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RESURRECTING THE FORGOTTEN ASSET CLASS

How unsecured personal and SMB loans can help banks drive growth and protect Net Interest Margins (NIM) leveraging AI-Powered analytics and bank transaction data.

AFT ANALYTICS, INC.

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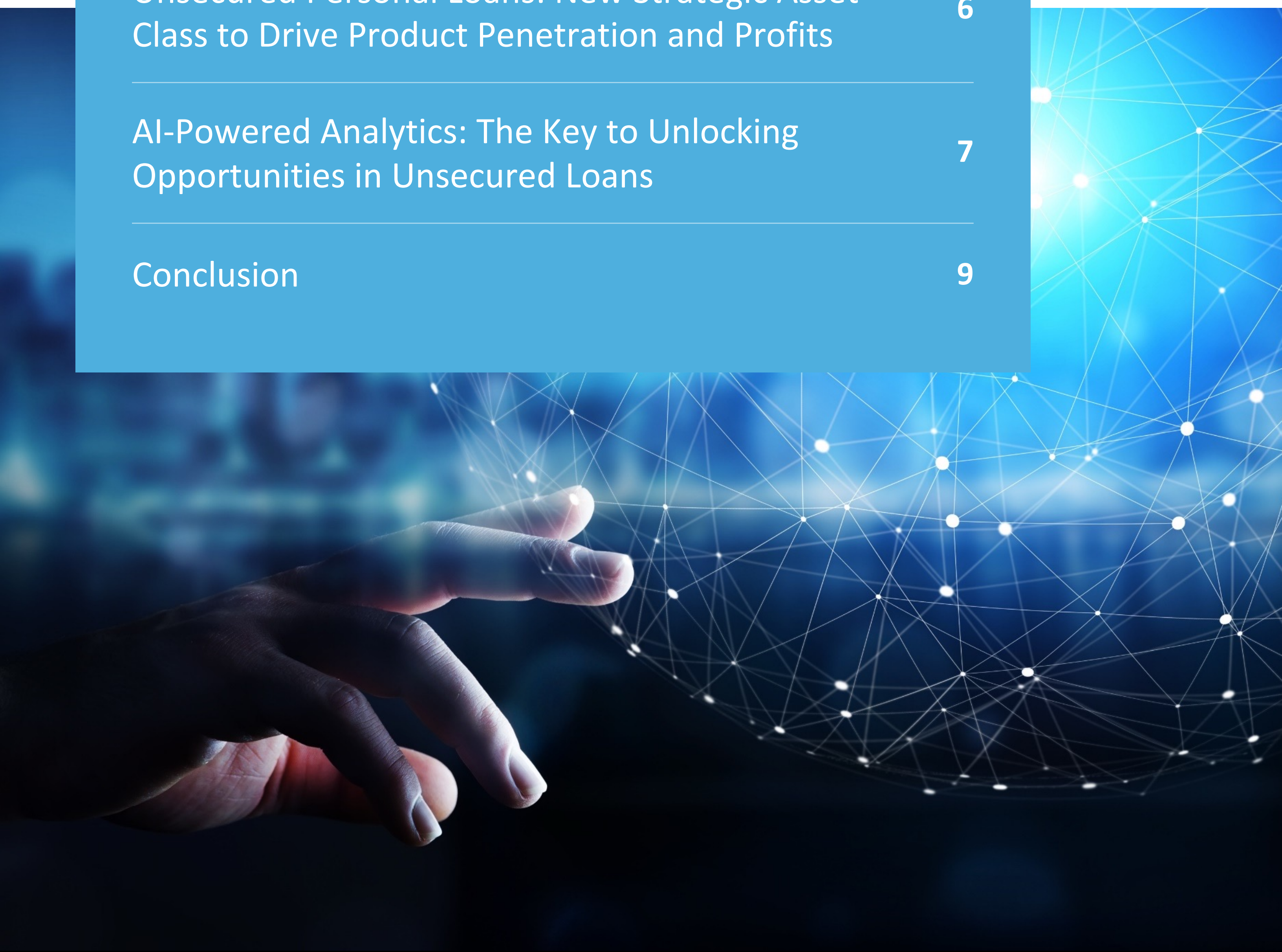
CONTENTS



INTRODUCTION

Banks currently face numerous challenges, including shrinking margins, declining customer loyalty, and increasing deposit competition. The rise of AI and Open Banking in the US presents both a compounding of the challenges and an enormous opportunity.

