

Alternative Lenders

Friend or foe?

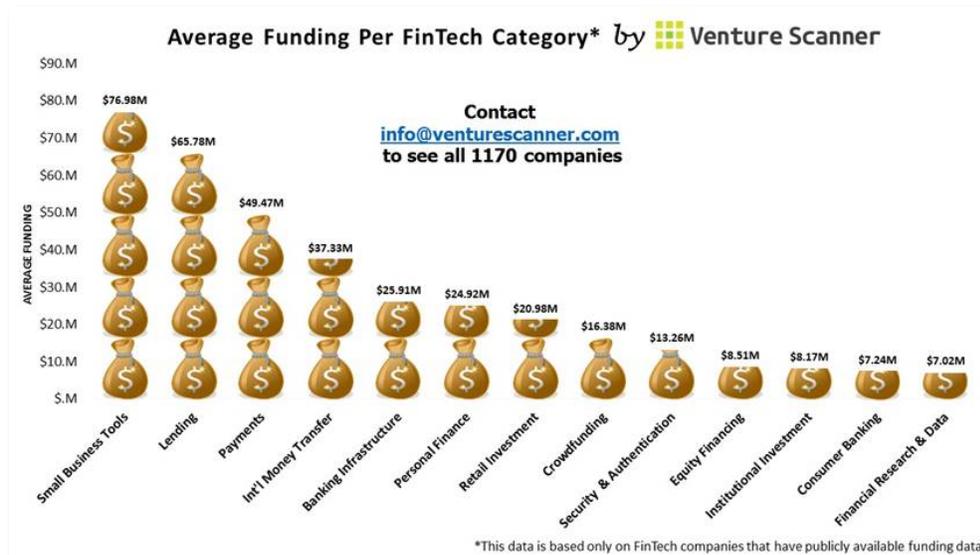
Alternative lenders are fueling growth and change.

The question that remains: What will the market look like tomorrow and what are lenders doing today to keep pace?

The traditional lending model is being upended by innovation, competition, and consumer preference for immediacy. New entrants to the consumer lending market are bringing new technologies to market quickly and reaping the benefits of being smaller, more agile, and less burdened by inefficient organizational designs and cumbersome processes.

These technologies are the key advantage of alternative lenders, enabling them to approve loans in minutes instead of weeks—the typical turnaround time for traditional lenders. These technologies also enable lenders to host their banking systems in the cloud at a fraction of the cost of traditional banking systems, in addition to creating new ways of assessing risk, therefore expanding their target market.

The following infographic from Venture Scanner summarizes the average funding for each FinTech category. It highlights that Lending is the second largest category of FinTech funding.



Alternative lenders: Friend or foe?

As lenders take sides on this newly emerging landscape, one thing is clear: alternative lending is becoming a major force and creating an entirely new lending model, which has the potential to offer more to every player in the value chain, including those referring, originating, servicing, and receiving the loan.

Traditional lenders have the potential to obtain sophisticated capabilities (e.g., enhanced scoring capabilities; next-gen platforms; and managed service providers, focusing on specific operational processes) at low cost by learning from or acquiring cutting-edge solutions.

But in the **large bank space**, industry research has identified mixed reactions to the significant growth in non-bank lending, and everyone seems to have a different opinion about the opportunities.

Alternative lending is becoming a major force and creating an entirely new lending model, which can benefit traditional lenders as well as consumers.

- **Market Expansion:** Some banks, such as MUFG Union Bank and JPMC, are going on the offensive, turning to alternative lenders' scoring models and data sources to augment a prospect's credit history, especially useful for banks looking to target new entrants with little to no credit bureau data. For example, MUFG Union Bank has a strategic partnership with marketplace lender LendingClub in a number of areas. By providing referrals for customers they are unable to lend to, Union Bank can meet customers' needs while avoiding the risk that they will leave for another full-service financial institution. LendingClub also determines the credit worthiness of borrowers on unsecured loans by scoring the applicants, relying on additional alternative data sources such as payment histories for utility bills, rent, and insurance premiums. Lastly, Union Bank and LendingClub entered a strategic partnership where Union Bank will purchase personal loans from LendingClub and will collaborate with them on new products to target both of their customer bases.

Other banks, including J.P.Morgan Chase and Royal Bank of Canada, turn to Verde International's automated loan underwriting engine, which uses behavioral models, including job and education information and financial analytics, to assess risk, make decisions on loans, and set terms.

