innovations to micro-SME lending products and business models
- PayPal launches working capital loans to merchants in the UK
- Amazon enters UK SME lending market offering small business loans to website companies

2.2 FinTechs are also disrupting the market

Additionally, a number of FinTechs are active in the business banking space, offering products and services to address a spectrum of targeted needs.

The table below shows a selection of FinTechs that have impacted the SME market in recent years.

Figure 7: FinTechs targeting the SME sector



The range of services offered to SMEs by FinTechs is both broad and deep, enabling SMEs to access new levels of financial services that were historically only available to corporate clients.

2.3 The regulator is incentivising this change

The Alternative Remedies Package was introduced in 2017 to boost competition through regulatory intervention.

In 2009, the European Commission approved a number of state aid measures granted to The Royal Bank of Scotland Group plc (RBS). This approval was given on the basis of a restructuring plan submitted by RBS and a number of commitments given by the UK Government, including the divestment of a part of RBS' branch-based retail and SME business, which later became known as Williams & Glyn (the divestment).

As a result of considerable challenges in achieving the divestment, the UK Government proposed substituting the 2014 commitments with a revised package of measures, with the objective of promoting competition in the market for banking services to SMEs. The Alternative Remedies Package was agreed in principle in July 2017 and formally approved by the European Commission on 18 September 2017.

Fund	Details
Capability and Innovation Fund (£425mn)	▶ The Capability and Innovation Fund aims at encouraging challengers to develop and improve their capability to compete with RBS in the provision of banking services to SMEs, to develop and improve financial products and services available to SMEs. ▶ This fund will be administered by an independent body and will comprise of 15 grants that eligible challenger banks and other financial services providers can compete for to increase their business banking capabilities. ▶ These awards will range from £5mn to £120mn and have been categorised into four pools: ▶ Pool A – for development of advanced BCA offerings ▶ Pool B – to facilitate modernising existing BCA or new proposition development ▶ Pool C – to facilitate development of SME lending and payments ▶ Pool D – to facilitate commercialisation of FinTech providing SME services
Incentivised Switching Scheme (£350mn)	▶ The Incentivised Switching Scheme funds are to be used to encourage SME customers who were intended for Williams and Glyn (W&G) to switch their BCAs and loans to eligible challengers ▶ The funding aims to incentivise 120,000 relevant SMEs to switch their accounts to eligible challengers, comprised of: ▶ £225mn paid in the form of 'dowries' to challengers to incentivise SMEs to switch their BCAs ▶ £50mn to facilitate the switching of related loans ▶ £75mn set aside by RBS to cover customers' switching costs

2.4 The rise of the challenger banks

More than 50 institutions have been granted a banking licence in the UK since 2008, with a number focusing on the SME banking market.

A number of challenger banks have emerged with a specific focus on serving the needs of SMEs, including those detailed below.

Aldermore	Aldermore was launched in 2009 as a specialist lender and savings bank to SMEs, homeowners, landlords and individuals. Key products include savings accounts, mortgages, invoice financing and asset finance. Following its acquisition by FirstRand, Aldermore is planning to employ investment from its new owner to accelerate the delivery of its business banking proposition.
Shawbrook Bank	A specialist bank founded in 2011 that focuses on the needs of SMEs and individuals, Shawbrook Bank offers savings products, loans, commercial mortgages and business finance. It is currently following a diversification strategy to expand into new areas such as motoring, online estate agencies and new propositions such as financing for IVF.
OakNorth Bank	A specialist lender launched in 2015 focusing on UK entrepreneurs and owner-managed businesses, OakNorth Bank was established on a cloud-based technology platform, using machine learning techniques and artificial intelligence tools. Key products include business savings, loans and property finance.
Redwood Bank	A 'born in the cloud' bank that launched four months after receiving its banking licence in 2017, Redwood Bank focuses on lending to local communities in the UK from offices in Letchworth and Warrington.

New challenger banks and fintechs have emerged that are successfully targeting a specific set of financial needs. These new challengers are not constrained by legacy processes or technology, and are able to offer targeted products and value-add services created specifically to meet the demands of the SME business.

2.5 The major high street banks are beginning to respond to disruptive forces

Businesses professionalise as they grow — and banks can help SMEs develop their financial maturity and capabilities.

Whilst focus may have been on averting the flow of consumers to disruptive players, the major high street banks are also now focusing efforts to retain their market share in the SME market.

A number of market forces are driving this impetus, stimulating a new critical period for the development of competition in the SME banking sector.

Collaboration and partnerships	Banks are increasingly partnering with providers of SME services to increase the attractiveness of their proposition. NatWest has partnered with Sensibill, an electronic receipt management system which is built into the bank's banking app. Other banks are providing access to alternative sources of finance via select partners or discounted access to SME tools such as Xero accounting software.
Contest over the £700mn Alternative Remediation Package	Smaller rivals, including Clydesdale Bank and Metro Bank, are competing for funding from the Alternative Remedies Package. The pool, which will be funded by RBS as a result of regulatory pressure, will be available to a number of challenger banks and financial service providers, with the intention of creating further competition in the SME banking market.

Those high street banks that leverage their deep knowledge of business banking and sector specialisation (such as agriculture), and combine it with the richness of data available to them, will be able to offer increasingly competitive products and services to SMEs.

