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THE STATE OF

ONLINE MARKETPLACE LENDING

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Introduction

In 2008, a short two years after the first online marketplace lenders opened for business, the Great Recession began to wreak havoc on worldwide financial markets. Small businesses struggled to survive, banks failed and access to capital was limited. This imbalance of capital supply and demand was simultaneously a threat to our economic growth and a historic opportunity for innovation in the financial markets. The online marketplace lending industry moved quickly. These technology-driven newcomers hired an army of data scientists, coders and digital marketers. Using online platforms, Big Data and powerful analytics, they forever changed the small-business lending landscape.

Existing regulations — crafted before the advent of online marketplace lending — may not be up to the task of providing a clear legal framework for the industry and protection for small businesses. The industry recognizes this challenge and has responded by forming the Responsible Business Lending Coalition and authoring the Small Business Borrowers' Bill of Rights — a step toward self-regulation. The U.S. Treasury Department is looking closely at online marketplace lenders and considering whether additional regulations are necessary.

The innovation, industry disruption and regulatory uncertainty that characterize this dynamic sector led Experian to produce a series of articles focusing on different aspects of online marketplace lending. This report contains those articles.

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Chapter 1

Attractive Alternatives

How online marketplace lenders are changing the rules of small-business finance

By Gavin Harding

Attractive Alternatives

Disruptive technology has radically changed how we shop, socialize, book vacation rentals — and even how we hail a cab. Now we have another Web-based disrupter upending yet one more venerable American institution: how we secure small-business loans.

Over the past two to three years, online marketplace lending (OML) — also called alternative lending — has made dramatic changes in the landscape of financing businesses. Companies like OnDeck®, Kabbage®, Funding Circle, CanCapital, Lending Club and dozens of others have created what amounts to a $1 trillion market, according to a recent article on TechCrunch.

This doesn't mean that OML is going to send traditional banks the way of typewriter and buggy whip makers. Your neighborhood bank branch and small-business lender still do and will have an important function to perform. But strict regulation and rigid business models within the traditional lending industry have left major gaps when it comes to funding activity in the small-business marketplace. It is in these voids that creative and aggressive entrepreneurs are finding not only amazing business opportunities, but also an entire class of customer that until now has been grossly underserved.

What is online marketplace lending all about? How does it work? Why is it so attractive? Who are the customers? And why now?

The answers to all these questions lie in one of those serendipitous confluences of economic necessity, technological advancement and entrepreneurial creativity that creates a paradigm shift in what we believe is possible. The result is a new model for commercial financing that may soon become the primary medium many small to medium-size companies use to secure the capital they need to grow and prosper.

Over the next eight weeks, Experian® will deep dive into the State of Online Marketplace Lending, examining the lending market from all sides, piecing it together with opinions from thought leaders throughout the space and publishing our findings in a compendium ebook.

Let's begin by tracing this trend to its source.

The roots of online marketplace lending

It is said that the Chinese character for disaster is the same as that for opportunity. If so, then it makes sense that the disastrous Great Recession of 2008 to 2010 should serve as the crucible from which the alternative lending industry should spring. When the economy crashed in 2008, the Western financial industry responded by replacing its overly lax lending requirements with regulations and lending standards so strict that many businesses, especially younger or smaller ones, found it all but impossible to secure financing under any conditions. Having been burned by their formerly liberal attitudes, banks and other traditional lenders decided the best way to minimize risk was to avoid lending to all but their most financially secure customers. (In other words, the only way to get a loan was to prove you didn't need one.)

Enter the online marketplace lenders.

OMLs — particularly peer-to-peer lenders — began to appear a year or so before the market crashed. The rise of Facebook and similar social media platforms coupled with rapid advances in Big Data management allowed those with capital to quickly qualify potential customers via the Internet and issue short-term loans without the red tape and regulations that made borrowing from banks such a challenge.

"Technology is what has made online lending possible," said Laura DeSoto, Senior Vice President of Strategic Initiatives for Experian. "Online lenders benefit from having a much lower cost basis than banks. As a result, they can price their loans differently. And they can often make their lending decisions on the same day they receive an application."

