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THE BANKING SOFTWARE COMPANY

Merchant Lending

A Fresh Perspective on Growing Your Account Holder Base

Contents

Introduction

The “farm to table” movement has grown in popularity in the culinary worldas consumers have gained an appreciation for the health and economic benefits of serving fresh, locally-sourced ingredients. There are many parallels between a successful indirect merchant lending channel and the “farm to table” concept. Throughout this article we will investigate methods for cultivating that merchant lending channel.

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This philosophy means a disintermediation of the traditional “middle man” in the food industry – those responsible for the frequent processing, storage, and long-distance distribution of raw ingredients. Consumers in this case can eat fresher, healthier food while also supporting farms in their immediate and nearby communities.

dis·in·ter·me·di·a·tion
noun

Reduction in the use of intermediaries between producers and consumers.

Disintermediation. In financial services circles, it's a big word with big ramifications. In the point-of-sale financing market, community banks and credit unions face the continued challenge of gaining market share for financing of larger consumer purchases (referred to as indirect merchant lending or “lifestyle lending”) in verticals such as home improvement, furniture, and elective cosmetic surgery. Today, the merchants are primarily steering those financing decisions toward such organizations as Synchrony, Citi, and Greensky[1] – without a thought of lending options available from the local bank or credit unions (even if the consumer is an existing account holder).

> Results have shown an average interest rate on funded indirect merchant loans of over 13%, and an average credit score of 718. The delinquency rate comes in under 1%, and portfolios can exceed $16 million.[2]

Throughout this article we will investigate methods for cultivating an indirect merchant lending channel within your bank or credit union – whether this is a channel where you are currently harvesting new business or if this an area you are looking to freshly seed. There are many parallels between a successful indirect merchant lending channel and the original “farm to table” concept, many of which we've incorporated to illustrate our points. Don't have a green thumb? Don't worry, we'll provide with the insight you'll need to reap a fruitful harvest.

1. Medium.com. “Innovation in Point-of-Sale Finance.” 2016.
2. Credit Union Journal. "“Lifestyle Loans” Offer Host of Lending Opportunities." 2012.

Fresh New Business

In an age of diet fads and Hollywood health trends, many of us have looked for ways to bolster our personal health by introducing a variety of nutritious foods. Similarly, credit unions and community banks are in search of avenues to increase account holder bases and grow and diversify their lending portfolios.

A 2015 research report from Filene Research Institute estimates an annual potential market size of $391 billion for point-of-sale financing (defined as financing at the point-of-sale for large consumer purchases).[3]

Fresh Ingredients

In many cases, community banks and credit unions are only brought into the fold once consumers seek to refinance and consolidate a series of high-interest private label card and credits accumulated over a number of larger purchases. This is not unlike introducing fresh veggies into a diet only after having a doctor warn you about weight or cholesterol level.

The private-label credit card business is currently around $270B.[4] Consider these are the fast food companies of the financing world – quick and convenient to get, often enticing (for example: an introductory rate), but not ideal for your financial health.

However, many consumers are spurning credit cards, none more so than Millennials. Roughly 30% of all Americans – and 60% of Millennials – do not have a credit card.[5] This is despite the need for access to credit, with nearly half of all consumers lacking the ability to accommodate an unexpected expense of even $400 with their savings account. In other words, people have an appetite for credit, especially for larger purchases, they are just more cognizant of exploring a healthier option. A nice dish of lower rates and better service offered by community banks and credit unions can fit this need very well.

Fertile Land

Research conducted by the Hitachi Capital Consumer Finance team further reveals the fertile market for efficient point-of-sale financing solutions. The research shows that retailers which don't offer finance, both in-store and online, stand to lose 44% of potential customers. 26% of the respondents indicated they would have gone to another retailer if financing hadn't been available, and only a third would have bought the product the same day. 83% of the participants answered 'yes' when asked whether the offer of financing 'heavily influenced' their decision to buy.[6]

The message is clear: merchants and consumers are growing equally reliant on quick, easy access to competitively priced consumer credit. Community banks and credit unions can provide a "win-win-win" through a fair and efficient indirect merchant lending program.

