Guide to Disruption in Small Business Banking

autobooks

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Introduction

“Banks have enormous competitive threats — from virtually every angle. Fintech and Big Tech are here... big time!”

Jamie Dimon, CEO, JP Morgan Chase, in his annual letter to shareholders

The majority of financial institutions (FIs) want both small business relationships and commercial relationships. But in the inevitable tug-of-war that comes with prioritization, it’s typically the latter customer base that reaps the benefits. From a business standpoint, it makes sense. Commercial clients generate higher margins and less foot traffic — while small businesses eat up finite resources.

This sort of preference may not be explicitly embraced at your institution. However, a quick look at most banking websites will bear out this reality. A small business owner will encounter a bewildering assortment of commercial accounts and treasury management services — along with the one requisite small business account. But as we will see, the majority of these accounts and services woefully underserve small business needs.

The problem is, over time, preferences are put into practice. And most FIs will set their sights up — toward higher profit margins. In the other process, they abandon the bottom end of the market: specifically, micro- and small businesses.

And it is this very tendency that has opened the door to disruption.

In the last ten years, we have seen an onslaught of new competitors. FIs must now contend with first movers —big tech players and fintech challengers — while keeping up with megabank rivals with deep pockets and established customers. In 2020 alone, we saw Square become a bank, Stripe Treasury offer embedded banking to a number of platforms, and Quickbooks unveil a small business deposit account.

Small business is a huge contributor to the GDP and to banking. SMBs generate $850B of annual revenue for banks, a pool expected to sharply rise in the next seven years. The U.S. economy is further changing the look of small business: independent workers now hover at 41 million adult Americans of all ages, skills, and income levels — consultants, freelancers, contractors, solopreneurs, temporary, or on-call workers — who work independently to build businesses, develop their careers, pursue passions, and/or supplement their incomes. Together, they combine to make a powerful economic force.

Over the past year, independent workers generated roughly $1.28 trillion of revenue for the U.S. economy — equal to about 6.2 percent of U.S. GDP (2018), or the entire economic output of Spain.

Incumbent banks — especially the larger ones— are not likely to go away anytime soon. But they also can't afford to continue to ignore small businesses (SMBs).

In addition to full-time independent workers, more Americans are taking up a side hustle to supplement their income. In 2019, these occasional independents rose in ranks 6.3 percent to 15 million. That number is up more than 40 percent since 2016. Over the next five years, we project 53 percent of the U.S. adult workforce will either be working or will have worked as an independent. (For more on the state of small business, please take a look at Autobooks Small Business Report 2020.)

In this guide, we will delve into the factors that have led to this crowded competitive environment through the lens of disruptive innovation theory. To better familiarize ourselves with this important concept, we will review the process step by step, with a focus on the small business banking space.

Our desired outcome is two-fold:

- First, in describing and applying this theory, we will help your financial institution to make better sense of the current competitive landscape, and the factors that contributed to this disruption in the first place.
- Secondly, that you take this opportunity to re-evaluate your small business offerings and course correct if necessary, so that you can begin the hard work of reclaiming and growing small business relationships.

Throughout each chapter, we will look closely at one disruptor in particular, Square, to serve as an ongoing case study.

The Role of Jobs to be Done

This guide is designed to be read alongside the Autobooks Guide to Small Business Customer Research. The latter guide delves into the theory of jobs to be done, and the four specific jobs of the small busines owner according to our research. The theory of jobs to be done (JTBD) was developed in part as a complement to the theory of disruptive innovation.

According to JTBD, people buy (or “hire”) products and services in order to make progress with some problem they are struggling to solve in their lives. A company can quickly gain traction in the market by building products and services that help customers solve their workflow-related challenges — regardless of whether they are an established player or a new disruptor.

The team at Autobooks applies the jobs to be done framework to help ensure the needs of the small business are never set aside. The “jobs” we have defined inform every aspect of our business — including our product roadmap, marketing services, small business customer service, and financial institution training.

JTBD theory can help companies better understand consumer behavior by helping them to uncover the rationale behind their decision making.

2.

What is Disruptive Innovation?

“Inequity is a breeding ground for disruption, leaving underserved markets for insurgents to seize and launch an attack on incumbents from below. We have good reason to believe that’s happening in banking.”

Scott Galloway, Professor of Marketing, NYU Stern School of Business

At its core, the theory of disruptive innovation is intended to help established companies identify and mitigate disruption — ideally before it takes hold — so that the incumbent can continue to operate and grow.