3 The evolving needs of the SME

Bespoke targeting of SME customers to address individual needs

3.1 Small business owners have unique needs, many of which are not addressed by traditional banking propositions

As a consequence of the complex needs of small business owners, SMEs are increasingly turning to challenger banks, FinTechs or non-financial institutions to service their financial needs.

Techniques such as design thinking, improved customer experience and the use of internal and external data provide opportunities for banks, FinTechs or non-financial institutions to service SME financial needs by segment. Several examples identified by EY research are listed below:

The storefront entrepreneur	The factory home	The freelance plc
		
I need to meet my financial goals.	My first year was critical.	I had to get the location right.
It's my name on the door.	I want more time with my customers.	Digital is at the heart of my business.
I can't be great at everything.	I miss having peers.	I am open to collaboration.

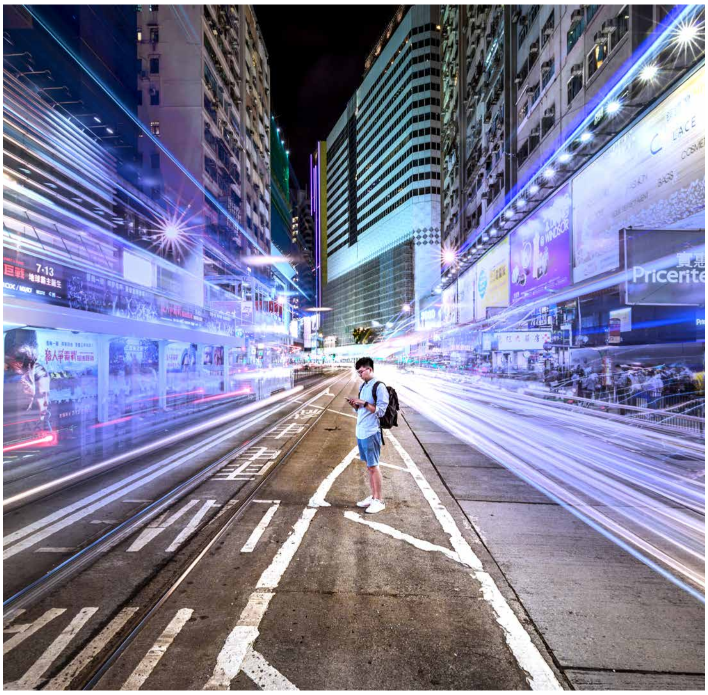
Designing products and services around the jobs that SMEs need to do provides the basis for more targeted and innovative solutions. This can include addressing previously unmet needs such as cash flow management, working capital solutions and payroll services.

3.2 Targeting products to business life stages

There is a real opportunity to grow market share across existing products, by tailoring products for each SME segment.

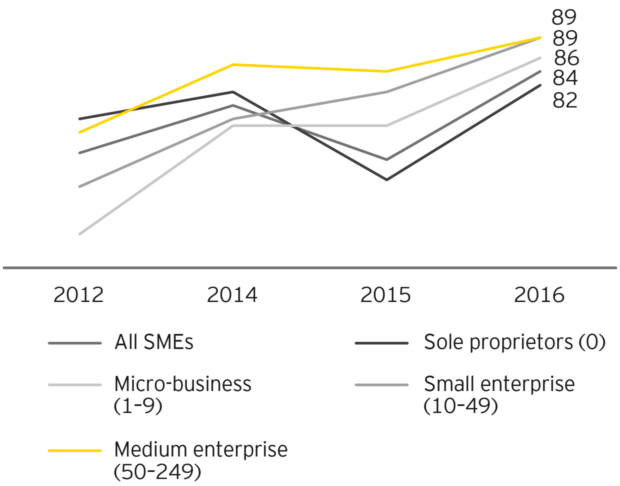
There isn't a 'one size fits all' approach to servicing SME customers. Rather, providers should tailor their proposition to service a specific SME segment or offer products according to the life stage of the SME.

As small businesses grow, their needs become more complex – creating an opportunity to provide tailored products based on maturity stage, to help them realise the next stage in their growth journey.



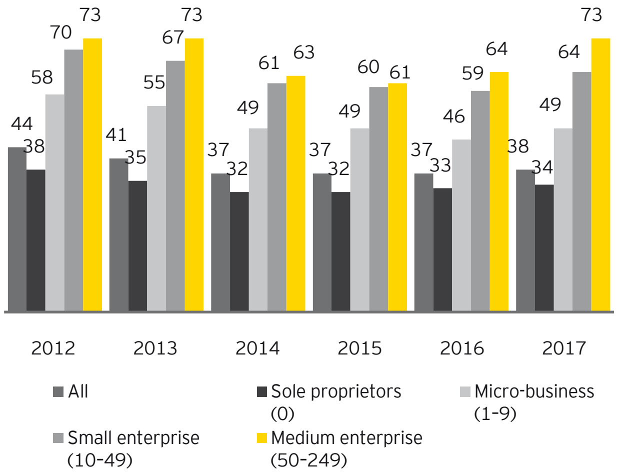
Success rates for lending applications vary by the size and scale of an SME. As demonstrated in Figure 8, the success rate for lending increases as the business grows.