3. Filene Research Institute. "Blue Ocean Lending for Credit Unions: Point of Sale Financing." 2015.
4. Medium.com. "Innovation in Point-of-Sale Finance." 2016.
5. Medium.com. "Innovation in Point-of-Sale Finance." 2016.
6. Retail Times. "In my opinion: retailers who don't offer point-of-sale finance risk losing 44% of customers, says Hitachi Capital Consumer Finance." 2016.

Planning Your Garden

Nothing beats the taste of fresh vegetables grown in your own garden. Some of that taste is probably some appreciation for the effort you've put in to cultivate and harvest your hard work. That successful work begins – as any successful initiative does – with a good plan. Where should I position my garden to maximize sunlight and water? What are the best crops to grow where I live? Finding the right answers to these questions will ensure you get off on the right path to a fruitful harvest.

With an indirect merchant lending channel the questions are somewhat different, but the need for a plan is just as critical. Banks and credit unions can draw upon their experience in indirect automobile lending to guide their efforts. Successful indirect lending programs, whether for auto financing or these other point-of-sale opportunities, are built upon effective development of merchant relationships - driven by a focus on service and competitive pricing. There are some key similarities and differences of which the financial institution establishing a new indirect merchant lending "garden" should be aware.

A 2013 whitepaper on merchant lending from Jeremy Schaar for the CUNA Lending Council points out a few such differences:[7]

The Results Are Smaller

With an average of around $4,200 for funded "lifestyle" loans,[8] financial institutions running a merchant lending program should prepare for the potential of a larger volume of smaller loans. You may not get the jumbo vegetables grown in a hothouse, but you can get a larger yield of smaller (but home-grown, healthier, and tastier) pickings.

The Competition Is Unique From Other Loan and Account Acquisition Channels

You're not the only one looking to benefit from merchant lending relationships, you'll also need to contend with the proverbial insects, moles, or rabbits trying to pilfer your crops.
As outlined earlier, the current financing options for consumers at the point-of-sale are dominated by credit cards – a financing option offering speedy approval, but also very high rates. But, just as financial institutions own the tools of lower rates and better service to successfully compete in this market, you have the unique insight and access to the proverbial pest control solutions to come out on top. The APR on many of the private-label cards can jump to 30% (or higher) with a missed payment or at the conclusion of an introductory period.

Roots Must Be Established

Due diligence surrounding partnering with merchants is vital. Of course, there are limits. The goal is to develop a relationship with the merchant, and you want to be an attractive option when that merchant is proposing financing to the consumer. Just as a lack of rain may force you to react and water your garden a little more often, you'll need to effectively manage your merchant network to be successful.

The Relationships Require Nurturing

The last key difference relates to the management of this channel. Financial institutions should expect to be more hands-on with the merchant channel relationships than they are with the auto dealers in their network. In other words, we aren't dealing with evergreen shrubs, where you plant and just prune every once in a while. Know your relationships, as some will require a great deal of attention to pay dividends.

7. CUNA Lending Council. "Merchant Lending – Indirect Opportunities." 2013.
8. Credit Union Journal. "'Lifestyle Loans' Offer Host of Lending Opportunities." 2012.

Weeding Out the Plot

Continuing our garden analogy, the merchant network is the bed of soil from which we can grow business – and expert gardeners agree that building up the soil is the single most important factor in pumping up yields. Remember, the merchant is the party steering the financing decision (remember that 'disintermediation' word), so failure to tend to the needs of the merchant is akin to futilely planting seeds in dry, rocky dirt. So, how do we build a fertile network of merchants to provide business?

To start, you need to determine the target merchant network in which to plant the seeds of your indirect merchant lending business. Just as different vegetable plants will have unique care and feeding needs, different merchant verticals will have different priorities and considerations. A dental surgery office will demand speed. (Can you imagine, "We'll get the financing decision at some point tomorrow, Mrs. Smith, and then we'll be able to take care of that root canal!") A home improvement provider, on the other hand, may place more emphasis on flexibility of terms or variety in programs.