The following definition comes from the Clayton Christensen Institute, founded on the theories of Harvard professor Clayton Christensen:

"Disruptive Innovation describes a process by which a product or service initially takes root in simple applications at the bottom of a market — typically by being less expensive and more accessible — and then relentlessly moves upmarket, eventually displacing established competitors."

Importantly, disruptive innovation takes time, and introduces products to the market that are never as good as the current products and services — at least not initially. However, these disruptive offerings provide other desirable benefits, such as convenience, ease-of-use, affordability, and simplicity.

Once these entrants gain a foothold at the bottom of the market, their product(s) will undergo refinement and improvement, until they can meet the needs of the majority of customers in the middle. Established companies (incumbents), in a bid to move upmarket and capture higher profits, often ignore these competitors. By the time they take notice, it is usually too late.

Steps: The Process of Disruptive Innovation, with a Focus on Small Business

Disruptive innovation is a process that takes place over a number of steps, as described here. In our case, we will also take a high-level view of how one particular entrant, Square, is currently disrupting small business banking.

Step 1 | Innovator gains a market foothold and begins to expand. Incumbent remains dismissive, focusing its efforts on developing sustaining improvements for products targeting the high end of the market.

Spotlight on SMB Banking:

- FIs focus on higher profit margins by pursuing commercial clients with treasury services and other related commercial services.
- Square introduces a dongle-style card reader to simplify card acceptance for micro-businesses.

Step 2 | Innovator gains a market foothold and starts to refine and grow its offerings. Incumbent continues to remain dismissive, focusing its efforts on developing sustaining improvements for products targeting the high end of the market.

Spotlight on SMB Banking:

- FIs ignore the vast revenue potential of simplifying payment acceptance for small businesses.
- Square partners with established players like Visa, Apple, and Starbucks, and launches a POS system with terminal capabilities for bigger, upmarket merchants. Importantly, their growing lineup of products are designed to be self-serviced by users, allowing the company to keep costs down.

Steps: The Process of Disruptive Innovation, with a Focus on Small Business

Step 3 | Incumbent begins to take notice of the innovator, and may react in a number of ways: bringing a complex solution down market, copying the innovator's technology (but rarely the business model), or ceding the mainstream market entirely. Innovator continues to grow.

Spotlight on SMB Banking:

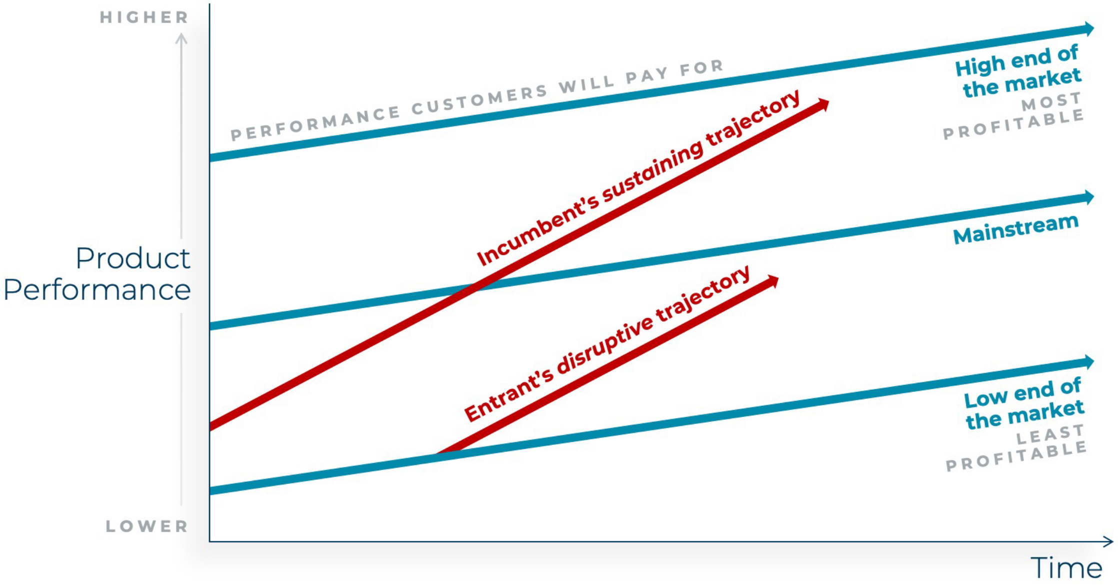
- FIs add a virtual terminal tool, but still rely on legacy models for customer onboarding (e.g., customers must visit a branch, fill out paperwork, wait weeks for approval).
- Square moves beyond payment acceptance and adds banking products — a real-time business debit card and online lending — essentially creating a complete banking ecosystem that begins to dramatically reduce the SMB's reliance on an FI.