Open Banking enables the secure sharing of financial data between banks, Fintechs, and other third-party providers through APIs with customer consent.

Most banks view Open Banking primarily as a compliance issue, focusing on the requirement to share data rather than recognizing its potential as a transformational event. However, the threat is that Open Banking allows third-party financial institutions to access previously proprietary customer bank account transaction data. Competitors with advanced analytics can use this data to tailor solutions and make better loan offers, threatening the bank's deposits and customer base. This threat is magnified by the mega banks with dominant credit card businesses leveraging their product suite and massive data set with AI powered tools.

The opportunity is that Open Banking enables the bank to collect significantly more customer data for DDA (Demand Deposit Account) customers who use multiple institutions that, when combined with AI and advanced analytics, can provide a significant competitive advantage to convert them to primary customers.

Banks that do not implement a proactive and offensive Open Banking and AI strategy will be outcompeted, putting their deposits and profits at risk.

The first step in the strategy must be to maximize the use of existing customer data from primary DDA accounts that the bank already has access to. Proactively meeting the liquidity needs of these customers will help to prevent them from being courted from the outside. An unexpectedly viable and immediate solution, often overlooked, lies in personal and SMB unsecured installment loans (UIL). Historically, these loans have been burdened by high credit and production costs and charge-off volatility, which were hard to justify given their typically low average loan sizes. Consequently, banks overlooked UILs as a viable product in the decade-and-a-half zero-rate environment.

It’s time to revisit UIL loan products after years of neglect. With high interest rates, low costs, end-to-end digital originations powered by AI analytics, transaction data, and smart infrastructure, UILs present one of the most compelling and largest risk-adjusted return and growth opportunities for banks. Finally, with the concentration of credit cards in a handful of large and powerful banks, the strongest potential competitors in the UIL market will continue to avoid it for fear of cannibalizing their card ecosystems.

Offers for bridging cash flow needs on improved UIL terms provide a powerful incentive for building customer loyalty. Moreover, with Open Banking, fully utilizing DDA transaction data enables banks to expand their customer base beyond primary DDA holders and existing customers, fostering broader account relationships. This approach significantly reduces charge-offs and charge-off volatility, cementing UILs as a highly profitable and strategic growth opportunity.

Banks have an inherent competitive advantage in the DDA transaction data, which they are not fully utilizing presently. When combined with hundreds of other data points, this data can completely transform the risk-adjusted returns of UILs.

With machine learning and AI, banks can look beyond basic FICO scores to identify hidden prime borrowers in non-prime pools, many of whom need liquidity. Analysis of the DDA data allows lenders to have a granular view of actual affordability to determine how much to lend, rather than guessing. These new capabilities can transform UILs into a strategic asset for banks offering high net interest income (NII) of 7-8% (assuming current market conditions and a cost of funds of approximately 4%) and annualized loan losses of around 2% across a portfolio range of FICO 850 to 600 borrowers, with very low charge-off volatility. Consequently, UILs can enable banks to significantly increase loan growth by expanding the addressable market and profits while reducing typical market loss rates by as much as 5%. The added benefit of serving more customers, particularly when you don’t have a competitive credit card product is not just the boost in profits but also the improved product penetration which results is greater deposit stickiness.

COUNTERING OPEN BANKING, MEGABANK AND FINTECH THREATS

Banks face a challenging operating environment, growing competition, and complex consumer needs and preferences.

For decades, banks operated in a low-rate, easy-profit environment. However, that changed as rates rose dramatically in March 2022, and banks are now trying to reduce operating costs and grow revenues to mitigate shrinking profit margins and deposit instability. The advent of Open Banking further complicates the problem. The CFPB recently announced the final set of rules and implementation timelines. It is worth noting that in many countries that have introduced Open Banking already – the UK, Australia, and Brazil to name a few, there is clear evidence customer behaviors and their banking expectations have changed forever since the introduction.