Ultimately, the community bank or credit union should draw upon its 'local knowledge' to determine the verticals and specific merchants with whom to partner to be most effective. These financial institutions have the best insight into where their current and prospective account holders are spending money – and where their advantageous financing options can best serve the local community.

One great method to get started (or expand) is to evaluate your portfolio of existing business accounts to determine if their consumers would be good prospects for lifestyle lending.[9] This path can greatly reduce the need for due diligence of the merchant. And, the merchant can benefit from the security in knowing exactly where to go with any questions or concerns about the financing solution it will rely upon to drive its business. Think of this as a boost of starter fertilizer to your soil bed!

9. CUNA Lending Council. "Merchant Lending - Indirect Loan Opportunities." 2013.

Planting the Seeds

Once we've determined the plot of land we want to farm, how can we most effectively prepare for a successful garden? There are four areas for enabling growth to consider for institutions looking to serve as good partners to retail merchants in need of financing options.

1 Acceptance Rate

Ultimately, merchants are in business to make the sale of a retail product, and they don't want to waste time and risk losing the deal if a credit application is declined. Financial institutions need to prepare to underwrite a wide array of consumers, and design offerings that effectively maximize the delivery of risk-adjusted approvals. Where these decisions can be automated, the acceptance rate will increase.

2 User and Salesperson Experience

Ever been in a furniture store and peeked into the business office to see stacks of paper piled up on the poor business manager's desk? Non-digital, paper-based application processes are cumbersome and inefficient – for the merchant and the financial institution – and they contribute to prolonged decision times. Merchants and consumers will have an expectation of a quick turnaround on the decision, so a solution that can pre-qualify a consumer in seconds will see wider adoption by the merchant.

3 Rates and Terms

More advanced underwriting enables lower rates for consumers. This means more affordable payments or even the ability for the consumer to purchase more. Additionally, many merchants will have an eye toward promotional finance terms – where the merchant will typically pay to subsidize the promotional rate. The ability of the financial institution to offer more advantageous rates can mean a lower subsidy cost to the merchant – making it a more attractive financing solution. This allows merchants to potentially move inventory faster which will further increase their technology adoption rate.

4 Communication

Ultimately, as with every successful relationship, communication is the key to building and maintaining a successful indirect merchant lending channel. It's the irrigation system for our garden. We've outlined the advantages community banks and credit unions can provide the merchants, relative to current competitive offerings. Getting face-to-face with the merchants – through periodic visits from the sales team or participation in major sales events – is key to helping the merchant understand the value of your solution and soliciting feedback on ways to improve your value to the merchant and consumers.

Cultivating Your Garden

Now you have a well-planned garden and rich soil that you've seeded. The success of your garden will require support of the bed – watering, fertilizing, weed control – and of the plants themselves – pest control, pruning, support for growth. Similarly, success in the indirect merchant lending channel requires support of the merchants as well as care and attention to their consumers.

1

First, the convenience of an "omni-channel" solution will allow the merchant or consumers to electronically originate the application from the device of their choice - whether it be a laptop, desktop, tablet, kiosk, or mobile device. The ability to pre-populate existing account holder information into the wapplication can serve to further personalize and streamline the experience. That convenience should not stop at the submission of the application. Consumers should be able to electronically upload (whether it be attaching a file or taking a picture) any documents required for loan approval, and electronically sign required documents.

2

Next, the financial institution should strongly consider employing an automated underwriting strategy to meet the new demand from both the consumer and merchant for an immediate decision without adding staff. Since the credit policy and pricing strategy may require adjustment from one vertical to the next, and as the financial institution analyzes results and optimizes those strategies, having an easily-configurable loan origination system will be very important. Additionally, the ability to automate the loan processing as much as possible will reduce the time-to-close, increasing the likelihood of gaining the business from that transaction and also building the relationship with the merchant and consumer for future business.

