Figuring out Who's On First in Alternative Finance
by Charles Wendel

I began working in the alternative finance company (AFC) space over two years ago. For the uninitiated, at first alternative finance largely involved non-banks lending to consumers and small businesses by leveraging digital capabilities in origination, loan process, underwriting, and virtually every other part of the loan and customer service business system.

A few years ago, alternative finance companies aimed at competing with traditional bank lenders. Companies like Lending Club and OnDeck offered very fast decision-making and excellent customer service. Loans at higher than bank rates could be made in hours or days rather than weeks or months, an attractive alternative to some borrowers.

Early on, AFCs were either marketplace lenders or direct lenders. Direct lenders made a loan themselves based upon their funding sources. In effect, Marketplace Lenders matched up borrowers with individuals and institutions that had excess cash to invest. Borrowers could refinance high rate credit card or other debt and investors gained higher than usual returns for the risk they take.

Over the past two years the AFC world has become increasingly complex; barriers between approaches have broken down and categorizing the players has become more difficult. The distinct approaches outlined above have often morphed together, and the number of players has increased. Estimates put the number of consumer and small business platforms at 100 and 200, respectively. In many cases the AFC's go-to market approach has also shifted as these companies "pivot" in light of market opportunities.

Virtually all the AFCs I know would like to work with financial institutions (FIs), partnering with them in various ways, in many cases on a white label basis. FIs need to determine what they want to gain from a relationship with an AFC; if anything their options (and perhaps the difficulty of their decision-making processes) are increasing. We know a number of banks that have signed on with a third-party without determining their longer-term strategy for working with AFCs. In some cases their partner may be acceptable in the near term but lacks the a sustainable fit with what the FI needs.

Options for Working Together Continue to Grow

The options for how an FI and AFC can work together have increased significantly and will continue to expand as creative minds continue to focus here. The list below captures most of today's options, but expect changes over the next three-six months as more bank deals are announced by AFCs. Some but not all of the approaches range on a spectrum from a "light touch" to heavy linkages between AFC and FI.

Loan/Turndown Referrals. Most AFCs first approached FIs to review and fund their turndowns. Banks usually approve no more than 20-25% of loan applications, potentially generating significant leads for AFCs that can provide loans. However, in most cases both FIs and AFCs were frustrated by this involvement. FIs did not generate significant quality referrals; relatively few turndowns were funded by the AFCs. Neither the FIs nor the AFC generated significant revenue from these transactions, and in some cases FIs abandoned these types of referral relationships.

Segment Expansion. Using the strong proprietary analytics that some AFCs have developed, they can analyze a bank's current business portfolio and targets to uncover loan opportunities overlooked by a more traditional lender. The AFC will typically fund the loan, providing the originating FI with a fee and additional cross-sell opportunities.

*Digital Banking as a Service***.** Most FIs need to provide their customers with digital capabilities, even if they do not want to enter a lending partnership with an AFC. Working with companies like LendKey on the consumer side or Mirador in small business, they can "rent" these digital platform, improving their competitive position while minimizing the time and capital expenses required to do so. The risk parameters applied in this digital environment come from the FIs and third party lending may or may not be part of this technology offer. However, as with other aspects of the AFC world, that could change.

Lending as a Service. Lending-focused AFCs want to pursue full digital integration with an FI, whereby, they handle all the lending up to a certain dollar amount. Applying the FI's risk criteria, if a loan meets that threshold, the FI can purchase the loan for its portfolio. Loans that fail to meet the FI's requirements can be funded by the AFC, either directly or through a marketplace. (Many AFCs now do both direct and marketplace lending.) In at least one case we know, the AFC does not charge for the digital platform it provides. However, the bank must generate a certain minimum loan volume to avoid paying a fee. This resembles the compensating balance requirements of the past.

Portfolio Purchases. Institutional investors (II) and some FIs are now purchasing loan portfolios from AFCs. IIs want the yields and the FIs want both yield and the opportunity to put their excess deposits to work. FIs focusing heavily here may also indicate an inability to originate loans organically and raise issues of bank earnings sustainability.

Competition. Rather than cooperating with AFCs, several banks are developing approaches that compete directly with AFCs. For one, Eastern Labs, part of Massachusetts' Eastern Bank, has created a venture headed by lenders experienced in this space. Other bank-owners players are in various stages of market development. We expect that only a small handful of banks will go this route *and* make it work.

Determining whether and how to cooperate. Up to now, only about six lending-oriented bank/AFC deals have been completed in the small business space. Many more exist on the consumer side. Many of these relationships are still gearing up, and their success remains unknown. In several cases banks have picked their partner based not upon a rigorous analysis of the bank's needs and goals but due to personal relationships or having worked with that AFC previously. Understandable, but that approach can be suboptimal versus developing an RFP that forces an FI to make concrete statements about what its goals (and concerns) are.