Once the Great Recession hit in force, small and medium-size businesses, finding that traditional capital sources had dried up like Lake Shasta in the California drought, flocked to these aggressive start-ups en masse. OML marketing messages soon became ubiquitous, ranging from 30-second radio spots to robocalls to business owners' cell phones. Web-based payment services like PayPal began to offer their own business capital lending programs. To the surprise of the cynics, many of the new lending platforms actually worked. Businesses were able to borrow the funds they needed. Lenders enjoyed solid returns on their investments. And consumers reaped the benefits of an economy offering a broader range of goods and services.

Today, OML looks like it's here to stay — which is not to say that banks have reason to panic.

"It's important to note that many online lenders actually get their funds from traditional banks," DeSoto stated. "Some people call OMLs 'shadow banks' because they're able to use banks' funds in ways that are not subject to all the same federal regulations."

What makes online lending "alternative"

It is not just the source of the loans that distinguishes alternative lending from traditional commercial banking. The method, speed, qualifications and form of the loans themselves are also distinctive.

As the name implies, online lending is done via the Internet. Borrowers need not walk into a brick-and-mortar bank to fill out reams of mind-numbing paperwork. Instead, they need only fill out a usually brief online application and attach whatever documentation the lender requires.

What kind of documentation? Often, alternative lenders don't require the detailed financial statements and tax returns commercial banks demand. Instead, a month or two of retail receipts may be all that's necessary.

"Technology is what has made online lending possible. Online lenders benefit from having a much lower cost basis than banks. As a result, they can price their loans differently."

This is because many alternative loans are not the long-term, interest-based instruments to which we're accustomed. Instead, many alternative lenders use "factoring" or revenue-based lending in which they take a small portion of each sale as repayment on the loan. Steady cash flow is more important than yearly sales volume or annual profits/losses. Another popular vehicle is so-called "peer-to-peer" lending that often involves small loans of $5,000 to $50,000 with terms of just one to five years. And now that online lending has become legitimate in the eyes of many, we're seeing loans or "working capital advances" in the millions of dollars.

Like the most sophisticated banks, many OMLs — even some of the smaller ones — have access to advanced algorithms that allow them to evaluate a potential borrower's suitability based on readily available business credit data in addition to cash flow, and other activity data. But because their systems are mostly or even totally automated, OMLs can prequalify applicants in a matter of hours, if not minutes. Following prequalification, additional documentation may still be necessary before a loan is approved.

Key points about online lending:

Online applications usually are fast and simple and require minimal documentation

Technology allows lenders to prequalify borrowers in hours, sometimes minutes

Loans can be as low as a few thousand dollars or as high as several million dollars

Most lenders eschew traditional long-term interest rates in favor of cash flow or other short-term repayments

Prime customers are small, younger retail or services businesses with high, consistent cash flow

Online lending is expanding the market, creating opportunities where none existed previously

Of course, the larger the loan, the more documentation lenders require. Online lending reduces paperwork, but it doesn't eliminate it altogether.

"Some companies still rely partly on manual application reviews. Some even promote their 'live' customer service," DeSoto noted. "Still, it probably won't be long before most online lending is 100 percent automated."

Are you a candidate for online marketplace lending?

The ideal candidate for today's online marketplace lending is a small to medium-size retail or commercial B2B company with a steady cash flow and a need for small, quick cash infusions to buy new capital equipment, hire new personnel or otherwise expand operations. Restaurants, retail stores, and B2B service companies like office equipment suppliers and marketing/ad agencies fit this profile perfectly.

Because cash flow is essential, most marketplace lenders are not interested in financing start-ups. These are still the purview of venture capitalists. Most online lenders also are not interested in manufacturing companies that make perhaps one or two large sales every couple of months.

Expanding the market, not cannibalizing it

DeSoto stressed that online lenders are not taking business away from traditional lenders but are serving customers who probably would not qualify for traditional business loans. As such, they're expanding the market, not cannibalizing it.

"Most small businesses that have been in business just one or two years wouldn't even be on a commercial bank's radar," she noted. "These people would otherwise have to rely on friends, family or personal credit for funds. Online lending offers opportunities that simply did not previously exist."