3

Finally, you should leverage the fact that as much as 90% of lifestyle lending applicants are new to participating financial institutions[10]

This opens up the ability to cross-sell other account and loan offerings beyond the financing solution originated at the point-of-sale. According to a study commissioned by CUNA[11], the three keys to transforming new account holders acquired through an indirect channel into new sales are careful pre-screening, calling the new consumers to provide personal contact, and being able to send them money. A technology solution can arm the community bank or credit union staff with pre-qualified offers for an immediate follow-up welcome call to the new consumer. This could be offering full membership to the credit union or perhaps a replacement credit card offer uncovered during the credit pull for the initial application.

Have the Right Tools

To begin, you'll need the right quality tools and materials to best facilitate the growth of your garden. Just as the staple garden tools include fertilizer, garden hoes, hoses and trowels, in the indirect merchant channel, you can look to technology as the main tool set to allow financial institutions to capitalize on the market opportunity.

Plan for Long-Term Growth

In your financial "vegetable garden", the work does not end with the planting of the seeds – continuous effort is required to maximize the harvest. Similarly, the financial institution must be prepared to staff, organize, and market properly in order to maximize the business in the indirect merchant lending channel.

The right technology tools can reduce the need to increase staff to support a new channel and additional business. However, the financial institution should establish a staffing plan to support the unique needs of merchant outreach and maintenance. We've outlined a few of the distinctions between the indirect merchant lending channel and an indirect auto channel, and those must be considered before combining the two. Most importantly, community banks and credit unions should consider one of their greatest competitive advantages in the eyes of the merchant – service. Committed staff dedicated to educating, managing, and supporting the merchants will be a key success factor.

Get the Word Out

One more important aspect of cultivating relationships with the merchant network is a collaborative approach to marketing the financing options to consumers. This can consist of any number of initiatives – from informational brochures in financial institution branches, kiosks, and online and mobile real estate, to financial institutions participating in merchant-driven advertising campaigns. The most effective joint marketing will leverage technology to achieve consumer convenience. One example is an application portal provided by the merchant (via the financial institution) that allows 24/7 application availability to the consumer. The merchant could take this another step forward by providing a link to the digital application portal from within, for example, a work quote delivered electronically to the consumer. Ultimately, the "win-win-win" available in this lifestyle lending channel is only available if the financial institution and merchant establish and maintain a partnership focused on accentuating the value that can be delivered to the consumer.

10. CUNA.org. "How to Get Started in Lifestyle Lending." 2012.
11. CUNA Lending Council. "Developing Members from Indirect Borrowers. Lessons Learned." 2008.

Enjoy Your Harvest

Consumers and merchants alike can benefit greatly from greater participation from community banks and credit unions in this growing merchant lending market. Your financial institution can find competitive advantage relative to the very large financing and private label card providers in this space through advantageous pricing, local marketplace knowledge and merchant relationships, and your inherent focus on first-class account holder service.

Learn More

Additional Sources

CUES Credit Union Management Magazine. "We have a Loan for That!" 2015.
CUES Credit Union Management Magazine. "Loan Zone: Lifestyle Lending Q&A." 2012.

About Temenos

Temenos AG (SIX: TEMN), headquartered in Geneva, is the world's leader in banking software, partnering with banks and other financial institutions to transform their businesses and stay ahead of a changing marketplace. Over 3,000 firms across the globe, including 41 of the top 50 banks, rely on Temenos to process both the daily transactions and client interactions of more than 500 million banking customers. Temenos offers cloud-native, cloud-agnostic front office and core banking, payments, fund management and wealth management software products enabling banks to deliver consistent, frictionless customer journeys and gain operational excellence. Temenos customers are proven to be more profitable than their peers: over a seven-year period, they enjoyed on average a 31% higher return on assets, a 36% higher return on equity and an 8.6 percentage point lower cost/income ratio than banks running legacy applications.

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