Figure 8: UK SME success rates in applications for finance (%)



Base: All SMEs that sought external finance in the last three years, %, 2017 (886 in 2016)

Figure 9: SME use of external finance by size, %, 2017



External finance, such as bank loans and lending, is a key source of funding for SMEs. As shown in Figure 9, use of external finance is much higher amongst medium SMEs. In 2017, 73% of medium businesses (with 50–249 employees) used external finance compared with 49% for micro-businesses (1–9 employees). Medium enterprises are a key area for business finance and consistently demonstrate approximately 50% higher demand for financing.

Whilst lending outcomes are broadly positive, the service and experience often fails to meet the needs of SMEs, presenting a sizeable opportunity for institutions that are able to deliver an exceptional customer journey.

3.3 Needs become more complex as SMEs grow

The businesses that constitute the SME sector are hugely diverse, with needs that depend on both their development stage and their industry focus. Small business owners want their bank to provide targeted solutions based on their business needs.

As shown in the following table, SME needs vary by the size of business.

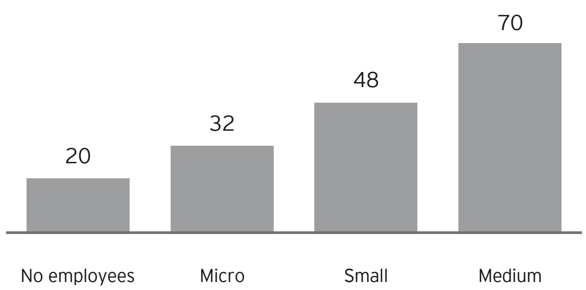
	Micro-business (1–9 employees)	Small enterprise (10–49 employees)	Medium enterprise (50–249 employees)	Corporate (250+ employees)
Example drivers behind need for working capital finance	▶ Day-to-day liquidity ▶ Smoothing out irregular cash flows with low level of predictability ▶ Releasing liquidity for growth ▶ Seeking less rigid, time-consuming forms of finance	▶ Day-to-day liquidity ▶ Smoothing out irregular cash flows that may be highly predictable ▶ Releasing liquidity for growth ▶ Seeking less rigid, time-consuming forms of finance	▶ Releasing liquidity for growth ▶ Performance metric management ▶ Investment for short-term projects	▶ Performance metric management ▶ Investment for short-term projects
Financial challenges	▶ Highest credit risk across all segments ▶ Generally find it difficult to provide security, but owners may be able to provide personal guarantees ▶ Limited financial data available ▶ Very limited ability to handle administrative burden ▶ Limited ability to handle multiple relationships with finance providers	▶ Higher credit risk than larger firms ▶ May find it difficult to provide security ▶ Limited ability to handle administrative burden ▶ Limited ability to handle multiple relationships with finance providers	▶ Higher credit risk than larger firms ▶ Limited ability to handle administrative burden and complexity of some traditional products	▶ Lowest credit risk across all segments
Level of financial engagement	▶ Generally no dedicated finance function ▶ Low awareness of financing options	▶ Relatively unsophisticated finance function ▶ Relatively low awareness of variety of financing options	▶ Sophisticated finance function ▶ Awareness of variety of financing options	▶ Sophisticated finance function ▶ High level of awareness of variety of financing options ▶ Ability to automate processing of payables and receivables

Businesses professionalise as they grow

Unless businesses professionalise, there is a risk the wrong financial products maybe used.

As SMEs grow in size, they are more likely to engage financial specialists to professionalise and manage the complexity of financial products they use.

Figure 10: SMEs employing a financial specialist (%)



Source: EY analysis/Harvard Business Review (HBR)
https://www.bdrc-group.com/wp-content/uploads/2018/03/RES_BDRC_SME_Finance_Monitor_Q4_2017.pdf.