In the US case, Open Banking is happening when most banks face a growing threat from megabanks.

These players dominate the credit card market and are embarking on new initiatives to capture a greater market share of deposits and technology modernization to compete in the Open Banking era. For example, JPMorgan Chase announced in July 2024 an ambitious goal of growing its 11.3% of the country's customer deposit share to 15%[1]. And it is worth noting that JPMorgan will spend a massive $17Bn on tech in 2024. The threat is not just from mega banks with massive marketing budgets, tech spending, and vast product portfolios. As Open Banking takes hold, it will bring in powerful brands such as Walmart and Apple, who understand the immense value of DDA data within banks and are poised to leverage their coming access to this data, to grab a share of the consumer financial wallet. This poses a significant threat due to their extensive customer data, technological advantages, large, loyal customer bases, and their expertise in using data to drive consumer demand and transactions. On the Fintech side, the likes of PayPal, Stripe, Block and Intuit via her brands – TurboTax, QuickBooks and Credit Karma – are also positioned as credible threats.

Banks urgently need new ways to compete against megabanks, Fintechs, and other consumer-facing brands encroaching on their deposits, lending products, and customer wallet share. They also need a way to identify new sources of profit with customers with unmet needs. Finally, they must adopt a more sophisticated lending culture that can look beyond simple FICO scores and expand the lending pool.

Banks that remain passive will continually lose opportunities and market share. Without ways to deepen engagement with their DDA customer base and enhance relationship stickiness, Open Banking will enable competitors to dominate. Conversely, the strategic use of AI and machine learning will not only blunt competitive threats but also equip banks with offensive strategies to directly combat these threats and seize opportunities arising from Open Banking. By leveraging AI, banks can monitor customer data-sharing activities and promptly respond with tailored loan offers, utilizing existing DDA data and preferred pricing to strengthen customer relationships and enhance competitiveness.

For banks, Open Banking cannot be about simply allowing competitors to take customer data. There is a lot to be learned from giving up the data in terms of customer behavior and it is in effect a front row seat to how effective your competitors are with your customers. Think of Amazon's marketplace where third party sellers provide Amazon with a ton of data that allows them to build their own products and compete.

[1]JPMorgan Aims to Amass 15% of US Consumer Deposits, Boost Credit Card Share, Reuters, July 11, 2024, https://www.reuters.com/business/finance/jpmorgan-aims-amass-15-us-consumer-deposits-boost-credit-card-share-2024-07-11/

UNSECURED PERSONAL LOANS: NEW STRATEGIC ASSET CLASS TO DRIVE PRODUCT PENETRATION AND PROFITS

One area in which banks can compete and find sources of profit is in the unsecured personal and SMB loan market.

Many banks have historically overlooked unsecured lending, deterred by high risk, persistently low rates, and poor credit loss predictability of traditional scoring models. An additional impediment has been the introduction CECL (Current Expected Credit Loss) by the **Financial Accounting Standards Board (FASB)** which became effective starting January 2020. In a nutshell, it requires institutions to estimate and recognize expected credit losses over the lifetime of a loan at the time of origination or acquisition. The increased upfront provisions for credit losses, affects earnings and regulatory capital volatility. However, it is worth noting the earnings impact and regulatory capital volatility occur mainly during the portfolio build-up phase and stabilizes when the portfolio reaches steady state.

However, Fintech companies (not subject to CECL or regulatory capital) and credit unions have filled the gaps recently, proving financial success and a market ripe for opportunity. Banks with a better ability to predict charge-offs and thereby lower losses, combined with the advantage of primary account transaction data can compete very effectively and potentially dominate the unsecured lending market. As for the impact of CECL on earnings volatility, this too can be addressed by taking a page out of the Fintechs by managing the mix of originated loans held to maturity, held for sale and originated for immediate sale. Given the competitive dynamics of the credit card market in the US, unsecured personal and SMB loan offer a credible growth strategy.

Growing Demand

The demand for unsecured personal loans is growing. In the current rate environment, these loans are more attractive than credit cards across all credit score buckets, with significantly lower interest rates and long-term amortization. Gen Z consumers, in particular, are looking beyond credit cards to new lending options, such as BNPL and fixed personal loans.[2]

The personal loan market reached $356 billion, or about 1% of non-revolving consumer credit in 2022, and is expected to experience strong growth in the coming years.[3] More than 23.5 million Americans now have a personal loan, with the average personal loan debt per borrower at $11,829 as of the first quarter of 2024.