Step 4 | Innovator wins over the majority of the incumbent's mainstream customers, eventually displacing the incumbent in the process. Disruption has occurred.

Spotlight on SMB Banking:

- FIs are now losing significant market share in the small business and commercial space to Square and other similar disruptors.
- As of early 2021, Square has become a fully-chartered bank, and now offers all of the core products and services that a traditional FI offers.

Graph Product Performance vs. Time



SOURCE CLAYTON M. CHRISTENSEN, MICHAEL RAYNOR, AND RORY MCDONALD
FROM "WHAT IS DISRUPTIVE INNOVATION?" DECEMBER 2015

This diagram shows product performance trajectories (red lines) and customer demand trajectories (blue lines).

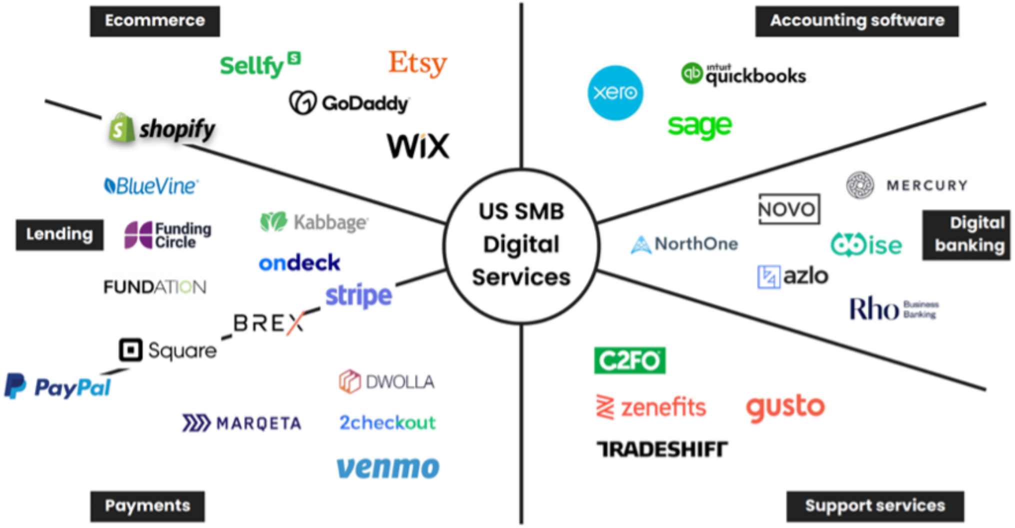
As incumbents introduce higher-quality products to satisfy the high end of the market, they overshoot the needs of low-end and mainstream customers. This creates an opportunity for entrants to gain footholds in the less-profitable segments that incumbents have neglected.

Over time, disruptive entrants improve their offerings enough to appeal to the mainstream segment, displacing incumbents that fail (or refuse) to go downmarket.

The Disruptive Potential of Fintech Challengers Today

Although our focus is on Square, virtually every category in financial services is facing some form of disruption. Savvy entrants have zeroed in on the specific needs of small business owners — such as digital payment acceptance for getting paid, digital banking for storing and accessing funds, and accounting software for managing cash flow.

Once a foothold is established, many of these disruptive entrants follow the same process described above, and over time expand to related categories (sometimes called verticals).



Credit 11FS

Currently, small businesses (SMBs) spend roughly $225 billion on services from non-bank and newly banked fintechs, such as accounting and bookkeeping, invoicing, bill payment, and payment acceptance. In addition, there is an opportunity with those small businesses making do with makeshift solutions or no solutions at all — often referred to as non-consumption.

And just as significantly, many of these same small business owners would consider obtaining these services from a bank or credit union. The $370 billion question is: what must an incumbent financial institution do to win their business — or win it back, in some cases?

A Look At The Rest of This Guide

In the following pages, we will be touching on each step of the disruptive innovation process. Along the way, we will focus on one disruptor in particular — Square — to learn more about how they have successfully entered the small business space and are now in the process of disrupting traditional financial institutions.

In total, there is a $370 billion opportunity to provide accounting and payments services to SMBs, according to Cornerstone Advisors.

