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Get Sexy with Alternative Lending
By Alan Snyder

The sexiest thing in the world is being smart and thoughtful. Everything else is crap."
- Ashton Kutcher, famous actor and successful venture capitalist

We want you to be sexy, smart and thoughtful about alternative lending and will try to move the ball forward in this brief (actually not so brief).

Scale counts!

We have seen larger executions enjoy better structures, a wider base over which to allocate fixed costs and lower financing costs. Shinnecock has achieved similar results by negotiating lower sub-manager fees and more favorable liquidity provisions.

Independent research insights
Orchard, a research and technology provider to the alternative lending sector focused primarily on consumer platforms, published an interesting piece on "stress testing." They detail some worthy due diligence touch points all of us should consider.

1. Apply extra scrutiny to lenders that have just commenced operations, and also to the associated principals and their directly relevant prior experience.

2. Beware chasers of growth.

3. Examine servicing capabilities and backups.

4. Consider sustainability of the relationship between lender and borrower.

5. Ascertain payback schedule. Is the loan amortizing and if so, what frequency, e.g., daily direct bank debit or term bullet?

6. Compare apples to apples. What is the seasoning in the comparative portfolios under consideration?

7. Understand carefully the mark-to-market rule set. (our addition)

Orchard performed an analysis of various loan vintages that showed an encouraging fact: loans in vintages beyond 2006 - 2008 have performed increasingly better, possibly as the earliest entrants gained experience. And, we might add, as the Great Recession faded. Moreover, as part of their analysis, they demonstrated how defaults can rise 225% over the life of the loan cohort before losses.

Lastly, they reinforced the Towers Watson report:

"Investors who diversify their market participation across multiple originators - particularly among those of different asset classes, borrower types and loan product durations - will be in a stronger position and less vulnerable to originator-related volatility."

Ernst Mayr, the deceased leading evolutionary biologist, gives a more generalized view:

"... geneticists described evolution simply as a change in gene frequencies in populations, totally ignoring the fact that evolution consists of the two simultaneous but quite separate phenomena of adaptation and diversification."

In short, evolve and diversify, or die.

Third party commentary on traditional bank difficulties

Many investors have asked us why traditional deposit-taking banks have abandoned these loan sectors to the new breed of lenders. In a recent blog post, Bill Blain of Mint Partners offered this opinion: "I sincerely believe that banking establishments are more dangerous than standing armies..." And he continues:

"I'm absolutely fascinated by this morning's comments from BBVA Chairman Francisco Gonzalez, who told El Pais, '90% of the world's banks will disappear within 20-yrs.' He goes on to say the current structure of banking is "unsustainable" and, as no parts of the sector cover their capital costs, the system is unfeasible. He predicts a wave of consolidation coming. He also expects political ructions will slow investment and the current Spanish recovery will falter.

"While great minds may think alike, fools seldom differ. I agree with him: banking is utter Pants.

"Regular readers of the 'Morning Porridge' will be well aware of my own thoughts about banking post the 2008 Global Financial Crisis - which generally align as:

a) The financial system is rapidly evolving away from banks towards direct lending - platforms and institutions.

b) Much of the bulk banking businesses currently sponsored by banks will be replaced by simpler, cheaper to run, fin-tech type solutions.

c) Regulation has hamstrung banks and impinged the efficient functioning of markets.

d) "The only thing worse than too little capital is too much" - hence bad capital rules have resulted in the current unsustainability of over-capitalized banks.

e) Banks no longer manage for growth - they manage to regulatory threats and the threat of government sponsored fines.

f) As competition eats into basic banking, more sophisticated business such as investment banking and PW are being closed to them by regulation and capital rules, meaning banks increasingly look flabby.

g) Yet most banks need massive basic investment into digital and IT systems simply to remain current in an increasingly competitive environment.

h) While US banking was rapidly recapitalized and "fixed" following the crisis, the lack of single European "voice" and consensus via ECB means European banking is still essentially unfixed.

"As a result of all the above arguments becoming increasing clear, the investment community is finally waking up to the banking sector's problems. We've seen the rising tide of doubt through the year - fuelled by doubts about CoCos, fears about German, Italian and even French names, and the shenanigans at names like Nova Bank and Hypo-Alpe.

"In the last few days we've seen HSBC stock slide further as analysts question if it can maintain its current high dividend yield. When even the largest (and arguably best) European bank is up against the ropes, let me be clear - yes, I do hold HSBC in my PA portfolio... and it's causing me angst.