Better Analytics to Reduce Risk

Advanced analytics can enable banks to reduce the risk in ways that weren't possible in the past. And, while credit cards typically require an extensive portfolio and can take three years to break even, unsecured loans provide an almost immediate return as they are fully drawn at origination.

Consider the typical FICO 600 to 850 portfolio in the current rate environment, which yields approximately 12%, substantially higher than other retail bank asset classes. Additionally, with an average life of 22 to 24 months, these assets offer more protection in a volatile rate environment. In many cases, AI and machine learning offer an opportunity to transform unsecured personal loans into a high-risk-adjusted return asset, yielding consistent NII of 7-8% (assuming current market conditions and a cost of funds of approximately 4-5%) while maintaining average annualized losses in the 2% range.

Customers and DDA Data

Banks already have data on thousands/millions of existing customers through DDA data, and many of their customers may already be in the market for an unsecured loan. In one case, an analysis by Aliya® of one of the top ten US banks found that nearly a third of their customers had an unsecured personal loan with another financial institution.

Many customers may not even know their bank offers such products. When powered with AI, customers' DDA transaction data enables them to identify high-quality borrowers who may have a need or have been declined elsewhere on metrics alone. Banks can also use analytics and data to support more precise risk management, pricing, and loan sizing, enabling them to lower credit losses and charge-off volatility while growing customers served and loans.

Technology to Reduce Cost-to-Serve

With low balances and a high cost to serve, the profit margins on unsecured loans have historically been low. However, new technologies can now reduce the cost-to-serve by as much as 80%, boosting profits in the process. Modern straight-through processing solutions and e-commerce style onboarding applications can automate the entire process and streamline operations.

These advantages enable banks to compete, find new opportunities, and potentially dominate the unsecured personal loan market. In pursuing new profits in the unsecured loan market, banks can also create a uniform and objective risk/pricing mechanism to apply across all products. This enables them to optimize portfolio construction using predictive risk analytics to manage portfolio risk more precisely and effectively.

[2] Gen Z Consumers are Using Credit More, and Differently, than Their Millennial Counterparts at the Beginning of their Credit Journeys, TransUnion, May 8, 2024, https://newsroom.transunion.com/gen-z-using-credit-differently/

[3] An Overview of Personal Loans in the U.S., Board of Governors of the Federal Reserve System, August 2023, https://www.federalreserve.gov/econres/feds/an-overview-of-personal-loans-in-the-us.htm

AI-POWERED ANALYTICS: THE KEY TO UNLOCKING OPPORTUNITIES IN UNSECURED LOANS

Fortunately, new technologies enable banks to use transaction data to capitalize on the unsecured loans market. An AI-powered analytics and lending platform can leverage advanced data science and the bank's existing customer data to identify prime-risk borrowers among those with non-prime FICO scores and vice versa. This offers more accurate risk assessments and dynamic line sizing while providing a uniform organizational risk and pricing mechanism.

Based on analysis with a top ten partner bank, Aliya® estimates that the average bank could be sitting on an untapped unsecured loan opportunity, with between 20% and 30% of their existing customer base having UILs outside the primary bank. While these loans are relatively small (avg. $15,000) relative to mortgages, HELOCs, and auto loans, they have a shorter duration and offer +3% ROAs.

There are several ways AI-powered analytics can help unlock this opportunity.

Better Credit Decisioning to Write More Loans

AI-powered analytics enable banks to look beyond using FICO to assess the probability of default of potential borrowers. Traditionally, many banks miss out on opportunities because they only consider customers within a specific FICO range. The ability to more accurately determine defaults means that for a given level of risk a lender is able to target a much broader customer base by identifying "hidden" prime borrowers in the non-prime pools and vice versa. Additionally, the greater default accuracy the more accurate the pricing is.

