Selecting an Alternative Lending Approach and Partner
by Charles Wendel

More banks understand that alternative finance companies (AFC) are here to stay in the business lending space, but too many still view AFCs simply as high risk and high rate competitors, focusing on targets that are closer to sub-prime than bank credits. Increasingly, AFCs both want to cooperate with traditional lenders and have a lot to offer them. Banks need to understand the benefits of working with AFCs and create a process that determines how best to team up with them and which AFC to partner with. Many banks will find that cooperation can reduce the operating costs of their small business lending, generate some revenues and fees, increase deposit levels, and even address vexing regulatory problems.

A Brief History. AFCs expanded in business banking largely as a result of bank limits on lending; in effect banks invited AFCs into their world. In reaction to the last downturn, banks narrowed their "credit box," tightening lending criteria and eliminating more businesses from loan consideration. While to some degree alternative non-bank lending has always existed, this time is different in part because of the extent to which this new breed of lenders integrates technology into origination, underwriting, pricing, and risk management, causing one industry insider to suggest that a better descriptor for AFCs is "digitally enabled lending."

Initially, these companies competed with banks, operating under the bank radar, since their primary focus centered on targets that banks did not find of interest. Based upon the speed and responsiveness AFCs offered, an increasing number of borrowers showed they were willing to pay multiples of bank rates for the speed and execution AFCs provided. While estimates vary, AFC business loan outstandings in 2014 reached at least $5 Billion in the U.S. While this represents only 1-2% of current small business lending, growth rates are increasing, and in any case, this may be an insufficient metric to consider in determining the impact of AFCs.

Over the past few years, several AFCs, primarily Merchant Advance Companies (MCAs), experienced limited success in partnering with banks, focusing on providing financing to companies banks turned down. But, turndown lending has severe limits: banks refer a limited number of opportunities, with many banks deciding not to participate because of concerns over privacy, regulations, and low revenues to them that "do not move the needle." AFCs needed to develop a more value added approach in order to interest banks.

Pivoting for Success. AFCs are currently focusing on one or more of four lending areas:

- Turndowns
- Market expansion
- Integration
- Related to the above, specialized lending

- As an alternative, DIY

Turndowns. As noted above, this activity provides limited revenue growth. It may serve as a starting point to work with AFCs, but will be of limited interest to most banks.

Market expansion. Rather than focusing on limited "second looks," AFCs now approach banks with loan growth opportunities. For example, many banks for reasons tied to high cost and internal risk parameters provide loans to just 20-30% of their small business customers. With the cost efficiencies and risk insights that AFCs bring they can offer loans to a significantly higher percentage of current customers on a white label or co-branded basis. Banks may receive a fee and/or retain a portion of these loans for their own portfolio.

Integration. Small business loans, in particular loans below $100K generate losses or subpar returns for the majority of banks. Rising costs tied to origination, underwriting, monitoring, compliance, and other areas lock in loses for traditional lenders. At the same time banks want the deposits that small businesses provide. Recent months have seen banks and AFCs move from turndowns to market expansion, to, in some cases, steps toward full integration whereby, the AFC in effect assumes responsibility for the bank's low dollar business lending. With input from the AFC, the bank focuses on what should be its greatest strength, origination, shifting most back office and risk expenses out of the bank and to the AFC. This relationship also results in fee income and/or the opportunity to purchase loans for the bank's portfolio.

Specialized lending. Related to both market expansion and integration, AFCs realize that success increases with their ability to address bank "pain points." Among others, two areas of pain involve banks meeting CRA and Fair Lending hurdles. Even banks that meet these requirements often do so with high operating expenses. Several banks (most notably, Citibank) have begun to work with an AFC in these areas with the AFC largely taking on increased responsibility for meeting loan goals. The AFC operating platform reduces costs while their data analytic and risk management capabilities increase productivity and the quality of prospecting. Look for more activity in these and other priority specialized areas in which banks recognize the need for third party assistance.

DIY. A small handful of banks is pursuing a different path, having decided that they can replicate the AFC's approach based upon internal data. This approach should be avoided by the faint of heart or those lacking sufficient data and investment dollars. Banks may think they can go this route but most lack the data, analytic capabilities, risk management appetite and culture to do so.

Managing through the Alternative Finance Ecosystem. Senior bank management needs to analyze whether they should work with AFCs and which of the above approaches to pursue. Doing so requires the bank to assess its current small

business portfolio, current loan economics, and likely growth opportunities. As they do so, they also should be developing a checklist that prioritizes their selection critical related to potential AFC partners.

While each bank will create a customized checklist, we expect all of them will include the following: reviewing the AFC's other bank clients and their satisfaction levels, assessing compliance and regulatory capabilities, analyzing the ability of the AFC to provide a turnkey solution that minimizes the time and investment burden on the bank, and determining the AFC's reputation for performance and quality based upon competitive intelligence.

Banks also need to decide between working with direct lenders (for example, On Deck and Fundation) or marketplace lenders (such as Lending Club and Funding Circle). Banks considering between direct and marketplace lending need to assess issues of sustainability and reliability. Marketplace lenders do not make loans but provide a platform to match up borrowers and lenders. This method has quickly transitioned from what was termed P2P lending to involve portfolio purchases and investments made by banks, family offices, and other sophisticated investors. In turn marketplace lending has resulted in the development of an investment and analytics platform (Orchard Platform) that helps loan originators and investors to connect and complete transactions, particularly for large numbers of small loans.

In the near term the number of AFCs pitching to work with banks will rapidly increase. However, as banks determine their best approach and screen players based upon their partnership criteria, fewer AFCs will survive the cut. Ultimately, reputation and the "fit" between the bank and the AFC will become critically important in final decision making about how to participate in and manage through the alternative finance ecosystem.