Are Alternative Lenders Evil?
by Charles Wendel

In the course of a client engagement, we were interviewing a number of banks concerning their knowledge of and interest in working with alternative finance companies (AFCs), specifically in the small business space. A President of a regional bank almost stopped our question mid-sentence to comment about one very prominent AFC, "I think it is evil." This particular AFC has been examined and prodded by analysts and regulators; most view the company as disruptive, but to my knowledge no one had ever described it as evil.

In another conversation, the CEO of a larger and very prominent regional bank dismissed AFCs. He did not see how they were relevant to his bank with his company's high-end focus and emphasis on banking only the most bankable clients. His implication was that AFCs were bottom feeders rather than potential partners, basically exploiting the most needy customers.

A third regional bank President commented that the volumes the AFCs have generated were a very small percentage of total loan volume, indicating that AFCs were outliers and did not merit much consideration by banks like his. He viewed AFCs as largely irrelevant and unlikely to "move the needle" on his P&L.

By "evil", the bank President meant the AFCs were offering high rates versus banks and undercutting the traditional bank relationship with its customers. The larger bank CEO had no understanding of the value and flexibility of what AFCs offer and their potential ability to provide loans to customers who fail to meet the bank's risk criteria while allowing the bank to build a non-credit oriented relationship. The third banker failed to recognize the long-term nature of the commitment that AFCs have made to the industry and may be unpleasantly surprised as more share shifts over to AFCs year-by-year. The top performing AFCs are now part of the permanent financing infrastructure; they are not going away.

Those of us who are close to the AFC industry see increased (but still slowly developing) bank interest in working with AFCs and substantially greater activity between banks and AFCs. The Chase/OnDeck deal woke a lot of banks up to the reality of AFCs and the opportunity they offer. However, despite potentially ground-shifting events like that deal, misinformation remains rampant and will continue to slow the growth of AFC/Bank partnerships and delay the benefits that AFCs can provide the banking industry.

One issue is that AFCs take many banks out of their comfort zone. They approach lending with a somewhat different philosophy and, frankly, operate with a culture that many banks find off putting and, perhaps, intimidating. Unfortunately, many banks are looking forward to the failure of AFCs as a justification for their banks' more traditional, constrained, and bureaucratic approach to lending.

To the banker who thinks some AFCs are evil, three comments:

1. Unlike banks, AFCs price based on their evaluation of risk; tougher credits pay more. Banks often price reactively, based upon market pressures and seem almost diffidence about pricing too high. Recently, for example, one banker told me he "felt guilty" about charging a price based upon his bank's stated pricing parameters rather than providing the 20-25% discount that he almost automatically offers. That is not the way AFCs or, for the most part, other profit-oriented businesses operate. That is not evil but just good business sense.
2. In many cases AFC pricing is declining as they improve their funding options and respond to competitive and bank pressures. Now their pricing often does not exceed credit card rates, if that.
3. Increasingly, borrowers view AFCs as helpful providers of financing in less time than a bank takes to approve a loan. The business press also sees this and, as the *NY Times* did last year, features articles with titles like "Online Lenders Offer a Faster Lifeline for Small Businesses." A mid-year 2015 survey supported that view, finding that one out of ten small businesses felt that banks had stopped lending to small businesses. (Based upon our experience, we think that 10% number is too low.)

To the CEO who does not see how his high-end bank can work with an AFC, consider the following:

1. Your growth is constrained by your bank's rigorous credit policies. Understandably, you may be uncomfortable loosening them. AFCs can provide loans to companies outside your credit box while you reap the benefits of revenues tied to deposits, cash management, and other areas.
2. If and when those companies develop a more acceptable credit profile, their loans can become part of the bank portfolio.
3. Some AFCs can provide you with a digital platform that will improve the customer service and reduce costs to serve. It would take internal IT resources years and many dollars to build the same capabilities.

To the bank President who thinks AFCS have not shown their impact, read an article in *American Banker* dated April 8^{th} and titled, " Marketplace Lending Grew by 700% in Four Years: Report." The report by the California Office of Business Oversight found that online lenders made $16B in loans in 2014, up 700% from 2010. Note that in the first six months of 2015, credit outstandings exceeded $12B. Using different data, a TransUnion analysis states "FinTech lenders have surpassed banks, credit unions and traditional finance companies in personal loan issuance to near prime and prime consumers."

Ignoring the growth generated by AFCs and its implications puts a bank at peril. The borrowers may not be bank credit worthy today, but what happens to these companies if they improve their credit position? Is this another group that will remain disenfranchised from banks? One survey of small businesses states that 72% of AFC users do so because they could not obtain funding from traditional sources. Banks cannot afford to lose these customers.

The AFCs we work with are very focused about transparency, market reputation, and developing a cooperative and trusting relationship between themselves and their bank partners. Yes, there are some bad actors within the AFC community, and some even appear to be surviving the bank due diligence process, potentially resulting in some unpleasant surprises for a bank. Bank management may need to spend more time doing Google searches and attending conferences where as much information about AFCs takes place in the hallways and over cocktails than in the formal sessions.

In the main, however, AFCs represent an industry that knows what it has to do to become part of the financing fabric for small businesses and consumers. The top players have hired experienced bankers and/or former regulators to make sure they are in synch with the regulators, meet the hurdles required to work with banks, and follow the spirit of the law. With very few exceptions, evil, no. Eager to work with banks and to grow, yes.