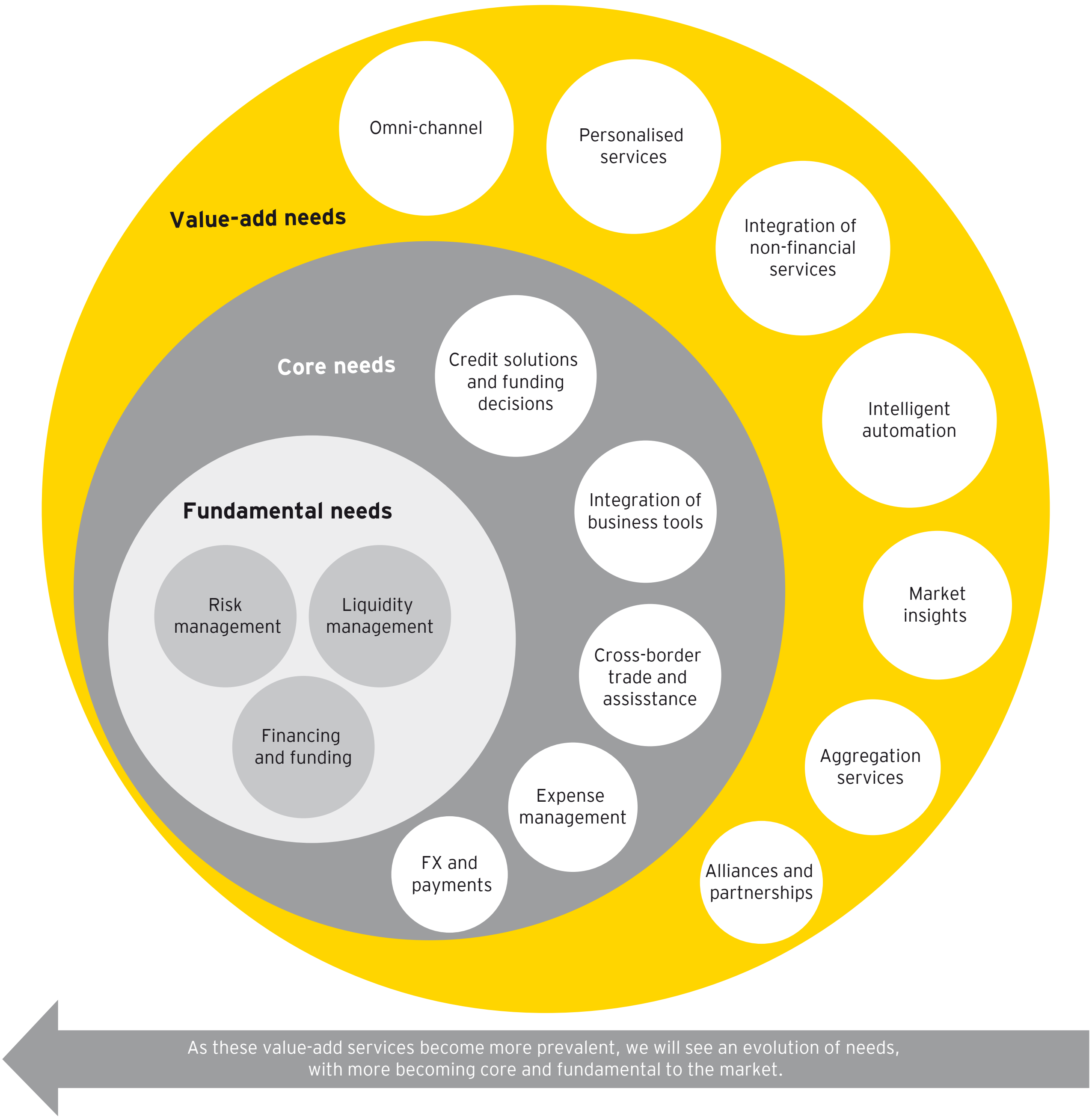
3.4 The emergence of ecosystems for SMEs is a global trend

The introduction of value-add services on top of traditional core banking offerings is allowing providers to position themselves in the centre of an SME's financial network.

In the face of constant competition within the SME banking market, providers need to provide a broader, more integrated offering with relevant value-add services. The provision of services beyond those traditionally offered within the core banking proposition will enable access to new revenue pools that may have been previously inaccessible.

Moreover, strengthening the understanding of the SME market will reinforce and bolster their SME relationships. This will not only deter SMEs from switching, but will also widen access to information that can then be used to tailor current services and gain further insights into the SME banking sector.

Figure 11: SME value-add needs



Single provider

SMEs are increasingly looking for an easier way to meet all of their needs to run their business. This provides an opportunity for providers that are willing to address wider business needs to deepen their relationship with their SME customers.

3.5 SMEs want an omni-channel experience

Omni-channel banking provides seamless and consistent customer interactions through multiple touchpoints. Integrating digital and traditional channels into a truly omni-channel offering helps to anticipate and fulfil customer needs seamlessly across multiple channels.

A number of financial institutions are either developing or have recently launched digital offerings to the market. Whilst this will serve a significant proportion of the market, some SMEs will continue to demand an omni-channel experience in order to benefit from existing products and solutions such as cash management or alternative lending via intermediaries.

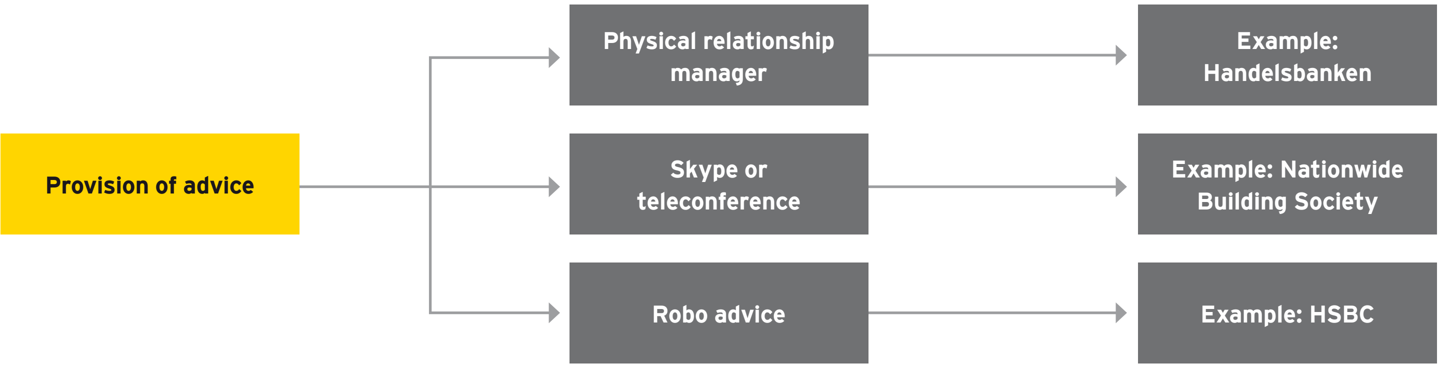
Cash solutions

For SMEs that want to maintain cash-based banking services, a digital-only service will not suffice.

