LJN LAW JOURNAL NEWSLETTERS
LJN's
Equipment Leasing Newsletter ®
An ALM Publication
Volume 36, Number 2 • March 2017

FinTech Pressure on Equipment Finance Companies Serving SMB Markets

Challenges and Opportunities

By Brett Boehm and Patricia M. Voorhees

Financial technology companies (FinTechs) have revolutionized consumer and commercial finance in recent years by providing automated financial services marketplaces for swift, online loan originations and approvals. These alternative lenders are now in the early stages of disrupting the equipment leasing and finance industry, and transforming how small and medium businesses (SMBs) access equipment funding. This article discusses the initial impact of FinTechs and resulting opportunities and challenges, including strategies for recovering non-performing loans and leases within the fast-paced FinTech business model.

Brett Boehm leads marketing and business development for TBF Financial, a commercial debt buyer of equipment leases and loans. Boehm is on the ELFA Credit & Collections Management Committee and ELFA Membership Committee. He can be reached at bboehm@tbfgroup.com. **Patricia M. Voorhees** is a director of The Alta Group, a global consultancy focused on equipment finance. She has presented on FinTech topics at the ELFA Annual Convention and at events sponsored by the Commercial Equipment Marketplace Council. She can be reached at pvoorhees@thealtagroup.com.

Early Observations

The equipment leasing and finance industry is in the nascent stages of dealing with FinTech's impact and considering new business models and ways to leverage technology to embrace FinTech strategies. Firm estimates are not available, but based on Equipment Leasing and Finance Association (ELFA) data, FinTechs considered to be pure leasing players probably represent no more than one tenth of 1% of the $1 trillion U.S. equipment leasing market today.

While some FinTechs strictly provide small business and consumer loans, others, such as Currency, are forming working partnerships with regional banks, online equipment sellers and traditional lessors. CAN Capital and OnDeck are among the larger merchant lenders loaning cash for commercial purposes including payroll, goods and equipment. Other key FinTechs operating one way or the other in the equipment finance space today include LeaseQ and LiftForward, and there are dozens more of varying sizes and in varying stages of market entry.

At least three trends favor the expanding influence of FinTech models and technology on equipment finance: post-Great Recession lending practices, enhanced technology capabilities, and the shifting demographics shaping new buying patterns. Bank lending to smaller businesses has dropped off considerably since the Great Recession due to stricter regulation, capital requirements and credit standards.

Between 2008 and 2015, the number of bank loans to SMBs decreased an estimated 16% and the total money lent to these businesses plummeted 43%, according to Federal Financial Institutions Examination Council data from the Community Reinvestment Act. In fact, an ELFA study on The Impact of Alternative Finance on the Equipment Leasing and Finance Industry reported that more than 76% of SMBs may not even qualify for a bank loan under the stricter underwriting criteria.

Additionally, FinTech lending appeals to some SMBs as a fast, efficient channel for financing. Mobile technology and cloud-based computing have enabled the deployment of user-friendly finance solutions to facilitate loan origination at the point of sale. What's more, the millennials now gaining a foothold in the workforce are "digital natives" who are accustomed to buying online and have less loyalty to banks and traditional lenders than did previous generations. In other words, even if they could secure a traditional loan or lease, some SMB executives naturally prefer the speed and convenience of a FinTech-based solution integrated at point of sale for equipment financing.

Key Differences

FinTech business models are unburdened by legacy systems, and leverage the newest cloud and mobile technology to deliver speed and efficiency to borrowers. Traditional equipment leasing companies also have invested in technology to improve customer experience and efficiency and continue to do so today. What is different about emerging FinTech leasing companies is their ability to cost-effectively originate and underwrite transactions to a wider customer base. Automation of the back-end placement of transactions is another key differentiator. The emergence of marketplaces for traditional buyers of lease paper as well as newer entrants such as accredited investors and managed funds is beginning to change the funding landscape for FinTech providers, enhancing their ability to match the right customer and asset with the right funding source.

Compared with lines of credit and the loan terms available from banks, FinTech loan terms can be much shorter — as little as three or six months, though more are beginning to stretch to 12 months and beyond. SMBs pay back their loans on a daily, weekly or monthly basis, and some prepay to shorten the term. Of course, for each month a customer does not pay, there is an added and substantial service charge. One way an SMB could easily get hammered by this model would be by stacking loans, which involves taking out loans to repay other loans, a practice that is unregulated though it is frowned upon as a breach of contract by the borrower.

