The 2017 Alternative Lending Gameboard

by Charles Wendel

At a marketplace lending conference in early December two speakers forecast that 2017 would be *the year of the bank partnership* for alternative finance companies (AFCs). Finally, these industry leaders suggested, a large number of banks would embrace working with AFCs and put programs in place resulting in significant growth for the AFCs, including those players focusing on lending to the small business space.

Maybe. For AFCs to achieve their growth goals, many need to change their approaches and address some current challenges. For banks to take advantage of the cost savings and revenue generation that AFC partnerships can help deliver, bank management needs to agree on its goals in working with a partner both in the near and longer term and in many cases change the way it approaches the small business space.

Issues for AFCs include funding, regulations, and post-bank sale implementation. As for funding, 2016 has demonstrated the need for funding diversity. Given institutional investor concerns, AFCs cannot rely on that group as their sole funding source. AFCs that lend need to expand their equity base, pursue securitization, add bank lines, and placate institutional investors. This requires a degree of sophistication and access beyond some players.

Dealing with increased regulatory scrutiny is not a new challenge, but the OCC's proposed charter for AFCs is. The OCC is exploring offering special purpose FinTech charters to AFCs. Once the OCC announces its final approach, AFCS will need to determine whether they want to go through the arduous and expensive process of obtaining a charter and subject themselves to its reporting and equity requirements. Most AFCs will choose not to do so for cost and related reasons. However, one question involves the extent to which potential bank partners will require the OCC "stamp of approval" before considering working with them. Will an OCC charter become a cost of business for AFCs?

A third issue for AFCs involves what happens after they sign an agreement with a bank. If the agreement involves the AFC providing a digital platform and evaluating loans that the bank does not want, signing an agreement can take a year or more. However, once the agreement has been signed, the real work begins. In the past year several existing bank/AFC partnerships disappeared due to minimal volume generation and the bank and AFC's view that the effort was not worth the revenue created. Some AFCs found the expense of working with banks did not provide the necessary payback.

Signing on the bank provides one challenge; getting the bank to generate loan volume offers another. Many AFCs have found that "If you build it, they will NOT

come," without some additional work. Providing a digital solution, whether it involves an origination platform or an end-to-end solution will not necessarily result in increased loan volumes.

Bankers stick to their old ways unless compelling reasons exist to do otherwise. The reasons/actions required to get a banker to change his current methods include: sufficient training, a belief by the banker that this new way will make his life easier, a willingness to break existing silos, a change in compensation to encourage the use of a digital approach, the demonstration that the AFC will improve the customer experience, a clear commitment from senior management, and, oftentimes, an enhanced sales management process.

Many of the above success factors are outside the control of AFCs and sometimes even bank management. But, since most AFCs rely on a percentage of loan volume for their revenue stream, significantly increased loan activity is critical. Even what "significant" means can differ for a bank versus its partner. Banks may view a 5-10% loan increase as a great step forward, but that may translate into insufficient income for an AFC and way below its revenue expectations.

To address this performance gap, AFCs will often need to rollup their sleeves and get more directly involved in a bank's sales and marketing process. Beyond a digital platform for originations, they may need to demonstrate improved workflow, generate enhanced analytics for customer and target identification, and provide other sales and marketing support. Many AFCs should start by assessing why origination levels are not growing at the rate they expected and work with their banks to resolve roadblocks.

On their part, while banks are continuing to wake up to the power of partnership, some have yet to determine their internal and longer-term priorities for working with AFCs

- Do they simply want to provide customers with a digital experience while maintaining current risk parameters and pricing?
- Do they see working with AFCs as a market expansion opportunity?
- Do they expect their partner to provide market analytics and lead generation?
- How do they expect their partner to assist in sales and marketing, if at all?
- Do they just want to take a first step with an AFC and then take a pause versus committing to a deeper relationship?

Each bank has different requirements and depending upon its needs and size, among other factors, different partners will be appropriate. However, effective partner selection requires bank management agreeing on both near and longer-term goals.

2017 is unlikely to provide a positive tsunami-like event for AFCs. Rather, more inroads will continue to be made, but in many cases at a slower pace and higher investment level than AFCs would like. Banks should remain a priority partner for many AFCs, but they need to understand what drives a bank's decision process and be prepared for continued close involvement with a bank or credit union, once the partnership contract has been signed. In turn, bank's need to understand the cost reduction and growth opportunities that AFCs offer and make sure they have implementation plans in place to take full advantage of them.