Approaches for Banks with Microbusinesses
By Charles Wendel

Last time we focused on the reasons for banks and credit unions to consider working with alternative finance companies (AFCs). Among the benefits: improved customer service, increased fee income, market expansion, and reduced costs. But, what specific options exist for working with AFCs and how should a bank assess its partnership options? Currently, there are at least five ways for banks to work with AFCs. They are not mutually exclusive approaches, and banks will usually find that they may be pursuing more than one goal in partnering.

1. Turndown Lending. Several years ago, when AFCs started working with banks, turndown or second-look lending served as their initial marketing focus and a way for AFCs to begin to work with banks. AFCs saw an opportunity to generate loan volume from banks because, depending upon their screening criteria, banks reject 30-70% of loan applications. The rationale for doing so ranges from the short time a business has been in operation to its recent operating losses to being in an out-of-favor industry.

A prospective borrower may be creditworthy and more than able to pay back a loan, but still not a good fit for a bank with its often limited “credit box.” Companies like OnDeck, Bond Street, and Fundera will work with banks to review the loans banks turn down and, as appropriate, approve and fund them. They pay the bank a fee for each closed loan, and the bank maintains control over the ongoing relationship, capturing deposits and other non-lending business.

While this has provided the entry path for many AFCs with banks, it has resulted in at best mixed success for both parties. Banks have often failed to fully enlist their bankers in the referral effort, with some bankers hesitating to refer deals because of their lack of familiarity with the third-party lender and concerns about sharing the relationship. Bank compliance staff has also expressed privacy concerns about sharing customer information, and senior management often raises market reputation concerns based upon the higher rates these non-bank lenders can charge. The net result is that relatively few banks have signed on for this program and that turndown lending has failed to “move the needle”, meaning generate significant volume, either for banks or AFCs.

To this day, however, turndown lending may serve as an appropriate starting point for a bank with an AFC. This first-step allows both parties to learn how to work with each other, requires less of a commitment than some other options discussed below, and, ideally, sets a foundation for a broader relationship. Banks beginning with turndowns should know that they are entering a path that can and should lead to greater cooperation and benefits. In order to take advantage of what an AFC offers a bank, they should want to go beyond this initial “toe in the water.”

2. Segment Expansion. One area in which AFCs can help to foster bank growth involves providing banks with leads to increase market share. AFCs collect and analyze data from both traditional and non-traditional sources to enhance their credit decisions and risk management processes. In addition, they can use their data analytics capabilities to assist banks wishing to improve their target marketing. For example, in one instance a regional bank wants to apply its current loan screening criteria to geographies in which it wishes to build share. However, it will maintain its current risk criteria and will not compromise in that area to generate volumes. It is now evaluating working with an AFC that can deliver leads for loans that meet risk, industry, and other bank specific criteria. The bank pays a fee to the lead provider, and the AFC also has the option of funding loans to companies that do not meet the bank's credit hurdle.

3. Integration. The first U.S. example of a bank integrating with an AFC to offer small business loans involves Regions Bank of Birmingham, Alabama and Fundation.
The press release announcing the relationship states small businesses can apply for a loan in less than 10 minutes and loans can be funded in three days. To apply, customers simply visit Regions.com/smallbusiness and are directed through a link from Regions.com to Fundation's online application. Region's "powered by Fundation" digital application allows Regions to lever Fundation's technology rather than trying to build it themselves. Kabbage has established similar integrated approaches with banks operating in Canada, Spain, and the UK and is also pursuing U.S. opportunities.

4. Software as a Service. Many banks either do not want to enter into a non-traditional lending relationship or place a greater near-term priority on being able to take advantage of the origination and processing benefits of a digital platform. LendKey on the consumer side and Mirador with small business lending, among other companies, offer banks and credit unions a well-tested digital platform that can be implemented relatively quickly. Banks with their often-slow development processes and competing software initiatives can take years to build what these companies can provide in months. In LendKey's case they can also assist with loan placement and syndication through their network of 300+credit unions and banks. For example, if a credit union originates a loan that exceeds its appetite, LendKey can in effect syndicate that loan to other lenders.

Recently, we have seen cases in which banks are considering a technology platform provider in addition to an alternative lender. The alternative lender may be able to demonstrate its ability to assist banks in increasing their lending in a specific product area but their technology platforms currently may lack the flexibility and other attributes to meet a bank's requirements for a comprehensive digital solution. Therefore, a bank may select an AFC to provide a particular product to its small business customers while choosing a technology company to provide its overall digital platform.

5. Portfolio purchases. Some banks lack the infrastructure, skill base, and/or culture required to generate significant loan volumes even with third-part marketing help, or they may view purchasing loans as a quicker and more efficient process for putting their deposits to work. Lending Club frequently focuses on providing loan sales to banks and views that approach as a way to serve a near-term need and further develop a bank relationship. A bank can specify the key characteristics for a loan to be acceptable, including risk rating, industry, geography, etc.

6. Direct Competition as an approach. In addition to the five ways to work with AFCs outlined above, a handful of banks are pursuing a different path that involves emulating AFCs. The best initial example of this approach involves Eastern Bank of Massachusetts, which through its Eastern Labs subsidiary is providing loans to companies previously viewed as unbankable based on an analytic approach that is similar to some AFCs. Note that this required the bank to hire a group of former AFC professionals, a route that most banks will not take.

Just as banks need to consider and choose among various approaches for working with AFCs, so too are AFCs increasingly choosing which type of bank or credit union to work with. Some AFCs prefer to work only with the top 20-50 banks while others refuse to begin with turndown lending and will only partner with banks where full integration occurs. Conversely, Alliance Partners has formed ventures with Lending Club on the consumer side and Fundation for small business lending to facilitate loans by community banks. Not surprisingly, as the market matures, AFCs are segmenting their activities and their target clients. Some are also disaggregating their offer to provide marketing services or software as a service while others are focusing on providing an A to Z integrated sale.

Co-opetition rather than competition with banks and credit unions has become the goal for many AFCs. At a minimum, banks should evaluate the partnership path, viewing it as an opportunity for growth rather than a threat.