3.

Step One: The Inevitable Upward Climb

“Consumers have stopped trusting institutions and started trusting strangers. Why? Because […] their focus on constantly pushing products doesn’t inspire, doesn’t engage and doesn’t drive action.”

Sean A. Culey, *Transition Point: From Steam to the Singularity*

In step one of the process, we learn that incumbent businesses typically focus on those customers that pay the most and invest their resources on those innovations that deliver the highest returns. This is simply a principle of good management. But it’s also the reason why so many incumbents fail. This is the paradox at the center of Christensen’s groundbreaking book, *The Innovator’s Dilemma.*

Well-run incumbent businesses will continue to improve their existing products and services — sometimes these improvements are incremental, other times they may become breakthroughs. Nevertheless, these innovations merely keep the company in business, and outspoken customers happy. These sustaining innovations, however, do little to meet the needs of down-market customers.

Step One:
Incumbent focuses on the high end of the market, neglecting the needs of downmarket customers. This provides an opportunity for an innovator to gain entrance into the market — even with a basic product.

As incumbents continue to improve existing products and services, they also tend to raise prices. Successive generations of smartphones, for example, often feature enhanced cameras, or higher resolutions, or faster processors. At some point, these pricier models begin to outgrow their practical usefulness.

SMB Banking, In Disruption:

Financial institutions continue to prioritize products and services built for commercial clients, as they've moved away from small and micro-businesses.

Historically, treasury management services like payment integration, disbursement solutions, payroll, and reconcilement have held an important place in an FI's business lineup. And for obvious reasons, these varied services can be effective when it comes to helping larger enterprises and corporate entities boost operating efficiencies.

The primary need of a small business is much more straightforward: to get paid. And secondly, to be able to manage their cash flow. Indeed, money is the lifeblood of any small business, and without an easy way to receive it and manage it, the reason why most fail.

According to a 2016 report from the JPMorgan Chase & Co. Institute, the median small business owner only had 27 days of cash in reserve. Detailed in the report is the tight correlation between daily inflows and outflows of cash for small businesses. This tight correlation highlights that any disruption in consistently bringing in cash can have a catastrophic impact on the health of a small business.

The problem is that most financial institutions lack the specific products and services that can help small businesses owners meet this basic needs. And it's hardly changing. There are over 10,000 insured financial institutions in the U.S., and the vast majority of them have underserved small businesses by offering them essentially the same commoditized products they did ten years ago.

In 2009, Square's founders uncovered this basic need for small business owners get paid — and did something about it.

As the story goes, artisanal glass blower and future Square co-founder Jim McKelvey needed a simple way to accept a card payment from a prospect, and realized later that this lost sale could become an opportunity. Soon thereafter, McKelvey partnered with Twitter co-founder Jack Dorsey to start Square, and introduced their remedy for an ongoing SMB pain point: the Square Reader.

Their idea was simple — as many disruptive offerings tend to be. The dongle would be connected to a mobile device, effectively becoming a point-of-sale system. Moreover, the accompanying app, called POS, would facilitate the interaction between buyer and seller, making the product and service a mostly seamless and enjoyable experience.

As mentioned earlier, a disruptive technology at the outset is rarely superior to existing, competing products. The Reader was far from perfect. It hardly resembled the more robust card terminals of the time, and there were concerns about security that were soon addressed with future iterations. Nevertheless, the dongle was inexpensive to manufacture, and offered an entryway to a market teeming with underserved micro- and small business owners searching for a convenient and affordable solution to accept card payments.

Summary:
FIs have focused on higher profit margins by pursuing commercial clients with treasury services and other related commercial services. In 2009, Square introduced a dongle-style card reader to simplify card payment acceptance — addressing an ongoing pain point for small business owners — and gained a foothold in the small business market.

4.

Step Two: The Foothold Becomes a Stranglehold

“Small business banking needs reinvention because small businesses view banking and financial management overall dramatically differently from the banks’ view. Small businesses think about workflows, and banks think about products. Platform players think about the actions small businesses want to undertake.”

Reinventing Small Business Banking, Celent Report

Despite the market demand, It takes time for disruptive products to take hold. Mainstream customers — those in the middle — often resist switching to these inferior products, even if they are less expensive. However, successful entrants will continue to improve existing products, and add more offerings over time. Once the quality becomes acceptable, mainstream customers begin to flock to these more affordable providers.