"Yet, in recent weeks we've seen a lot of the pressure diminish on banks - Deutsche Bank did not disappear in a dramatic puff of blue smoke as many expected. As a result... smiles all round. AT1s, which traded like falling dead cats following last month's banking wobbles have surprisingly (to my mind) recovered. But... beware... be very afraid..

"Unfortunately, the future for banks is getting even worse:

- The current pathway in the BIS over capital discussions, (Basel III, IV, n+1), have become absolutely impenetrable for anyone who isn't following it full time, and with a doctorate in quantum financial physics. If you don't understand it... don't buy it.

- Issues like TLAC, MREL and BOLX are utterly beyond the ken of common people.

- ZIRP and NIRP (zero and negative interest rates) mean disaster for banks in terms of rising NPLs and declining margins.

- Bank funding has become almost impossible as investors figure out senior debt is now subordinated to equity.

My old bank test was CAMEL. Banking Capital is in bits, Assets are under pressure from NIRP, Management isn't managing - its avoiding further fines, Earnings are swamped by capital costs, and banks' access to Liquidity has been crushed by bad regulation."

Bill Blain has really put the pickle on the fork about banks' competitive capabilities.

Factoids

Fintech has not escaped regulatory notice

- On March 28, 2016, Rachel Witkowski wrote the following in *The Wall Street Journal* about a speech delivered at Harvard University by Thomas Curry, Comptroller of the Currency:

> **"Regulator Moves to Create New Fintech Framework:**
> ***Office of the Comptroller of the Currency to issue white paper this week aimed at kicking off discussion on how best to regulate fast-growing sector***

"WASHINGTON - One of the top U.S. banking regulators will issue a formal call this week for officials to start crafting a new framework aimed at governing the rapidly growing financial-technology sector-a nod to complaints from traditional banks and startups alike that current rules both stifle innovation and provide insufficient oversight for new forms of finance."

- In numerous news articles, the Consumer Financial Protection Bureau (CFPB) has announced interest in examining sales practices in the high-growth sector.

- Supreme Court considers reviewing the Second Circuit Court of Appeals ruling on Midland which relates to avoiding usury limits for platform consumer lending, and other similar situations. No word yet on whether the Supreme Court will accept the case, but Lending Club

has already announced changes to how they compensate WebBank, as a way to eliminate this potential issue.

Mary Jo White, SEC Chief, didn't want to be left out. She worries about Fintech valuations and adequate disclosure. Signaling political positioning in this scrum, she wants a seat at the table.

None of this should be surprising given the rapid growth of alternative lenders, the onslaught of platforms for many, many different loan types, and a bit of grumpiness from deposit-taking banks finding a new competitive landscape. Time to abandon all investments? No, although there will be greater scrutiny and most likely, some additional costs. Yes, there will be winnowing amongst the various players. Investor margins can withstand some higher costs in the origination. Thorough due diligence of each alternative lender will be paramount.

Securitization challenges

- Investor sentiment abruptly cooled in a recent Citi offering of peer-to-peer loans, forcing rates to a high level. Also, Moody's cautioned, which has caused spreads to widen on the less secure tranches. This market kerfuffle may impact balance sheet platforms the most yet could ripple through to higher lending costs for any leveraged portfolios using bank debt. Possibly in anticipation, both Lending Club and Prosper, the largest players in the unsecured consumer lending sector, have meaningfully raised borrower rates, which can buffer investor returns.

- PeerIQ, a risk management provider to the peer-to-peer credit sector, notes in their recent report, "overall, consumer credit health remains strong."

Market growth and product line expansion abounds

- Morgan Stanley: Marketplace Lending Witnessing Exponential Growth
"... with auto and credit card asset-backed lending printing positive total returns, including a drop in delinquencies in credit card pools."

- *Money* magazine observes "new sources of small business financing are popping up all over."

- PricewaterhouseCoopers writes in a 2016 essay that these new technical disintermediators are voracious competitors challenging traditional banks. KPMG notes that this drive for efficient execution is driving innovation and successful penetration with big data, analytics, cognitive computing and digital (web savvy) executions aiding.

- Traditional banks seem to have adapted by "if you can't beat 'em, join 'em," given the number of joint relationships. "Co-opetition" is the watchword.

Alternative lending investment competitors have their own challenges

- Business development companies (BDCs) have a different profile than alternative lenders as we see it: larger individual loan sizes, longer duration, equity volatility, and often higher-risk loans given ties to LBO structured mezzanine debt. Fees can be high; a blend of public and non-traded private offerings makes selection challenging; for public BDCs, an investor is subject to changing sentiment as fund flows wax and wane. For non-traded BDCs, liquidity can be a challenge.