Cash withdrawals and deposits | **Cash management** | **Safe deposit boxes**

Alternative lending

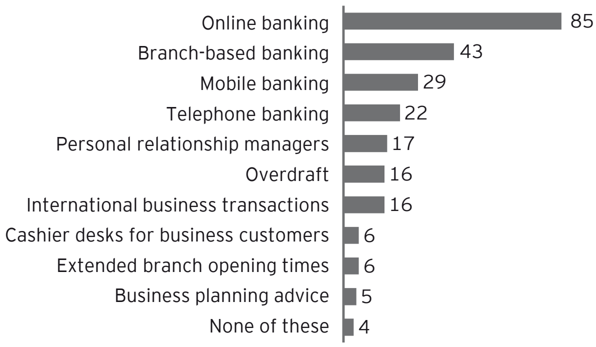
A number of SMEs are happy to use online channels only; however, as needs increase in complexity, SMEs are more likely to use advisors and third-party intermediaries.



Whilst the use of online banking remains the main touchpoint between an SME and its bank, as demonstrated in Figure 11, SMEs are still engaging with their bank via traditional channels for business purposes:

- 43% of SMEs have used their branch in their past three months compared with 29% using mobile banking.
- Personal relationship management continues to be an important offering which SMEs are using, with 17% interacting with the relationship manager in the past three months.

Figure 11 : Financial services used by SMEs in the last three months for business purposes (%), 2017



Those wanting to provide the most comprehensive SME proposition will need to provide an omni-channel experience, either through their core offering or by tailoring any targeted proposition to the need of SMEs, i.e., provision of branch-based banking for SMEs that have identified the need for cash solutions.

3.6 SMEs' advanced customer needs are not being met consistently

Despite the emergence of challenger banks and FinTechs, there is a gap between the increasing expectations of SMEs and what is being offered by incumbent players in the market.

Whilst there have been some new offerings to the market, the pace of change has been slower than demanded by some SMEs, and offerings can appear to be undifferentiated or based on the retail banking product. Propositions across the market show gaps in fulfilling the full suite of SME customer needs.

	High street banks	Challenger banks	FinTechs
Current proposition	▶ SME proposition, including BCAs, offered by all major banks ▶ Wide product range, but service focused on low cost only ▶ Strong insurance capabilities	▶ Specialised propositions based on knowledge of the SME market	▶ Specialised proposition usually based on specific SME need, e.g., lending solutions
Areas of strength	▶ Brand loyalty ▶ Low switching rates ▶ Products across full SME growth spectrum ▶ Customer contact options (branch, online and telephone)	▶ Products created to serve specific segments or industries ▶ Longer-term lending solutions ▶ Flexible lending options ▶ Personalised approach	▶ Digitally enabled offering built on new agile platforms without the constraints of legacy systems ▶ Frictionless processing and pace of change to introduce new feature-rich functionality
Areas of focus	▶ Innovative offerings via digital platforms and increased speed to market ▶ Catering to other service needs of SMEs e.g., accounting, HR, payroll ▶ Personalising solutions ▶ Using data more effectively to meet SME needs	▶ Building market share ▶ Developing transactional banking propositions ▶ Expanding suite of services to include value-add such as accounting and cash flow management (CFM)	▶ Customer contact options ▶ Developing in-house capabilities as businesses scale ▶ Partnerships and alliances to provide a complete solution offering to SMEs

3.7 What options can be employed by players in the market?

We expect there to be a number of pathways that will be employed by key players to provide the full spectrum of new innovative products and services required by SMEs. Banks will no longer dominate the provision of SME financial services. New application programming interface (API)-enabled platforms and mega tech platforms will start to target the SME sector.

Ecosystem and platform approach	New API-enabled platforms will enable providers to deliver a wide range of innovative third-party products and services, generating consumer stickiness and creating a network effect as the number of ecosystem participants expand.
Tech companies offering the full suite of services	Tech giants could enter financial services by extending their platform to provide core banking services such as BCAs and lending. Furthermore, the big tech platforms could leverage the abundance of customer data, advanced data analytic techniques and frictionless user journeys to offer new propositions such as cash flow management and working capital solutions.

These key pathways are described in more detail in the following sections.

4 The future: SME services in a platform world

Finding the right pathway for your business

4.1 It is not possible to ignore the rise of platforms and the development of ecosystems

Financial institutions must choose what role they want to play in the new world of open APIs. Options exist to create an API-enabled ecosystem market in the SME finance value chain, providing innovative third-party products and services to SME customers.

The prevalence of API technology in the ecosystem will also play a part in transforming and digitising relationships with SMEs, changing the way in which products and services are made available.

