Alternative Finance: Teaming for Success
by Charles Wendel

Our recent focus has centered on microbusinesses, the smallest of companies that include more than 90 percent of all businesses. As noted in our prior comments, microbusinesses make difficult borrowers for most banks. Lending to them can result in losses resulting from the costs of origination, underwriting, compliance, and related areas. Profits from this group largely depend upon a bank's ability to deliver on cross-sale opportunities, an elusive goal for most banks.

The result of these challenges is that many banks, while proclaiming their interest in business lending, have in effect shut off these small borrowers. Banks still proclaim how competitive the small business lending space is with margins being squeezed by tough competitors. However, many fail to highlight the fact that they have narrowed the type of borrowers they will lend to, concentrating their focus on fewer targets and, thereby, increasing the competitive pressure as more banks focus on a limited target set.

The economic downturn that began late in the last decade made many banks much more cautious in their small dollar business lending. Beyond concerns over risk, banks now better understand their economics and rightfully are skeptical about the profitability of offering small loans to microbusinesses. As banks withdrew from or limited their focus on this activity, others saw opportunity and, hence, the emergence of a strong and well funded group of non-bank or alternative finance companies (AFCs) to pick up the slack.

While non-bank lenders are hardly new, having existed as long as borrowers needed lenders, these AFCs differ from past lenders in several ways:

- They rely on the use of technology to increase their effectiveness and to streamline their processes. Most originate their loans online, decreasing origination costs. Paper has surrendered to digital technology, streamlining processes and significantly reducing the time required for decision-making. Initial credit decisions are often made based upon models that capture elements that exceed the information used by most banks, in some cases including daily assessment of a company's cash flows.
- AFCs provide multiple lending-related services, ranging from full integration with a bank's current lending to providing banks with the digital platform required to streamline their current origination and underwriting processes.
- While some banks view them as competitors, many AFCs focus on those borrowers that the banks largely avoid, willing to make loans to companies that meet its risk/reward criteria. Unlike for most banks, risk-based pricing is the norm for AFCs.
- An AFC's non-bank approach includes its internal style and culture: hoodies seem to dominate as the office standard with suits donned only for meetings with bankers and investors, if then. If you are 40, you border on ancient at

these companies, although increasingly they hire one or more highly experienced former bankers to provide banking experience.

- Arguably, with their reticence to lend, banks created the market opportunity for private equity investors and technology-based lenders to meet an increasingly unmet need. We have also seen multiple cases in which even bankable customers prefer to work with AFCs, paying higher rates for the speed AFCs provide and taking advantage of their relatively hassle-free process.

Beyond the above, one factor that distinguishes many AFCs, in particular the largest and fastest growing ones, centers on their desire to and increasingly their success at partnering with banks and credit unions. They provide traditional lenders with specific lending and other capabilities that they do not currently possess and likely do not want to or cannot develop internally.

Many AFCs have been focusing on working with banks due to the value banks can provide in addressing some of the challenges of the AFC operating model:

- *AFC's cost of origination*. Even though a few AFCs have built national brands, brokers and direct advertising expenses are often very high relative to revenues. Investors want those numbers to decrease.

- *Bank deal flow*. AFCs view banks as a source of consistent volume that can efficiently feed their deal flow capacity and help to cover their fixed costs. Well over 100 AFCs now operate in the small business loan space. One of the industry's challenges involves generating the volume required to provide the level of returns their private equity investors expect. It is highly likely that a significant percentage of those 200 players will disappear over the next 12-18 months as they fail to generate the loans to cover their fixed costs and return expectations.

- *Integration*. Many AFCs began working with banks by reviewing their loan turndowns and paying a fee for leads that turn into loans. However, based upon a number of concerns, banks are often unwilling to show these loans to AFCs. Issues include privacy and related compliance requirements and wanting to avoid potentially negative publicity about teaming up with a high-priced lender. This hesitancy results in the volume of turndown opportunities referred to banks being low in number and this initiative failing to "more the needle" for either the bank or the AFC. While turndowns may still be a first-step entry point for some AFCs, they quickly focus on trying to imbed themselves into the bank, increasing their services to include market expansion or other initiatives, ideally becoming part of the bank's infrastructure and, therefore, in place for the long term.

Why should banks consider partnering with a group that is viewed by many as dangerous competitors? Mentioning the rates that AFCs charge, a senior banker even went so far as to describe them as "evil".

Customer service. One client in the process of selecting an AFC partner cited the opportunity AFCs offer to provide a segment of his customers with loans his bank would be unwilling to make. Yes, banks are avoiding a large group of potential borrowers, but, understandably, banks are unwilling to loosen their lending criteria to make loans to these customers. With their broader lending criteria and their risk based pricing, AFCs are willing to lend where many bank are not. The AFC partnership allows the bank to maintain deposits and other product income while giving potential borrowers a borrowing option. And, while years ago the press wrote stories about the sky-high rates changed by AFCs, in many instances those rates, while still higher than bank rates, have declined from the stratosphere more to the level of credit cards or less.

*Market expan*sion. AFCs operate as data-driven companies that swallow and digest borrower-related information on a minute-by-minute basis. They can use that data to help banks grow their traditional loan business, providing marketing leads that meet a bank's current risk criteria and make the marketing effort more efficient. For example, one AFC is working with a bank on helping the bank target customers that meet its borrower and risk profiles but operate in geographies in which the bank wishes to expand its market share.

Reduced costs. Because of their application of technology and their lower cost infrastructure (e.g., no corner offices and no legacy systems to support), AFCs can lend more cheaply than banks. Banks can lever their capabilities to capture those cost savings and, potentially, turn a negative return loan positive.

Flexibility. Because of their desire to work with banks AFCs are flexible in how they structure their relationships. These remain early days in partnership building and to a certain degree banks can call the shots in negotiations; this is particularly true of larger banks with which AFCs are most interested in working.

Next time we will describe the different ways in which AFCS and banks can cooperate and provide brief case examples for each. Banks should know that they can serve microbusiness loan requirements and even make money doing so. They just need to approach this opportunity with a different mindset and a willingness to move outside their traditional comfort zone. Doing so it worth the effort and is becoming the norm rather than the exception.