EXECUTIVE INSIGHT

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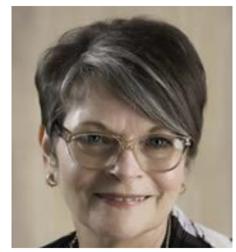
12 Clock Tower Place, Suite 150 | Maynard, MA 01754
www.mercatoradvisorygroup.com | phone: 1(781) 419-1700 e-mail: info@mercatoradvisorygroup.com

Where Banking and Commerce Really Meet: the Industrial Loan Company Revisited



Patricia Hewitt,
Director Emeritus

Patricia's career in the financial services industry spans 30 years and covers a wide range of the payments market. She has worked with companies across the market spectrum, from global card networks to platform developers to emerging technology entrepreneurs.

Alternative lenders and their regulated banking counterparts need to grow their portfolios. Is it time for the two to come together as Special Purpose Banks?

In 2013, the FDIC lifted its moratorium on issuing Industrial Loan Corporation (ILC or Special Purpose Bank) licenses. To date, their application bin is empty, but with investors looking for growth out of online alternative lenders and with traditional bank partner pools remaining shallow, the value of owning one of these special bank charters just might become more appealing.

Introduction

Financial services institutions have long been tightly interwoven with licensing agencies and regulators. There's a good reason for that since entrusting a company with one's money requires some degree of faith that the money will be returned to you when you ask for it. This is why deposits are treated as liabilities on bank balance sheets—it's not their asset, it's yours. The picture gets flipped when we talk about credit. Offering credit to the public requires that the institution trust the borrower since a loan balance is the bank's asset. It's the bank's money, and thus the credit market is centralized around managing risk. In the early days of regulated lending, consumers deemed less trustworthy, meaning those who had little or no credit or bad credit experience to vouch for them were left outside of the traditional lending market.

This environment is the reason that, in the United States, Industrial Loan Company (ILC) banking charters came into being in the 1900s. At that time, there was a need to provide loans to factory workers, individuals who were unable to obtain credit in other ways. Manufacturers had enormous power in the country then, and U.S. licensing agencies agreed to allow industrial commercial enterprises, in this case manufacturers, to make loans to their workers.[i] Over time, these types of banks began to be referred to as "Limited Purpose Banks" since they operated along specialized and narrow business lines.

A number of states issue Limited Purpose Bank or ILC banking charters (terms you'll see throughout this commentary), most notably Utah, which early on created a highly favorable environment for entities of this type. As the consumer lending industry began to hit its stride in the 1980s, retailers as well as manufacturers saw the opportunity to tie consumers closer to their brands by offering both merchandise and the ability to buy more of it with their private-label credit and credit card programs, which were generally geared toward subprime or thin file consumers. These were buyers who either had little or no credit history or bad credit history, and who represented a pool of spend in which banks weren't especially interested but which retailers found irresistible. Coupling this potential with an opportunity to make money off balances carrying higher than average interest rates, retailers were only too eager to dust off these obscure licensing rules and become their own lenders.

In this way, the retailer-controlled approval criteria as well as the all-important SKU-level spending data helped drive marketing into the era of personalization so familiar to us today. In relatively short order, Spiegel, Saks, Macy's, Gottschalks, Talbots, Cato, Dillard's, and more applied for and received ILC banking licenses that allowed them to originate and service consumer loans.

And, as long as these ILCs stuck to their knitting—that is, offered the same fee and repayment terms as cash loans and instant approval credit cards to pay for refrigerators and impulse buys—the banking industry stayed out of their way. After all, these companies were serving a segment of the public that the regulated financial institutions were not exactly striving to attract.

And Then Came Walmart

In July 2005, Walmart applied to the FDIC for an ILC license. To say that woke up the banking industry is like saying that Apple introduced a new music player to the market. That application hit the market like a meteor dropped from outer space, and traditional financial institutions and their trade groups reacted quickly and effectively, creating an uproar so loud and vehement that the FDIC suspended all ILC applications in 2007, sweeping other retailers' applications that were in the hopper, like Home Depot's, into a moratorium period. An ironic twist to the story is that many retailers subsequently sold their credit card portfolios to financial institution aggregators as they became weighed down by a combination of credit losses, declining demand, and rising servicing costs.

The Moratorium Is Over

Then, in July 2013, the moratorium on the FDIC granting ILC charters was lifted through none other than the Dodd-Frank Act, which also brought debit card interchange fee regulation as well as things like merchant debit transaction routing control to the industry. However, in the states that allow an ILC charter (California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah), no new ILCs have been opened since July 15, 2013 and in fact, only one new bank and one credit union have been licensed in these states since that time.[ii]

And so, with all the money being poured into fintech, the question we pose in this Executive Insight is: Has the time come for a resurgence of special purpose banks? Why wouldn't a company that wants to provide financial services to the public not want to be a licensed institution? At one time, there was a benefit to holding an ILC banking charter or it would have never existed in the first place. Are those benefits no longer valid? Is there another way to get those benefits that doesn't include licensing and regulatory oversight? What about competition: Can a company be more—or less—competitive based on its licensing status?