In an ecosystem where SME customer account and transaction data can be shared, the process of finding and applying for banking services, such as credit, will be quick and seamless.

The rise of API-enabled platforms

An API-enabled platform is a digital infrastructure that allows multiple stakeholders (the providers – platform owners, third-party developers, distribution and services partners – and end-users) to connect online, interact, and create and exchange value with each other. Participants in platforms shift from operating within a specialised industry to being part of a broader ecosystem, expanding their reach by linking to interconnected businesses from across multiple sectors. Operating in an ecosystem allows providers to fulfil customers' needs through an integrated user experience, raising collective value for all participating stakeholders involved.

These API-enabled platforms are based around four key principles:

1	**Data**	They are powered by interconnected customer data. Data is the collective digital asset upon which entire ecosystems are built, allowing providers to utilise integrated customer information and new data insights captured within their platforms to determine product strategies, identify new market opportunities or craft new commercial opportunities.
2	**Customer-centric gateways**	The ecosystems within platforms are highly customer-centric marketplaces that allow consumers to access and switch between a range of related offerings across different providers without needing to toggle between portals or manage multiple login identities. An example of such a frictionless gateway is Facebook Messenger, which enables users to instant message, make voice and video calls, transfer funds, place reservations, interact with retailers and play games amongst other features.
3	**Network effect**	They create a network effect as their ecosystem of participants expands. Well-constructed platforms take on a momentum of their own as participants interact, generate reciprocal value and help extend these ecosystems. As ecosystems grow exponentially, providers are collectively able to deliver a wider range of solutions and generate consumer stickiness. This, in turn, creates much greater distribution and access to a broader range of customers than could easily be achieved by any single company.
4	**Open APIs and standards**	Solutions on platforms are built using open APIs and standards, creating new distribution opportunities via partner technologies and channels, and facilitating expansion into complementary services or new, adjacent businesses. Given the more diverse community of providers, customers also benefit from feature-rich experiences and a much wider scope of offerings compared with the original platform.

4.2 Transitioning to a platform-driven business

Financial services providers are transitioning from a linear value chain to platform-driven business models.

From this ...	To this ...
Traditional value chain: product focused	**Platform-based models: customer obsessed**
▶ Typically singular provider ▶ Purpose-built solutions, with independent product offerings ▶ Proprietary protocols ▶ 'Command and control' product development methodology ▶ Slower time to innovate via a linear value chain (development, distribution and marketing to the consumer)	▶ Diverse community of providers (platform owners, developers and partners) and customers ▶ Solutions are built on an extensible platform, leveraging open standards ▶ Offerings are interoperable, feature-rich and targeted ▶ Flexible, iterative development and crowd-sourced innovation

Platform-based models in financial services

Platforms and their ecosystems are most mature within consumer-centric verticals such as health care and medical advisory, travel, real estate and financial services. In financial services, an ecosystem encourages financial institutions (FIs) to go beyond a proprietary, product-oriented approach (see table above) and work with partners to deliver comprehensive solutions that can simplify customers' financial lives.

For instance, insurers are embedding themselves into wider ecosystems for mobility, connected homes and cars, health diagnostics, medical advice and financial planning. Global payments technology companies, such as Visa and Mastercard, have platform strategies to connect card issuers, acquirers and other payments service providers to merchants and consumers for seamless e-payments.

Ideally, these innovative delivery models should embed customers' financial interactions as part of their daily activities (such as shopping and entertainment) and help them achieve financial goals (such as funding business expansion, property ownership or a trade acquisition).

This is possible due to rich customer data that enables FIs and their ecosystem partners to better understand customers and develop personalised or contextual offers that satisfy their current and perceived future needs.

Where there are regulatory mandates requiring open API policies, customers also benefit from new third-party collaborations. In those markets, customers' options for financial solutions will evolve from the current linear model to one where products and services are not limited to an individual institution's offerings.

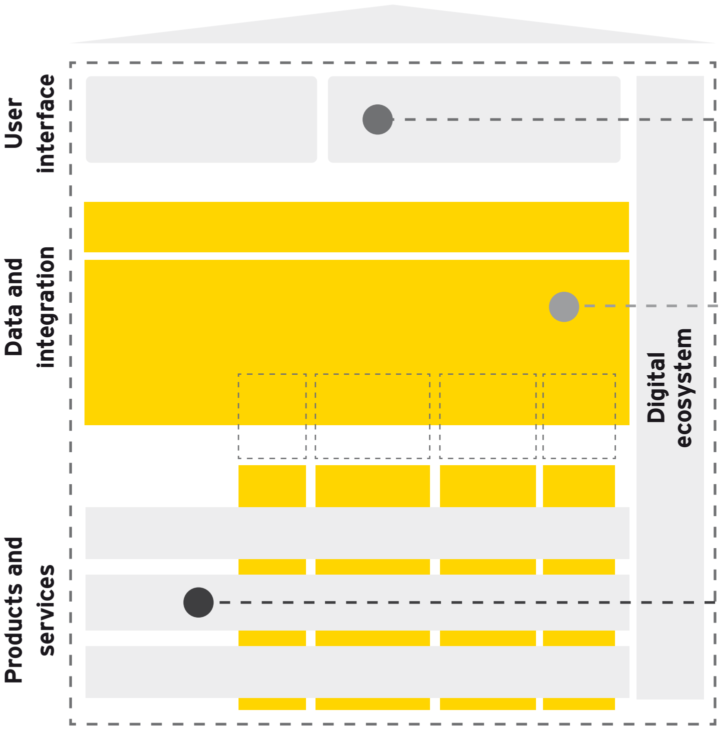
We expect to see financial platforms further evolve to digital FI 'app stores', where customers can select desired services from multiple providers to build their own bespoke financial experiences.