The role of business credit information

The role of business credit information — including any history of missed payments, delinquencies, pending judgments, bankruptcies and overextended lines of credit — is obviously critical to marketplace lenders' ability to quickly and accurately assess risk and advance capital responsibly.

"Experian, the industry leader in consumer and business credit reporting, is proud of the part we play in making marketplace financing available to thousands of businesses nationwide and of the good this new and growing industry sector is doing to expand the economy" Laura DeSoto concluded.

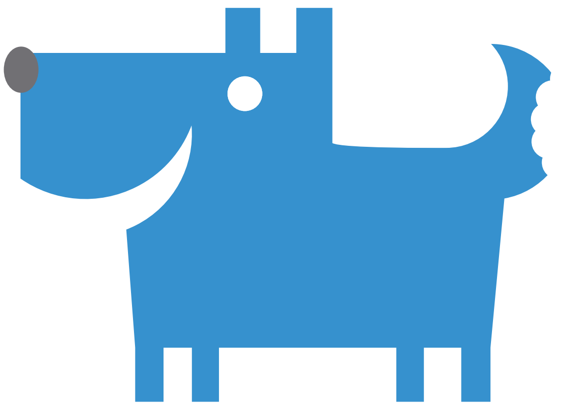
Chapter 2

Just How Alternative are Today's Online Marketplace Lenders?

By Charles H. Green

The phrase "man bites dog" is an aphorism in journalism that describes how an unusual, infrequent event (such as a man biting a dog) is more likely to be reported as news than an ordinary occurrence with similar consequences, such as a dog biting a man. In other words, an event is considered more newsworthy if there is something unusual about it.

Thus, the headline above likely will draw more attention than the same story with the headline "Hedge fund offers to refinance consumer loans for 7 percent APR." While both parties might actually own a portion of the same loan portfolio in today's "sharing economy," known in financial services as "peer-to-peer lending," this kind of loan is one of many that have evolved on the Internet under the new financial industry sector labeled "marketplace lending."



Online marketplace lenders, funders and investors have caused quite a stir over the past couple of years by offering alternative financing products and platforms to serve consumers and businesses that may have trouble securing a loan from traditional financial services, i.e., banks. But what's so radically different about what they do, other than using a Website rather than a drive-up branch to initiate a financial relationship?

After all, don't both extend money to another party with strings attached — that is, conditions about who gets the money, how much and when they promise to repay it, as well as the consequences if they don't? It seems like a better "alternative" would be to simply win the lottery!

In fact, there is plenty of "alternative" in alternative lending, and in a relatively short period of time, the results have been phenomenal for consumers and businesses alike.

What's so different?

For starters, the submission process for loan applications varies greatly. Due to supervisory oversight of the industry and a conservative lending culture, applying for a bank loan often means that a more complete disclosure of personal and business information is required. The aftereffects of the Great Recession and housing bubble meant that many banks curtailed most lending altogether until their balance sheets recovered.

On the flip side, online lenders process applications with very little information — generally about 40 data points. This is because these lenders leverage the information and often ask for a borrower's authorization to gain access to the cloud, where they can acquire more data on a borrower. Furthermore, online lenders have a narrow focus on where they are willing to lend money, so their decision analytics focus more precisely on a smaller set of information that really determines the risk for that particular type of loan.

This leads us to how online lenders make credit decisions. Most use proprietary algorithms that weigh various data collected from a borrower's application and reach a decision based on the numerical score produced at that time. There's little human intervention to sway the verdict positively or negatively since the decision matrix was developed by testing millions of blind data files with historical loan outcomes to measure and manage their exposure to credit loss.

There are plenty more differences in the online lenders' approach, but probably none more important than the customer experience.

Online loan applications can be submitted 24-7, and a borrower will be "conditionally qualified" or declined usually within minutes. Final credit approval often comes within a couple of hours, and funding might be in 48 to 72 hours.