What's the Difference?

To begin sorting through these questions, the table on the next page lists for comparison some of the key capabilities a commercial banking license and an ILC license grants the holder, as defined by the FDIC. We can see there are limitations to an ILC charter inherent in its core business as a provider of credit services rather than depository services, but there are benefits as well. In particular, exporting interest rates allows an entity to avoid the highly burdensome process of complying with each state's credit regulations. In other words, they can operate on a national basis. In addition, ILCs do not have to establish a bank holding company, which frees their business plan from the constraints of certain federal oversight conditions.

Capabilities Permitted to Two Charter Types		
	State Commercial Bank Charter	**Industrial Loan Corporation Charter**
Accept demand deposits	Yes	Varies with the particular state. Where authorized by the state, demand deposits can be offered if either the ILC's assets are less than $100 million or the ILC has not been acquired after August 10, 1987
Can export interest rates	Yes	Yes
Can open branches and is authorized interstate	Yes	Can only operate in seven states where ILC charters are valid
Can offer full range of deposits and loans	Yes	Yes (see demand deposit limitations above)
Regulated by federal authorities	Yes	Yes
Parent activities generally limited to banking and financial activities (a parent is a bank or financial holding company supervised by the Federal Reserve)	Yes	No

Source: Federal Deposit Insurance Corporation

Benefits of Limited Purpose Banks

The financial services industry benefited greatly from having limited purpose banks in the 1980s and '90s, creating businesses like MBNA (credit card issuer aggregator), Providian (subprime lending), and *Etrade (Internet-only financial services) and the business models they pioneered, which have survived in one form or another ever since. The advantage of having a singular focus on a specific type of business allowed these companies to rapidly acquire expertise and scale. The requirement to develop, manage, and adhere to an audited business plan necessary for regulatory approval provided the organizational discipline required to execute against that plan.

Investments in technology were also focused to benefit very specific business strategies, freed from the constraints of competing for resources across business lines and reducing the risk of failure due to lack of scale or the build-out of cheaper but less innovative solutions. Lacking direct contact with customers through branches or agents, these specialty banks were forced to develop and implement advanced scoring algorithms and data mining techniques to acquire, analyze, and service their accounts. These factors fostered an environment where innovation thrived and technical capabilities expanded, which ultimately influenced a generation of traditional institutions to adopt similar capabilities in order to remain competitive.

The conditions that spawned these companies—consumer demand, technical expertise, and the rise of virtual acquisition and servicing channels—sound much like the environment from which alternative lending companies we're familiar with today have emerged.

But That Was Then and This Is Now

What's changed in the interim are three main factors: First, it is primarily private equity investment that has provided the economic engine for market entry and expansion. Second, contemporary alternative lending companies view themselves as technology entities, not financial entities. And third, the regulatory environment for financial institutions post-Recession is much more onerous.

Putting aside whether or not the FDIC is willing to grant a Limited Purpose Bank license, the economic engine that's driving new ideas into the market—private equity groups—isn't interested in idling on the sidelines waiting for a green light. Instead, the market is betting on technologies designed to fix legacy banking processes primarily by building out the next greatest user experience and simply shifting the major cost of compliance onto the balance sheets of their regulated banking partners. So for example, alternative lending companies have created streamlined, transparent, and nimble processes that approve loans and provide funding in a fraction of the time it takes at a traditional lender. Another example is Internet-only banking applications that strive to create a personal financial ecosystem on a one-to-one basis complete with up-to-the minute spending and saving information, feedback, and resources. In both these use cases, however, getting scale to a sustainable size remains elusive.

Another factor impacting the expansion of alternative lending companies is banking partners' limitations, be they legacy infrastructure constraints, compliance boundaries, or business model weaknesses. The interdependency of alternative financial services providers with their licensed partners has enabled initial growth but may prove limiting in the long run.

Pushing operational expense out of the process has allowed these companies to claim superiority over legacy banks and in some cases, this is a valid argument. However, would being a regulated institution ultimately support evolution of these technical achievements into sustainable business models and build the scale necessary for profitability?

Is a Convergence Emerging?

For alternative services designed to disrupt traditional lenders, raising money based on a need to meet the capital requirements of a regulated lender, rather than for application development, is going to be exponentially more difficult if the main source of funding is the venture capitalist community, who are generally more focused on an exit plan. The kind of investors a bank like this requires must have a long view and a grounding in the industry, like investment bankers. Yet, these investors exited the de novo banking business after the Recession and haven't returned since. In essence, the problem faced by these start-up institutions was the difficulty of generating sufficient scale to become viable, performing assets for investors. Not a few alternative lending solutions have originated loans for many thousands of consumers and small businesses, but is that enough?