One reason why disruptive entrants are able to hang on, even as they rely on lower profits and fewer offerings, may have to do with their business models. They make do with less because they tend to have lower operating costs. Many entrants leverage digital channels or assets to attract more customers and keep costs down. This is also why customer self-service is so critical to many of these disruptors.

Step Two:
Innovator gains a market foothold and begins to expand. Incumbent remains dismissive, focusing its efforts on developing sustaining improvements for products targeting the high end of the market.

Christensen has cited Netflix as a classic example of a disruptive innovator. Netflix relied on its website to share its library, and the U.S. Mail to deliver titles to subscribers. This was an inferior service, by most accounts. Nevertheless, Netflix met marginal demand through convenience, access to more titles, and a lower price to compete with the like of brick-and-mortar rental stores like Blockbuster.

Netflix's advantages — coupled with its low-cost business model — allowed the company to remain in business as it refined its offerings. It also helped that the incumbent, Blockbuster, took little notice of the upstart during those nascent years.

Over time, the supporting technology caught up (broadband connections, set-top boxes, etc.), and the company was now well positioned to introduce a streaming service that essentially brought the video rental store to people's homes. It turns out that consumers didn't need cumbersome DVDs, late-night trips to the store, or late fees. What they wanted was movies all along.

SMB Business Banking, In Disruption:

Financial institutions stagnate, as Square makes its move to capture more small businesses.

At the outset, entrants often target the most neglected or underserved consumers. For Square, this was a segment of the SMB market referred to as micro-businesses. Like McKelvey, Square's co-founder, micro-businesses are run by individual entrepreneurs without employees (or for that matter, without much time). This deliberate move to go after micro-businesses provided Square with a significant foothold in the market.

Just six months after introducing its Reader, Square was processing millions of dollars in gross payment volume every week. By 2011, more than 100,000 new users were signing up for Square every month.

Just as amazingly, both financial institutions and major companies failed to see small business for what it was — an underserved market in need of a solution to an ongoing problem. Any number of competitors, especially business banks, could have introduced a similarly affordable card acceptance product at that time, unlocking a vast opportunity for additional revenue streams. None did.

Like all disruptors, Square didn't stop with its Reader. After all, an important component to disruption is the ability of the entrant to refine and expand its products in order to attract a more general, mainstream audience. Square was focused on continuing to solve problems. The ability to accept card payments was a huge challenge — but only the first.

Perhaps just as crucial was helping established SMB owners gather detailed sales data through a more comprehensive and robust POS system. To that end, a series of devices followed, such as the Square Stand designed to work with an iPad, Square Register, and later, an all-in-one system called Terminal.

Register was a hit with larger merchants, and an elegant follow-up to its Reader device. At that point, the company had already sold more than 500,000 Readers and processed more than $1B in gross payments.

One often overlooked key to Square's early success was the fact that their product lines were designed to be self-serviced by the customer. By adopting a self-service model, Square could provide online support to customers (via, FAQs, videos, knowledge bases, and the like) without necessitating a phone call or a visit to a storefront. This helped to keep costs down as the company quickly scaled.

Behind the scenes, the company was forging strategic alliances with established companies like Visa, Apple, and Starbucks to gain name recognition and higher investment valuations. Of course, this was also a clear sign that Square was diversifying its customer base in a bid to capture more of the mainstream market.

Summary:
FIs continue to ignore the vast revenue potential of simplifying payment acceptance for small businesses. In 2012, Square partners with established players like Visa, Apple, and Starbucks, and launches a POS system with terminal capabilities for bigger, upmarket merchants. Importantly, this growing lineup of products are designed to be self-serviced by users, allowing the company to keep costs down.

5.

Step Three: A Wakeup Call Often Ignored

"The challenge for banks isn't becoming digital, it's providing value that is perceived to be in line with the cost or better yet, providing value that consumers are comfortable paying for."

Ron Shevlin

As we have learned, incumbents frequently ignore entrants for a variety of reasons. Disruption is a process, after all, and can take years to materialize.

As disruption is happening, incumbents can take on tunnel-vision in their singular quest for higher profits. Plus, incumbents may not always view entrants as direct competitors, especially if they are no longer interested in the same emerging markets.

Nevertheless, at some point during the entrant's rise, the incumbent is bound to take notice. Perhaps the incumbent is losing significant market share at this point, or they may be hearing from customers seeking similar solutions. At this point, the incumbent may decide to take action.

But the question becomes: will it be too late to make any lasting impact?