- **Lending as a Service:** Since 2008, new compliance regulations, higher capital requirements, and much tighter underwriting standards have caused banks to rethink the cases of referring loan customers to alternative lenders and lending as a service. Many larger organizations are now considering partnering with companies offering a lending as a service model, in hopes to effectively and efficiently offer consumer lending in this new environment. Companies like Insikt use lending-as-a-service (LaaS) models to provide technology solutions that enable their partners to offer loans under their own brands. LaaS uses on-demand, cloud-based tools to allow any retail store, online brand, or bank to make loans or provide purchase financing to its customers anywhere they do business.

There is a benefit in leveraging the bank's or retailer's customer base. In return for that customer data, the bank/retail partner is able to offer quick, convenient application processing and an improved customer experience. The model is similar to what many banks have been doing for years with their credit card portfolios—outsourcing them to a company who owns and manages the portfolio, while keeping the customer relationship in order to build loyalty and cross-product engagement. The differences in this case are that the partner gets to maintain its relationship with the consumer as they are being serviced with a retail solution within their own branches or stores, and Insikt offers a modular technology solution that can adapt to the individual needs of its partners.

Wells Fargo initially took a more defensive stance. According to an article in the *Financial Times* that appeared in December 2014¹, some employees received an email saying they could not participate in peer-to-peer (P2P) lending because companies in that space are considered part of the competition. The ban was dropped a few months later.

Large institutions have vast distribution networks and cost bases that keep them from effectively competing on price. These institutions should consider that competing with the likes of online and P2P lenders could be fruitless, as it would require too big of a shift given their size.

At the other end of the spectrum, **smaller lenders** appear to have more to gain from partnering. Industry research indicates several community banks have also joined forces with alternative lenders with the following objectives.

- **Diversification:** Titan Bank, based in Texas, is buying P2P loans for its own portfolio in alliance with LendingClub. The biggest benefit for Titan is diversification. It concentrates on small-business lending, but with its new partnership with LendingClub, the bank can now offer unsecured consumer loans—which it couldn't afford to do on its own. Titan dismisses the notion of LendingClub being a competitor, at least for community banks. Instead, Titan views LendingClub as a partner that's able to meet a need that has not been filled, as banks haven't made unsecured consumer loans under \$10,000 for a long time.
- **Market Expansion:** Community banks are forming partnerships with alternative finance companies to automate loan originations, and regional banks are outsourcing small business loans to online lenders. This is all in an effort to expand target markets and services offered while reducing costs. For example, BancAlliance, a membership organization with more than 200 community banks, signed a deal with LendingClub, giving the banks an opportunity to buy consumer installment loans or portions of loans nationwide, as well as a chance to co-brand a marketing campaign where LendingClub will underwrite and solicit the banks' own customers for a loan. Prosper Marketplace signed a similar deal with Western Independent Bankers, giving the association's roughly 160 members across 13 states access to the Prosper Marketplace.
- **Product Expansion into Small Biz Lending:** Web-based platforms such as OnDeck and Biz2Credit partner with institutions such as Citizens Bank, Deutsche Bank, Goldman Sachs and KeyBank for small business lending, with the web platforms providing prospecting, underwriting, distribution, and performance-monitoring. Sam's Club has recently aligned with industry players to launch the Sam's Club Business Lending Center, which offers an online platform connecting its members with alternative lenders such as LendingClub and SmartBiz. Sam's Club provides a needs' assessment tool that helps their customers determine the appropriate lender and type of loan to meet their needs.
- **Debt Recovery:** Some financial institutions are partnering with startups such as LendStreet, a social lending platform with an innovative model to help consumers with distressed debt. LendStreet negotiates a discount with the financial institution and passes on the discount to the consumer with a restructured loan,

¹ "Wells Fargo reverses ban on staff making P2P loans," *Financial Times*, December 2014: <http://www.ft.com/cms/s/0/1c39964e-a8b0-11e3-b50f-00144feab7de.html#axzz3pKvJUajE>

which helps the consumer pay it off sooner and rebuild credit. The financial institution benefits from receiving the payment on a debt that may have otherwise gone uncollected.

What about the alternative lenders' perspective?

Do they have a "disrupt and displace" strategy? Or a "cooperate, don't compete" angle? Traditional large banks have access to assets that ensure they continue to be important players in the lending space. A number of alternative lenders are partnering with banks to leverage their assets to take advantage of opportunities.