4.3 Ecosystem and platform approach

A platform model is not only a new evolution of the banking business model; it also involves a major shift in culture and mindset. It implies building long-term win-win partnerships with an ecosystem of external providers to fulfil the holistic needs of SMEs.

Recognising the elements of a platform enables providers to decide where to focus.

Simplified description of the platform model



The **user interface** is the backbone of the SME customer experience, enabling the distribution of proprietary or third-party products.

The **data and integration** layer, built as an open platform, is connected to the digital ecosystem, with its own data layer and business process management.

The **products and the services** support the design and development of components that can be monetized to serve the needs of SMEs.

Financial institutions could adopt a number of platform scenarios as part of creating a future-proof SME bank.

EY has identified five ways financial institutions can reshape their future. In each of these, the provider takes on a new role, focusing on different building blocks of a typical bank.

Financial providers could decide to reflect holistically and define a model that the entire organisation reshapes towards. Alternatively, they could adopt different models for different parts of the banking value chain: for example, for a particular market, product or service line.

As a result, providers may adopt one or several future banking models. We have provided a high-level view of five scenarios below.

Scenario 1: Producer integrated model	The provider will supply integrated financial operations and technology, either as a full end-to-end banking proposition or for specific products or markets on a white label basis.	Revenue is generated by the organisations buying products and services from providers.
Scenario 2: Facilitator	The provider will offer specific components, rather than the full end-to-end proposition, such as KYC, management information, underwriting processes and data analytics.	
Scenario 3: Service provider	The financial organisation will compete with other providers, operating like an IT outsourcing provider but with banking ability.	
Scenario 4: Marketplace provider	The marketplace provider will be convenient for customers and attractive to third parties. This may include the creation of new value propositions, such as extending banking with non-banking products and services.	Revenue is generated by the end customer.
Scenario 5: Experience provider	The experience provider will need to provide a superior customer experience that can attract high volumes of new customers and increase the loyalty of existing customers.	

4.4 What questions should be asked when addressing platform options for SMEs?

1. Customer

In a platform-based model, the relationship model with SME customers may change. Banks are at risk of becoming a utility in the SME value chain, providing SME customer account data to FinTechs and aggregators.

> How will you maintain existing relationships with your SME customers when third-parties become a key part of the value chain?

2. Revenue and profitability

The increased transparency enabled by open banking will increase transparency, choice and competition for SMEs, potentially reducing brand stickiness and eroding profit margins.

> If traditional revenue sources are eroded, how will you ensure that SME financial products remain profitable? How can you leverage the platform model to create new sources of revenue (e.g., enhancement of SME products and services enabled by new insight provided by FinTechs)?

3. Risk and regulation

A platform-based banking model introduces new types of risk. These risks are amplified by the growth of open banking and the prevalence of API technology. Providers must consider the risk associated with moving to a platform-based business model.

> Can the provider protect itself against the regulatory and conduct risks associated with adding new participants to the value chain?
>
> What security vulnerabilities does the financial organisation need to protect itself (and its customers) against in the world of open APIs and shared data?

4. Technology and scalability

Building or participating in a platform ecosystem requires significant technological transformation. FinTechs have the flexibility to build new solutions at pace with changing customer needs. Banks must possess the fluency to align and integrate with these FinTechs.

> How should the bank upgrade its legacy systems to meet the demands of a platform-based model?
>
> What processes can be automated to provide friction-free and streamlined operations, so that the provider's capabilities can be delivered in real time as a platform-based service?
>
> How should the provider update its development approaches (e.g., Agile adoption, DevOps)?

5 The rise of technology firms

Mega tech platforms target the SME sector

5.1 Tech companies could offer the full suite of services

Technology firms are recognising the challenges faced by small businesses in obtaining finance. Technology and e-commerce firms are using data to reinvent SME lending and disrupt the traditional business banking model.

These organisations have an abundance of data about merchants' finances and business operations, and use machine learning to study trends and predict future creditworthiness. This not only enables well-informed lending decisions, but also replaces the more manual services historically provided by traditional banks. Many of these platform companies rely on e-commerce merchants for their revenue, so there is a mutually beneficial interest in providing working capital to SMEs.

The advent of open banking will only increase the availability of data in the industry, and providers should consider whether they need to adopt a partner-based model to avoid losing market share to new technology entrants.

Tech and e-commerce companies are already disrupting the market

Technology firms are already providing services which mirror traditional SME banking products provided by high street banks. Outlined below are a number of example services provided by technology firms which are disrupting the market.