Step Three:
Incumbent begins to take notice of the innovator, and may react in a number of ways: bringing a complex solution down market, copying the innovator's technology (but rarely the business model), or ceding the mainstream market entirely.

Because entrants are usually the first to tap into new or underserved markets, they typically have the first-mover advantage over later entrants and incumbents. According to Investopedia, a first mover is:

"A service or product that gains a competitive advantage by being the first to market with a product or service. Being first typically enables a company to establish strong brand recognition and customer loyalty before competitors enter the arena. Other advantages include additional time to perfect its product or service and setting the market price for the new item."

Although followers can sometimes find success, especially if they move quickly, it is very easy to be left by the wayside. When it comes to disruption, the first mover often prevails. In the aforementioned case of Netflix (see step two), the incumbent, Blockbuster, eventually copied the DVD-by-mail formula pioneered by Netflix. But by that point it was too late — Netflix had moved on to streaming technology that same year (2007). The outcome might have been more favorable to the incumbent if Netflix had not made the fateful decision to disrupt themselves in their quest to capture the market.

In his book, Christensen describes the fascinating story of Honda's entry, and eventual disruption, of the North American motorcycle industry. As the story goes, Honda discovered a new market for off-road riding almost by accident. Their inexpensive, lower-powered motorcycles were an ill fit for American roads, but ideal for dirt. In just a few years, this foothold in off-roading became a lucrative market for Honda — so much so that incumbent Harley-Davidson launched a stripped-down model for enthusiasts. This down-market foray, however, turned into a disaster as dealers and consumers were left confused and dissatisfied with these new products. This failed attempt also brought the company to the brink of bankruptcy.

SMB Business Banking, In Disruption:

Some FIs attempt to move down as Square continues to move up.

In an attempt to fend off Square and other disruptors in the merchant services space, some banks and providers have developed (or retro-fitted) products intended to attract down-market customers. One such example is a virtual terminal, a software-based service that allows vendors to enter payment card details manually, then submit the transaction for processing — all without a card. This is a good fit for lower volume small businesses that rely on card-not-present phone or mail order transactions.

This kind of technology addresses a clear need for down-market small merchants, and is comparable to a similar service offered by Square and other disruptors. The problem, however, is not with the solution per se, but with the delivery. Most traditional merchant services providers (especially those that partner with FIs) still require for business owners to visit a branch, fill-out paperwork, and wait for approval. This applies to most of their merchant offerings — not just virtual terminals.

Square has spent years honing their products and services to reduce unnecessary delays or any other friction in the onboarding process. And their website makes this fact explicit. Their virtual terminal product page, for example, emphasizes this key differentiator: "Accept and record payments on your computer. Get started in minutes, no monthly fees." A prominent button placed right below entices the onlooker to click with an action-oriented message: "Take your first payment."

Of course, a slick website can only take an entrant so far — they must have the product offerings to back it up. And Square has done just that. After dominating the growing small business payments-processing market, the company set its sights on expanding into adjacent financial services verticals to attract even more businesses of all sizes. It had already been several years since introducing their loan option intended for existing customers (Square Capital in 2014), but this was just a taste of what was to come.

In the last three years, Square has moved quickly to build out a wide range of financial services for small businesses. The obvious reason may come down to pent-up customer demand. According to Celent, "a significant share of Square's merchants are low users of banking services and hence offer the opportunity for new revenue streams." Square's own work with their Square Debit Card uncovered an eye-opening statistic: for 54% of users, the product was their first experience with a business debit card. In other words, far too many of their customers were relying on their personal debit cards for business needs.

A logical next step was for the company to introduce their own business deposit account. After all, customers had been using their aforementioned Square card as a quasi-business account at that point. The debit card already allowed merchants to access funds instantly — the new business checking account would improve on that basic, down-market functionality by allowing customers to deposit and access customer payments directly, plus it came with an official routing number, FDIC insurance, and so on.

Of course, from a strategic standpoint, these various banking products did more than offer convenience — they also helped to disintermediate the traditional FI from the small business relationship. Why rely on a bank, a Square customer might ask, when everything they need — from financing to cards, to now a deposit account — could now be had from Square directly?

This is the question that we will address in the next step.

Summary:
FIs add a virtual terminal tool, but still require business owners to apply/onboard through existing legacy channels (e.g., visit a branch, fill out paperwork, wait weeks for approval). Square moves beyond payment acceptance and adds banking products — a real-time business debit card and online lending — essentially creating a complete banking ecosystem that begins to dramatically reduce the SMB's reliance on an FI.