How can they do it? The answer lies primarily within four factors:

These companies are driven by innovation, with technology used to address many aspects that we don't like about traditional lending;

Online lenders are not banks, and as such they are relatively free of the regulation that comes with accepting public deposits to fund their operations;

By focusing on a smaller niche of prospective borrowers, online lenders don't try to be everything to everybody but rather specialize to serve a smaller set of clients better.

Finally, these companies have developed niche products to satisfy the particular needs of each market.

What happens next? Is the end of commercial banks as we know them at hand?

No. While the rise of online marketplace lending has been meteoric and the industry climbed to an admirable $9 billion of funding in 2014, it is a very small portion of the trillions of dollars funded by traditional banking today. Still, what they do is attract plenty of attention in the trade.

Expect to hear more about strategic partnerships, acquisitions and other flattering forms of imitation, as the banking industry will adopt and adapt many of the inspiring improvements brought by the online marketplace lending sector. Both sides will win, but the real prize goes to consumers and small-business owners who will have a more robust and competitive environment to get financing capital in the years ahead.

Chapter 3:

New Self-Regulatory Program for Nonbank Small-Business Lenders

Is Good for Consumers, Small Businesses, Lenders and Public Policy

By Tony Hadley

The Responsible Business Lending Coalition — a group of nonbank small-business lenders — announced a self-regulatory program that is designed to bring greater clarity and consistency to its industry's pricing and consumer protections. The Small Business Borrower's Bill of Rights outlines six primary principles that those signing the pledge will abide by when lending to small businesses. They include:

1. The right to transparent pricing and terms, including a right to see an annualized interest rate and all fees
2. The right to non-abusive products, so that borrowers don't get trapped in a vicious cycle of expensive reborrowing
3. The right to responsible underwriting, so that borrowers are not placed in loans they are unable to repay
4. The right to fair treatment from brokers, so that borrowers are not steered into the most expensive loans
5. The right to inclusive credit access, without discrimination
6. The right to fair collection practices, to prevent harassment and unfair treatment

"Online loans with shorter terms, and high-priced loans have a higher degree of creating debt traps," explained Conor French, director of legal & regulatory for Funding Circle, one of the coalition's founding members. "Borrowers in the online market need to be able to make an apples-to-apples comparison between lenders and between loans. We wanted to create a choice architecture that allows borrowers to see similar information."

Adoption of Industry Best Practices Helps Establish Clear Rules of the Road

The adoption of self-regulatory standards by this group of small-business lenders is an important step in proactively addressing some of the concerns that policymakers may have about this emerging market. It also is vital to helping provide transparency and assurance to small-business owners that rely on affordable access to capital to start and operate a business.

Non-bank small business lenders often fall outside some of the regulatory framework that regulated entities must meet. However, as new, innovative underwriting solutions will sometimes incorporate the consumer credit history of the business owner or entrepreneur, the line between consumer and business regulation can get blurred.

The self-regulatory pledge incorporates many of the themes that have been part of the Consumer Financial Protection Bureau's push for transparency across the consumer financial marketplace, including the short-term lending market.

"Abuses can come from lenders, brokers or other unsavory players," French noted. "For example, if you're using a broker or partner, are there conflicts of interest? Are they arranging the deal that's best for you or best for them? Only by having open transparency can you understand what your options truly are. You can't just accept what someone else chooses for you at face value."

Self-Regulation Shows Self-Discipline and Addresses Evolving Public Policy Priorities

Industry self-regulatory standards, such as the Borrower's Bill of Rights, can be a good way for market leaders to demonstrate self-discipline by responding to the evolving public policy priorities of legislators and regulators. Industry self-regulation can be preferable to legislative or regulatory changes in some cases because it is flexible and can accommodate evolving market trends and consumer expectations.

This is especially true when considering markets where innovative, disruptive technology and products are being developed, such as that of small-business lending and peer-to-peer markets. The fact is that the development of regulations takes considerable time. Self-regulation can change more quickly as technology and markets evolve and mature. Industry self-regulation can help to provide transparency and protect consumers without impeding innovation.

"Ultimately, I think government regulation of this market is inevitable," French conceded. "But, we don't know when it will happen, who will write the standards or who will manage enforcement. We believe by encouraging responsible self-regulation, we're not only forestalling federal involvement, but also creating a model for what the government should do should it step in."