Traditional banking	Product alternative solution	Overview
Current accounts	**Cash solutions**	▶ A number of tech firms are providing their customers the ability to shop without a debit or credit card number on their e-commerce platforms or in stores by using a personal barcode or mobile number. ▶ This functionality could be extended further across multiple points of sale (POS) and rival traditional personal and business current accounts.
Business credit cards	**Revolving credit line solutions**	▶ A major US technology firm has launched a 'revolving credit facility' for SMEs.
Lending	**Lending solutions**	▶ A US technology firm has partnered with a banking partner to provide loans to its merchants. ▶ Whilst the current partnership allows the tech firm to better manage its credit risk exposure, should it build a credit risk capability, it would be able to lend off its own balance sheet.
Payment solutions	**Payment solutions**	▶ A number of technology firms have launched their own payment solutions for e-commerce companies where they can accept online and mobile payments via their payment facilities.

5.2 Technology firms are disrupting banking

Whilst a number of areas will be impacted by the entrance of mega tech platforms, we have focused on three below and outlined some of the key considerations for banks.

Area	Impact	Key consideration for banks
Customer	▶ SMEs' and online merchants' trading and working capital requirements can now be met in the same place by technology firms. ▶ Furthermore, the scale and depth of the data used by these firms is unmatched by traditional banks. If non-financial services firms are better equipped to understand SME needs (particularly online merchants), banks will need to reconsider how they should manage customer relationships. ▶ On the other hand, banks' established relationship management models may continue to anchor the customer to their existing banking relationships.	▶ Is the bank better off refocusing its efforts, and allowing online SMEs and merchants to be financed by technology firms? ▶ Would a partnership model be more beneficial? ▶ Should the bank begin to offer any non-banking tools to its SME customer (e.g., financial management tools)?
Revenue and profitability	▶ In an era where technology firms are using predictive analytics to tailor financial products, banks will not be able to rely on traditional revenue sources, such as interest income and fees. ▶ Traditional banks' focus on the performance of their loan portfolios may also need to be reconsidered. Tech companies' income in the SME space will be generated by offering more tailored products such as cash flow management, payments and lending. ▶ Banks must also face the challenge of keeping operating costs down in the face of digital channels employed by technology firms.	▶ Does the bank need to re-assess its revenue model and consider moving away from reliance on traditional sources of income? ▶ How can the bank keep its operating costs low whilst serving the interests of its SME customers (e.g., process automation)?
Risk and regulation	▶ Technology companies may be able to use data to make better decisions than traditional banks. As such, they can sub-segment the SME market by risk profile, targeting SMEs according to risk appetite.	▶ How can the bank manage credit risk whilst serving the interest of its smaller merchant customers? ▶ If technology firms are offering unsecured lending options to SMEs, how can the bank do the same?

6 Closing the gap: how do you create a future-proof SME bank?

Making the transition from bank to business partner

6.1 Closing the gap: deciding where to excel in building an SME offering

Digitisation provides an opportunity for new ways of working, deciding where to excel and how to differentiate. The starting point and strategy of the SME offering will determine the actions that need to be taken. Detailed below are five areas of focus.

1. Be digital
Challenging existing business models to industrialise innovation and operational agility, creating new sources of value based on novel banking products and services

Transform — Innovate
1 2 3 4 5

2. Digitising legacy
Transforming core functions by upgrading outdated IT systems and processes to provide a new wave of innovation, such as rapid elasticity

Legacy technology — Cloud-enabled
2 3 4 5

3. Experience thinking
Providing the blueprint for experience strategy that enables market growth and differentiation

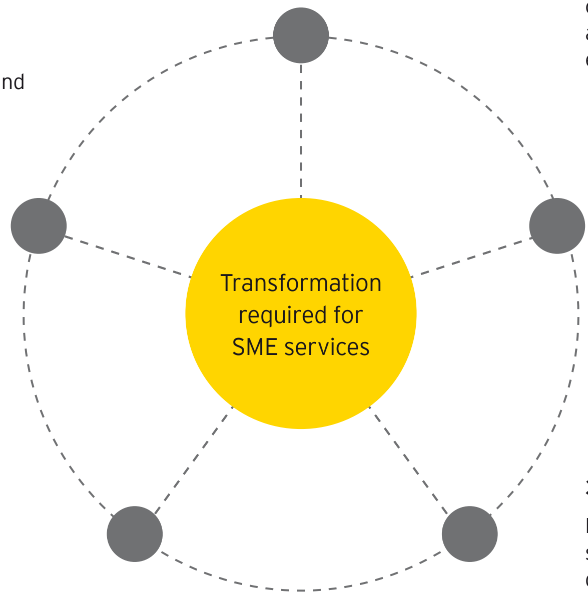
Undifferentiated experience — Customer journey differentiation
2 3 4 5

4. Digital platform thinking
New API-enabled financial marketplace, accelerating innovation and generating new commercial opportunities

Siloed products stack — API-enabled marketplaces
1 2 3 4 5

5. Digital trust
Operating a secure, compliant and protected environment to serve SMEs across both physical and detail channels

Reactive and unplanned — Robust, resilient and protected
1 2 3 4 5



EY's digital enterprise transformation services are delivered by practitioners who are passionate about the contribution of SMEs to our economy. For more details, please contact one of the authors of this paper.

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