6.

Step Four: Displacement by Design

"At 2030, I would say that you probably have two billion people that'll be using day-to-day banking services, independent of banks."

Brett King

In our final step, the innovator successfully disrupts by attracting a critical mass of customers, paralyzing large incumbents who are unable to compete for a wide range of possible reasons. In a closing chapter of his book, Christensen helps his readers to better understand why leading firms can sometimes stumble from their position by describing the concept of performance oversupply.

Step Four:
Innovator wins over the majority of the incumbent's mainstream customers, eventually displacing the incumbent in the process. Disruption has occurred.

In chapter one, we discussed how well-run incumbent businesses will continue to improve their existing products and services. These sustaining innovations, however, do little to meet the needs of down-market customers. There is however, another facet to this concept. There is a point where mainstream customers will stop caring about these often-unnecessary improvements — that is, the performance of the incumbent's product or service have become "good enough" to satisfy the majority of mainstream customers.

This condition of performance oversupply — regardless of the industry — opens the door to disruptors that have refined their products enough to appeal to these middle-of-the-road customers. Why not stay with a known entity, the incumbent, if a product's performance is similar?

One important reason is that the basis for competition will change. Other needs, not yet satisfied by incumbents, will become a priority. When a market becomes commodified with one too many undifferentiated products or services — as it has in financial services — it makes it easier for a disruptor to swoop in with products offering unforeseen benefits not easily duplicated by incumbents.

Prior to the iPhone's introduction, digital camera makers competed with ever growing features and resolutions — and higher prices. Customers found it difficult to navigate these products and make a qualified purchase. Of course, none of this made a difference once customers got their hands on a product that provided a good enough digital camera any time they needed it (that's right, their iPhone).

Christensen has pointed out that the iPhone was not a disruptor in the phone industry, but it did disrupt a number of incumbents in other industries (camera makers, but also handset makers and portable music makers — like Apple's own iPod!).

SMB Business Banking, In Disruption:

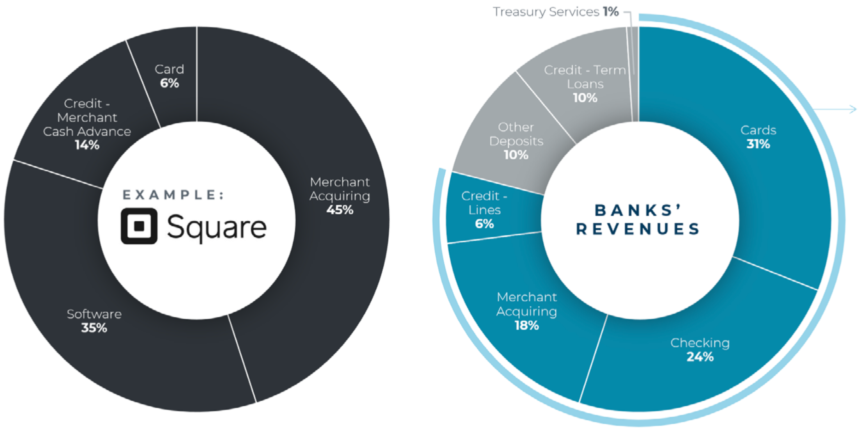
Square disintermediates the FI, then becomes an FI themselves.

As we've learned previously, Square made its foray into the small business banking space with a number of banking products (previously online lending, but later a debit card and a deposit account) designed to lock in small business customers into the company's platform ecosystem. The result — known as disintermediation — means that a small business owner no longer has to rely on a financial institution, since all of the same essential services are provided by the disruptor.

According to Celent, it is believed that Square is now targeting nearly 80% of the small business banking revenue pools. Significantly, these targeted pools include checking and cards — two longstanding and profitable products for FIs. The report further commends the company for its strategy and growth trajectory:

"Square has become the paragon of a platform strategy. Beginning with a humble dongle a decade ago, it now serves nearly 3 million active sellers, which generates $4.7 billion in annual revenue (2019) and around $100 billion in annualized card volume."

Platform players are targerting banks' revenues



NEARLY 80% of small business revenue is at risk

Source: Celent analysis, Oliver Wyman revenue pools, and Square

It didn't help that financial institutions — many in the midst of pursuing a multi-year digital growth plan — were ill-prepared to support the digital needs of small businesses during a pandemic. Many small businesses flocked to Square and similar providers during the outbreak, signing on for much-needed services without having to leave the confines of home.