Gaining Critical Mass and Ensuring Accountability

There are challenges when it comes to ensuring the effectiveness of a robust industry self-regulation regime. First, it can be difficult to have entities outside of the industry leaders to adopt and abide by the best practices. For small and medium-sized entities, the development of self-regulation may seem like a barrier to growth. Demonstrating the need and value of industry self-regulation to all market participants, regardless of size or market share, is essential.

Another key hurdle is that any industry self-regulation must be accompanied by clear and well-respected accountability measures. Self-regulatory pledges are only as good as the accountability measures that ensure compliance. Without being held responsible for meeting industry best practices, regulators are unlikely to take the self-regulation seriously and may be more willing to cite the need for new regulation to address a market failure. However, accountability measures that have real teeth and oversight from a third party, such as a trade association, help to ensure that the industry takes the matter seriously and additional action from regulators is unnecessary.

"Our Small Business Borrower's Bill of Rights is currently being enforced by the Small Business Majority, a nationally recognized nonprofit organization," French stated. "Having third-party endorsement helps avoid any conflicts of interest. As for actual penalties, we believe that reputational risk is quite significant."

Experian has experience implementing industry best practices

Experian has considerable experience with the adoption of industry best practices across all of our businesses. Most notably, we worked closely with our competitors and clients to develop and implement enforceable self-regulation for the digital marketing industry. The Digital Advertising Alliance's (DAA) self-regulatory regime has allowed for innovation and growth to continue, while at the same time enhancing transparency and consumer protection. Since its inception, there have been more than 50 million unique visitors to the DAA program websites, where consumers have been able to not only exercise their choice to opt-out of digital advertising, but also receive detailed education about the program.

Experian looks forward to working with clients in the online marketplace lending segment as they implement the Small Business Borrower's Bill of Rights in an effort to improve transparency and understanding of this market.

Chapter 4

Big Alternatives

How new forms of data are reshaping online lending

By David Huizinga

Big Alternatives

Online lenders represent a valuable resource for small businesses in need of working capital. Also known as “alternative” lenders, these entities are particularly useful to new businesses that do not have the long, detailed credit history that banks and traditional lenders usually require to underwrite a commercial loan.

This is why online lenders have become so popular with newer restaurants, small retailers, young business service companies and other enterprises that have no other place to go for working capital. Being unregulated, online lenders can be far more liberal with their lending requirements.

But online lenders don’t lend blindly. They don’t base their decisions on a catchy name and an inspiring mission statement. Online lenders have numerous sources of data upon which to base their decisions. And as you might imagine, many of these sources are as “non-traditional” as the lenders themselves.

For example, there are many names people use to describe the new types of data online lenders use to qualify applicants, such as “Big Data,” “alternative data” and “online data.” Essentially, they all mean the same thing: readily available information that, above and beyond traditional credit scores, can be used to determine a business’ financial health.

New Data Sources for Online Lenders

In addition to checking accounts and tax returns, online lenders may use any number of alternative sources of data to evaluate potential borrowers, including:

The Company Website

Having a website is the first clue as to whether an applicant is or is not a legitimate business. In addition, traffic *on* that website – from shoppers buying products, diners making reservations, or visitors simply making inquiries – can give valuable clues about the business’ viability.

Social Media

What customers say about a business on various social sites offer more important clues as to a business’ financial strength. A business with high ratings from a large number of customers may be a good risk, even if it’s only been in business for one or two years.

Online Financial Activity.

Heavy activity on sites like PayPal or Ebay suggest a healthy cashflow, something that’s important to many online lenders.

Accounting Software

Having direct access to a borrower’s accounting software (e.g. QuickBooks, FreshBooks) allows a potential lender to observe and track a borrower’s financial activity in real time. Such data can also provide a lender with an early warning signal should the borrower suddenly get into trouble.

Shipping Data

If a borrower is a retailer, whether B2B or B2C, are its products moving? Shipping data – both volume and frequency – is another valuable indicator of financial stability.

Privacy & Security Issues

How do online lenders get hold of this data, particularly the proprietorial information not readily available through a Google search or social media? They get it straight from the borrower.