Yet just as regulated institutions became more interested in partnering with alternative lenders, the FDIC issued an advisory letter[iii] pertaining to third-party risk that has placed banks in the position of having to underwrite the loans generated by these companies a second time, then conduct detailed due diligence on all aspects of its loan management. In addition, recent litigation[iv] signaled that banks that purchase these debts may not be protected by Federal interest rate preemption laws. And should this case be taken up by the Supreme Court (which is weighing it now), the banks would be open to a wide range of fiscal and legal risk. These compliance requirements, and others like them geared toward "helping" banks manage counterparty risk, result in throwing up barriers to partnerships that might make owning a bank charter, or simply purchasing one of these companies outright, a smarter strategy than trying to navigate through a minefield of regulations and litigation risk.

Even with these barriers, the need for new tranches of loan growth is so great that some banks are finding ways to enter the alternative lending market. Market excitement doesn't necessarily translate into strategic investments, though, as we saw with the prepaid card market, which resulted in few banks entering that market at the business line level. It is still early days for alternative lending. One highly cited partnership was that of JPMorgan Chase and OnDeck[v] in December 2015. In an interview about this partnership, OnDeck's CEO Noah Breslow sketched its main components, which consist of Chase using the company as a provider of white-labeled underwriting and servicing technology. Chase brands the loans and puts them on the bank's books, paying OnDeck an origination and servicing fee. OnDeck made note of the "significant" investments it had to make into infrastructure, technology, security, and compliance in order to make the partnership viable for the bank. This alliance illustrates the boundaries each organization needs to expand the scale of the business as Chase looks for increased relationship value from its significant small business account population and OnDeck needs access to new potential loan pools in order to please investors. In theory, Chase benefits from the technology investments OnDeck has proved out in the market and OnDeck further solidifies its position as a leading alternative small business lending platform.

Reporting Quarter	Origination Volume	Net Revenue	Net Revenue Margin	Provision for Loan Losses
4th Q 2015	$557M	$47.3M	41.5%	$20.0M
1st Q 2016	$570M	$31.5M	50.2%	$25.4M
2nd Q 2016	$590M	$28.9M	62.6%	$32.3M

Source: OnDeck Q12016 Earnings Presentation

In reality, since that partnership was announced in December 2015 and according to OnDeck's Quarterly Earnings reporting,[vi] the partnership is generating loans and increasing margins, but net revenue is declining while loan loss reserves are rising. Is it possible that the alliances like these (where the banking partner owns the loan) tend over time to pull away more profitable relationships from the alternative lender than they return in income? This theory is impossible to prove based on the analysis of one deal, but it's no secret that a number of these lending companies are struggling to reproduce the revenue gains from their salad days and the outcome to date does underscore the challenge alternative lenders have in growing their loan base, something that their investors will certainly weigh against an acquisition exit strategy.

The ILC Alternative

All this brings us back to the original thesis of this discussion, the possibility that the industry might see a resurgence of interest in ILC or Special Purpose banking charters within this segment. Whether this comes to pass will likely depend to a great extent on whether these alternative financial service providers are interested in evolving their business models from a valuation based on technical IP to one based on lending and financial services. If this very high-level examination of financial impact, post-Chase/OnDeck alliance tells us anything, it points to the fact that there is an inherent limitation in technology once it becomes a commodity. I argue that the partnership between alternative lending services and banks illustrates that when one places a click fee value on its technology, the commoditization shift has begun. This then places these alternative providers in the same category as processors, a business that has long been commoditized in the United States.

The only way out of this conundrum is to both own the technology and use it to build relationship value by providing enhanced services and cross-selling products—like a bank. This means that these companies' investors and shareholders have to be sold on the idea that in order to reach a sustainable and profitable scale in the market, these businesses have to face their regulatory challenges head on, perhaps as an ILC. Otherwise, their survival may depend on becoming a component of a larger, regulated financial institution and investors will realize their return through a traditional acquisition path.

Either way, it's unlikely that most of the current alternative lenders have the wherewithal to reach the required scale to be viable, long-term lending-enablement entities with a core business model organized around "technology first." State regulators are already circling this industry, the Consumer Financial Protection Bureau has laid out rules for payday lenders (which one might argue is a distant, adjacent business model), and once these kinds of organizational demands are factored into thinning revenue streams, it's entirely plausible that at least some of these companies will wish to maintain their independence through a Special Purpose Bank charter.

Endnotes

[i] Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate, Kenneth Spong and Eric Robbins, Kansas City Federal Reserve Bank, 2006

[ii] FDIC

[iii] https://www.fdic.gov/news/news/financial/2015/fil15049a.pdf

[iv] U.S. Circuit Court of Appeals for the Second Circuit, Madden v. Midland Funding

[v] http://www.lendacademy.com/an-in-depth-look-at-the-ondeckjpmorgan-chase-deal

[vi] OnDeck, Investor Relations, Quarterly Earnings

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For more information about this report, please contact:

Patricia (Patti) Hewitt, Director Emeritus
info@mercatoradvisorygroup.com

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