The impact of the pandemic on SMBs was vast. According to a Mastercard Survey of small businesses across North America:

- 76% say the pandemic prompted them to become more digital, with 82% changing how their business sends and receives payments.
- Citing difficulty with cash flow and collecting payments, 50% added a new digital service for collecting funds while one in four transitioned to electronic invoicing.

• With 68% saying cash and check deposits take too long, small businesses decreased their use of cash and checks more than any other payment types during the pandemic.

In 2020, Square announced its plans to pursue a banking charter. This move surprised many in the industry. However, viewed through the lens of disruption theory, the move made perfect sense. According to Steven Sinofsky, “Even when technologies are disrupted, the older technologies evolved for a reason, and those reasons are often still valid. The disruptors have the advantage of looking at those problems and solving them in their newly defined context, which can often lead to improved solutions (easier to deploy, cheaper, etc.).”

In early 2021, Square officially became an industrial bank, known as Square Financial Services. The company followed-up the news by introducing an all-in-one account, Square Banking. This product will bundle business checking, savings, and Square’s existing small business loans (now called Square Loans).

Square is not alone in its move to disrupt the industry, but they may be the biggest. Of course, these companies did not become giants overnight. As we have seen with Square, they have expanded strategically by continually introducing new products and services carefully aligned to the workflow needs of their core customer base — small and medium-sized businesses. In the process, the company is capturing more of the mainstream customer base that is being abandoned by financial institutions moving upmarket.

A number of entrants along with Square are now making their way to the mainstream middle, where the revenue potential becomes exponentially greater. The question becomes, how will incumbent FIs respond?

Summary:
FIs are now losing significant market share in the small business and commercial space to Square and other similar disruptors. As of early 2021, Square has become a fully-chartered bank, and now offers all of the core products and services that a traditional FI offers.

7.

Conclusion: The Way Forward

“Innovation almost always is not successful the first time out. You try something, and it doesn't work, and it takes confidence to say we haven't failed yet... Ultimately, you become commercially successful.”

Clayton Christensen

As financial institutions continue their push into more profitable markets, small business has been left behind. Entrants have seized this opportunity by leveraging technology and low-cost business models to capture small business owners.

Small businesses, for their part, have become receptive to the many solutions now easily available to them. And clearly, they are willing to pay to find relief, whether to streamline existing processes or find better ways to manage finances. As SMB owners add on more services with a few clicks of a button, their own FIs become less relevant to their day-to-day needs. As a result, SMBs are slowly but surely leaving their banks and credit unions behind.

Nevertheless, the dust has yet to settle, and the winners far from being decided.

A recent report by Cornerstone Advisors makes a crucial point: the majority of small businesses would still prefer to deal with a known entity — namely their own bank — than an unproven third-party provider. Of course, to become a viable option once again, FIs must begin to offer competing products and services at a similar price point.

Zelle is just one example of how future-focused FIs can respond to disruptors like Venmo, Stripe, and Square in the retail space. In 2017, a group comprised of several large banks co-launched Zelle, a P2P alternative to PayPal’s wildly successful Venmo service. Zelle has caught on very quickly, and now numbers over 140 million users, thanks in part to its embedded digital banking functionality.

Chase recently introduced their QuickAccept feature for business account holders. SMB owners now have the ability to accept payments right from their mobile app — either through a manual key-in process or through an optional card reader.

This is where Autobooks comes in. Like the Square dongle of yesteryear that solved a clear problem for merchants — and then opened a path for future growth — Autobooks has focused on a problem plaguing small businesses today: getting paid online.

Because Autobooks is integrated into an FI's digital banking platform, a small business can simply log in and send an online invoice right from their banking app. A customer can pay in any number of ways, including by credit card.

This much-needed invoicing tool has become a game changer. Now businesses can easily send an invoice and get paid in a matter of days — ensuring a steady flow of operating funds. In their research, Autobooks recently uncovered an encouraging trend: 95% of SMBs who rely on their invoicing tool are paid within five business days. This is in stark contrast to the industry average: a dismal 27 days.

Smaller regional banks and community FIs can become a viable option once again. Customer acquisition can begin now — but it must be based on a digital, solutions-first strategy. With the right technology mix, community and regional FIs can expand their market by better serving the needs of their small businesses.

For more on the state of small business, and how Autobooks can help, please visit us online at Autobooks.co.