- **Prospecting:** First, banks have a built-in source of consumers and small businesses prospects seeking loans. This can be achieved through partnering with banks to receive their declines or partnering with online marketplaces to receive prospects looking for home renovation loans. QuarterSpot recently began working with banks in this way, paying an origination fee for the referrals. LendingClub's business model, like most P2P lenders, is highly dependent on origination volume, thus a steady stream of new prospects holds significant appeal. From LendingClub's perspective, the partnership enables the company to expand its prospect base, gain scale, and diversify its funding sources by accessing the banks' customer base and lowering cost deposits. And the banks benefit by being able to monetize their declines.
- **Modeling:** Second, banks have transactional data on account activity for millions of customers, which can be valuable in a predictive model.
- **Security:** Third, traditional lenders have an advantage because customers instill more trust in them than they do in alternative lenders in terms of their methods of securing customer information. Therefore, partnering with a brand-name bank increases perceptions of security and trustworthiness.
- **Funding:** Banks have their own balance sheets to lend from and don't have to raise capital to compete. Some alternative lenders are starting to recruit traditional players in financial services—banks like Titan and institutional investors, for example—to help fund their loans and fuel their growth.

Cooperation between traditional lenders and the new kids on the block can result in a win-win

All these factors could make banks powerful competitors. So successful alternative players are looking for ways to partner and leverage these assets rather than compete with them.

The flip side of friendship

So why are partnerships not on everyone's radar? For banks, the rapid expansion in new product areas such as P2P lending could pose risks if robust oversight processes of underwriting and servicing are not in place. In instances where the banks assume the credit risk, they would have limited recourse to alternative lenders in the event that purchased loans do not perform as expected.

Some banks believe that the use of alternative data, such as social media data, may be perceived by consumers as too "big brother" and could bring reputational risk.

And for alternative lenders, partnering with banks could mean cannibalizing their own future business by teaching traditional organizations how to assess credit-worthiness and manage risk in this new landscape, essentially handing over their intellectual property.

Looking ahead

The paradigm of traditional lending needs to shift. This is especially true in the small-business market, which has challenged traditional lenders in the past due to the high operating costs and low margins associated with loan processing. Serving the needs of small business requires traditional lenders to partner with more nimble, technologically advanced non-bank lenders like LendingClub, OnDeck, CAN Capital, or Biz2Credit to efficiently and effectively provide access to loan products to meet the small business owner's needs.

When designing the lending model of the future, keep in mind that forward-thinking organizations don't think of the future as a magnified version of the present. They are imagining a completely different lending model, complete with its own challenges and opportunities.

Traditional lenders need to mimic the innovative, customer-centric culture of the disruptors, either through poaching from or partnering with these innovative start-ups. And alternative lenders can expand their prospect pool from partnering with and leveraging the assets of traditional lenders. It's no longer easy to categorize players as competitors or partners. Yesterday's foe could be tomorrow's friend.

In order to succeed, players need to determine how they fit into this new paradigm, what will it take to succeed, and what role partnership will play in their success.

When designing what the business model will look like in the future, innovative thinking is required. Forward-thinking organizations don't think of the future as a magnified version of present trends. Instead, they identify the real enablers and barriers of the current trends and determine which may or may not continue in the future. They imagine a completely different lending model of tomorrow, rather than extrapolating the present banking model into the future.

The keys to success

It's critical that both traditional and alternative lenders rethink their strategy and role in the wider lending eco-system, and evaluate the challenges and opportunities of the digital age.

Lenders need to consider inviting other players into the lending ecosystem to forge mutually beneficial lending experiences for customers.

The successful lenders of tomorrow are the ones driving change, the ones with business strategies that include collaborating with their ecosystem partners. Rather than guarding their traditional revenue streams, they're exploring revenue-sharing arrangements with developers, retailers, online marketplaces, alternative data sources, and analytical modelling companies that are developing services that could compete with traditional lending. They're opening offices in Silicon Valley, hiring technology

Lenders willing to collaborate with their ecosystem partners rather than guarding traditional revenue streams will be the ones driving change, defining the lending ecosystem of tomorrow—and ultimately, reaping the rewards.

entrepreneurs, supporting innovations labs, and transforming their business models to prepare for the future.

Successful organizations are those that understand that the lending industry is changing rapidly, fueled by technology, and that yesterday's revenues are no guarantee of tomorrow's. Companies willing to shift the paradigm of the traditional lending model and develop an innovative, yet realistic, business strategy that leverages what other parties have to offer will have the best chance of success in the future.

In the end, everyone including lenders, consumers and small businesses have something to gain from both industry competition and cooperation. Alternative lender competition makes the traditional players improve, while cooperation produces lower cost innovation, resulting in quick, convenient lending experiences for customers.

Slalom helps clients solve their most complex business challenges and identify their greatest opportunities.

Kathleen McDowell is part of Slalom's Financial Services practice, which supports client's growth and innovation.