Improved Loan Size, Price, and Terms with Lower Losses

Traditional personal lending often relies on rigid credit policies based on FICO scores and debt-to-income, which limits the pool of potential borrowers. AI-powered analytics, however, can significantly expand this universe by offering a more accurate and detailed prediction. By reviewing internal (and external where available) DDA data using AI-based algorithms a lender is able to better understand a customer's residual cash flow. These analytics enable banks to dynamically optimize loan size, price, and term based on cash flow and risk rather than static FICO bands. This approach provides a more precise measure of affordability and ability to pay, using bank account transaction data that maximizes opportunities for borrowers and risk-adjusted returns for the bank.

The charge-off impact of this new approach is massive when compared traditional lending practices where outsized losses on a small concentration of the portfolio do significant damage to the overall profitability of the business. By providing small balances and shorter terms to the higher risk applicants, their balances pay down quickly and when some do inevitably default, their impact of the portfolio is small. In addition, by calculating a payment they can afford, their probability of default is likely to be lower than expected as well. The combination of better predicting risk and via the DDA analysis giving the right loan size to the right borrower has resulted in almost a 50% reduction in charge-off dollars for higher-risk accounts.

AI-POWERED ANALYTICS: THE KEY TO UNLOCKING OPPORTUNITIES IN UNSECURED LOANS

Improved KPIs and Performance

AI-powered analytics enables a bank to improve nearly all of its critical KPIs, including financial revenue, expenses, operating profit, and return on assets.

However, there are steep opportunity costs in forgoing these technologies. In the case of personal and SMB loans, banks that delay implementing advanced analytics risk forgoing the chance to double their loan book and quintuple the profitability of their unsecured loan portfolio. These institutions also risk higher loan losses than competitors using advanced analytics and will continually lose more customers to big banks and fintech companies with more sophisticated loan decision processes.

Aliya®: Proven Technology. Rapid Deployment. Proven Results

Aliya® offers a well-governed AI-powered platform that helps banks improve their lending portfolio performance by expanding the lending pool, enhancing the customer experience, and reduce risk by optimizing loan amounts, pricing, and terms. It combines loan analytics with automated straight-through-processing in a system that opens more loans, significantly reduces cost to serve, and boosts bank profits, all in a regulatory-compliant manner.

Write More Loans and Optimize the Balance Sheet

Aliya®'s solution leverages bank transaction data with proven risk models to automate real-time decision-making. It standardizes and categorizes demand deposit account data and card transactions to create a 360-degree view of consumers' spending and cash flow.

Improved accuracy enables banks to expand their lending pool while reducing charge-offs and improving loan profitability. This offers banks better portfolio construction, and a culture based on risk-adjusted returns rather than arbitrary FICO cut-off changes.

Proven Results

A back-test with a large bank partner yielded impressive results. It analyzed a pool of booked loans originated in 2018 and re-underwrote each booked loan using Aliya®'s proprietary aSCORE® risk scoring model and matching DDA data for each of the borrowers. The performance characteristics are discussed above, but when the results were mapped against a pool of new applications (2021 UIL applications) the results are even more compelling:

- Identified prime behavior borrowers (aSCORE® ranges of 720-850) even among customers with FICO scores as low as 650 which led to the credit policy FICO cut-off to be moved from 660 to 600, resulting in a 2X increase in the number of customers served and a 60% expansion of the booked loan volume.
- Despite the impressive increase in customers served and booked loan volume, the expected 24-month cumulative charge-off rate declined by 28%.
- From a profitability perspective, the new process and credit policy adjustments (2024 credit policy) allowed the bank to increase profits by 40% from the same pool of applicants.

CONCLUSION

The unsecured personal loan market offers banks a significant growth opportunity, driven by leveraging customer relationships, data, and funding advantages, alongside advanced analytics and technology.

Traditional lending practices, relying on rigid FICO-based credit policies, limit borrower pools and often lead to suboptimal terms and high exposure at default. By utilizing AI to analyze cash flow and other data points, banks can more accurately size and price loans, reducing risk and loan losses.

Acting now is critical to avoid missing out on growth and losing market share to fintech companies and new entrants. By integrating AI-powered risk analytics and pricing tools, banks can achieve immediate results with no infrastructure investment required, lower costs, boost profits, and strengthen customer relationships, ensuring a competitive edge in the evolving market.