Selecting an Alternative Lending Approach and Partner:
The Banker's Perspective

By Charles Wendel | FIC Advisors, Inc.

"I would not be surprised if within ten years alternative finance companies generate 75% of non-subsidized small business loans."
Larry Summers, former Secretary of Treasury

Increasingly, banks understand that alternative finance companies (AFCs) are here to stay in business lending. Still, many continue to view AFCs simply as high risk and high rate competitors for loans. In fact, many AFCs want to cooperate with banks. Working with AFCs can reduce business lending operating costs, generate new loan revenues and referral fees, increase deposit levels, and address vexing regulatory challenges. But, what issues do banks need to consider in choosing an AFC partner and what process should they follow to ensure they pick the right one?

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 when, in reaction to the last downturn, they narrowed their "credit box," tightening lending criteria and eliminating more businesses from consideration for loans.

Based upon risk, industry, and other factors, we estimate that banks view only about 10% of businesses as acceptable lending targets, leaving the remainder to AFCs and others funding sources.

Bank Qualified and Non-Qualified Business

Category	Number of businesses (Millions)	Potential $ Loan Value (Billions)	Percent of Businesses	Percent of Value
Qualifying	3.7	$544	10.2%	23.8%
Not Qualifying	32.4	$1,745	89.8%	76.2%
Total	36.1	$2,289	100.0%	100.0%

While to some degree alternative non-bank lending has always existed, this time is different in part because of the extent to which the 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, AFCs competed with banks, operating under bank radar, since their primary focus centered on targets that banks avoided. Because of the speed and responsiveness AFCs offered, in recent years an increasing number of borrowers showed they were willing to pay above bank rates for the speed and execution AFCs provided. Although 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 rapidly. And, new loan revenues provide only part of an AFC's value to a bank.

In recent years several AFCs experienced limited success in partnering with banks, focusing on providing financing to companies banks already turned down. This emphasis often resulted in frustration for both banks and AFCs. Banks referred a low number of acceptable deals, raised concerns over privacy and other regulations, and found that their likely revenue potential "did not move the needle." AFCs quickly realized the need to provide greater value-added in order to interest banks.

Pivoting for Success. Moving beyond turndown lending, AFCs are currently focusing on one or more of three lending-related activities:

- Market expansion
- Integration
- Related to the above, specialized lending
- As an alternative to AFCs, DIY

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 no more than 20-30% of their current 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 while maintaining relationship control

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.

$100.000 Loan Example: Cost per Loan		
Loan origination	$1,000-1,500	
Underwriting	$1,000	
Loan review	$100	
Operations	$250	
Monitoring	$500	
Compliance	$250-500	
Total	$3,100-3,850	
Interest Income (assume 6.25% loan)		$6,250
Loan cost to bank (3%)		$3,000
Total non-interest costs to generate loan		$3,100-3,850
Net Income		**($600) to +$150**

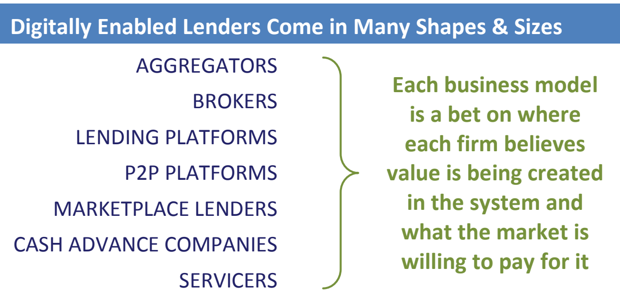
Banks want the deposits that these small businesses provide. As bank /AFC relationships progress, the business focus has been moving toward full integration, whereby, the AFC in effect assumes responsibility for the bank's low-dollar business lending. The bank focuses on origination, shifting back office 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. Leveraging the operational and risk platforms some AFCs offer can change a bank's business banking economics.

Specialized lending. Related to market expansion and integration, AFCs realize that success increases with their ability to address bank "pain points" including efficiently meeting CRA and Fair Lending hurdles. Banks have begun to work with AFCs in these areas with the AFC taking on increased responsibility for meeting loan goals. The AFC operating platform reduces costs while its data analytic and risk management capabilities increase productivity and the quality of prospecting. Expect more activity in priority areas in which banks recognize the need for third party assistance.

DIY. A small handful of banks are pursuing a different path, believing that they can replicate an AFC-like approach based largely upon their internal data. But, most banks lack the data, analytic capabilities, risk management appetite, and culture required for this approach.

Managing through the Alternative Finance Ecosystem. Senior bank management needs to analyze which approaches to pursue, which AFC to work with and/ or explore a hybrid approach. The AFC ecosystem is becoming more complex and the number of potential AFC partners continues to increase.

Digitally Enabled Lenders Come in Many Shapes & Sizes



Source: Fundation

Banks should determine their preferred approach and create a checklist of partner selection criteria likely to include assessing compliance and regulatory capabilities, analyzing the ability of the AFC to provide a turnkey solution to minimize the burden on the bank, and determining the AFC's reputation for performance and quality based upon competitive intelligence.

As part of this process, banks need to decide between working with direct lenders versus marketplace lenders that do not take credit risk but provide a platform to match borrowers with lenders. Direct lenders operate with the funding and risk expertise required to assess and book loans themselves and have "skin in the game," an approach some banks may prefer.

Managing through the alternative finance "ecosystem" presents banks with multiple challenges, including tracking developments in this space. AFCs are not going away; as they achieve greater acceptance among borrowers and provide more economic benefits to banks, they will play a larger role in business banking. Banks should take advantage of what AFCs offer.

About FIC Advisors, Inc.

For 20 years FIC has focused on assisting banks to grow in the commercial banking space. Most recently, FIC has been working with alternative finance companies and banks on issues related to growth and partnership development.

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