From a legal perspective, contracts and collections are two aspects of FinTech business models worth mentioning. All contracts are handled electronically. The applicant checks a box, the FinTech loans the money, and there are no actual signatures. Instead, the system tracks IP addresses to help verify against fraud.

Additionally, FinTechs in the equipment leasing space still do some manual audits to verify equipment delivery, since there is a third-party vendor involved and the capital cannot flow until equipment is delivered. This added layer of complexity is one reason why more FinTechs have not tackled the leasing product to date. Interestingly, based on TBF Financial's experience with FinTech customers, there does not appear to be any more fraud here than with traditional equipment leases and loans, which is itself only a small percentage.

Reasons given for non-performing FinTech loans also differ somewhat from traditional ones. Those borrowers freely admit that they owe the money and say they want to repay. There is typically no dispute over equipment maintenance or other matters that can make some non-performing leases more complicated and contentious. The problem is usually straightforward — the SMB's inability to repay.

Attorneys involved in recovery matters should also note that the FinTech business model is not designed for rigorous internal collection efforts beyond the period prior to charge off. Chasing collections internally after that point is counterproductive as FinTechs are designed for quick loans and repayment in order to put that capital back out on the street making loans. The section below addresses strategies for challenges like this, as well as FinTech-related opportunities in equipment finance.

Challenges and Opportunities

The FinTech business model generates revenues by making loans, getting repaid rapidly and making more loans — not by spending time, money and overhead on chasing defaults internally beyond the period before charge off. One strategy some FinTechs are using to handle charge-offs and recoup some of their cash is to sell charge-offs outright to purchasers of non-performing equipment leases and commercial loans.

A FinTech executive who has opted for this approach says selling charge-offs to debt buyers has increased the efficiency of his recovery department, which no longer has to manage the process or deal with third-party collections agencies. He noted that charge-offs are paid at closing in a simple transaction, and at a better rate than third-party collection agencies were delivering for him.

Another executive reported that charge-off sales have actually outpaced previous internal collection efforts. For most FinTechs, however, efficiency is the primary motivator for managing charge-offs this way. However, they were not the innovators in this case; traditional equipment finance companies have been utilizing this practice for managing charge-offs since the late 1990s.

Likewise, traditional equipment finance companies and FinTechs can learn from each other in many ways. It is not destined that FinTechs and SMBs will be the only beneficiaries of the FinTech-inspired evolution of the equipment leasing and finance industry.

The methods and human considerations that make an equipment finance operation successful will still be necessary, but technology will play an even greater role in the business than it does today. Traditional leasing players will be seeking innovative ways to offer more to customers online and reduce their costs.

There will be opportunities to make positive changes such as offering the right kind of financing at the right time — when the customer wants it and where the customer wants it — increasingly on mobile technology and at point of sale. And, more data can be harnessed and used strategically in asset management.

There will be increasing opportunities for FinTechs to access traditional capital markets products such as bank lines and securitization, and their scale and performance is demonstrated. In fact, representatives of those markets attended a recent event held by the Commercial Equipment Marketplace Council, founded by Currency and The Alta Group to provide education for a more technology focused industry.

FinTechs and their influence on traditional equipment finance companies will put increasing pressure on institutions serving SMBs to speed their origination processes. So, traditional equipment finance companies in this market segment cannot ignore the FinTechs.

On the other hand, such new industry entrants will need to learn what they can from the equipment finance industry's best practices that helped it more than survive the "Great Recession." To be successful, FinTechs will need to demonstrate mastery of both parts of the term "Fin … Tech," offering not only the right technology solution to customers, but also strength in traditional areas such as underwriting and portfolio management.

A PwC Global FinTech Survey in 2016 underscored the top concerns about FinTechs, which include pressure on margins and loss of market share. To deal with the new competition, some companies are engaging in joint partnerships, as JPMorgan Chase has done with OnDeck, or they may launch their own FinTech subsidiaries.

Conclusion

Clearly, the legal profession will play a key role in the FinTechs' growing involvement in equipment finance. Already we are seeing seasoned industry attorneys assist in-house counsel on the nuances of the business. Though it is still the early days for FinTechs in the industry, both traditional finance companies and new entrants would be wise to use the coming months to prepare for evolving developments.

—❖—