When a business owner agrees to an online loan, they're often agreeing to provide the lender direct access to their business accounting and management system. And not just for a one-time look, either. This may involve long-term access so the lender can keep an eye on its investment. The downside to this arrangement is, of course, privacy and security vulnerabilities. The upside is that it may help expedite the lending process.

Interpretation is Critical

Of course, data by itself does not tell the whole story. It must be properly interpreted. This is particularly true of alternative data.

For example, the ratings a restaurant receives on Yelp can't be judged against ratings for a dry cleaner. A restaurant in any city is likely to get far more social media coverage than is a neighborhood dry cleaner. However, a dry cleaner with just two or three reviews may be a far better business risk than a restaurant with 500. It's all about being able to interpret and glean insights from the data you collect.

Packaging Online Data for Risk Assessment

Five years ago, Experian created its Global Data Laboratory in San Diego for the express purpose of mining alternative data and seeing if it could be packaged as a commercial product to help online lenders and other companies evaluate new, small companies. Staffed with a team of Ph.D.'s in data science, the lab has built a one 1,000 terabytes – database containing information from thousands of sources, particularly social media.

"One of the big challenges any lender faces is determining if a borrower is legitimate. This is true even for traditional businesses, like a Home Depot that may want to open a credit line with a small contractor that has little or no credit history. For every 100 companies that are 'invisible' to lenders, we can now establish the legitimacy of 20 businesses using nothing but online sources. That means a business can now have as much as 20 percent more customers than before just by accessing this alternative data. The lab's new algorithms are also highly predictive of a company's longevity."
– Eric Haller, EVP Experian Data Labs

For new and emerging businesses, leveraging data from the Web, including social media, can deliver a 40 percent lift in predictive performance compared to the industry averages for predicting whether a company will go out of business or not.

Just Part of the Equation

As useful as alternative data is, it's just part of the algorithm an online lender uses to score borrowers. Traditional credit scores are usually still part of the evaluation process.

Even the most liberal online lenders are still going to look at trade experience, business registrations and other third-party information. Big Data becomes just one part of their equation.

New sources of customer information and readily available online data, combined with traditional data and metrics – and the experience necessary to properly interpret both – has created a robust online financial marketplace and gives small business owners unparalleled access, flexibility and choice when it comes to capital financing.

While it's still kind of like the Wild West out there, there are risks, as well as incredible opportunities. Through the use of Big Data, Experian is able to provide insights that help minimize those risks for borrower and lender alike. And that helps everyone.

Chapter 5

Playing To Your Strength

Opportunities for Regional Banks to Build Better Lending Portfolios

By Charles H. Green

The evolution of commercial lending over the past seven years has certainly had its share of ups and downs. Remember the ominous days leading up to the financial crisis when it seemed like everything was teetering on collapse? In the end, and more than five hundred bank failures later, the economy found a very slow path back to growth.

During that uncertain time, commercial lenders took a lot of criticism from several directions. Regulators were skeptical of the risk level that lenders accepted, borrowers argued when their credit score did not qualify them for a loan and seemingly everyone else had an opinion on how long it took to turn lending volumes around. On top of those worries, a new channel emerged, "online marketplace lending." These new lenders funded loans from technology platforms that turned around loan applications in very short order, seeming to best banks at their own game.

Fast forward several years, and traditional lending has had plenty to cheer about, even if not recognized in the broader economy. The bank failures largely have been resolved, making some of the healthy surviving banks much larger and eliminating some competitors in many markets. Additionally, bank profits are back up as balance sheets have been mostly cleared of underperforming credits, with a renewed focus on good underwriting and solid risk management.

Banks have advantages

This new phenomena known as online marketplace lending has grown dramatically on the strength of loans that traditional banks have had difficulty serving in the past: small, unsecured working capital loans to service and retail businesses. By performing the sorely needed task of scaling smaller business loans, online marketplace lenders have strengthened many small companies that were otherwise unable to secure financing from banks.

However, banks never lost their core strength: their customers. While deregulation gave rise to competitors from a long list of bank services and products, few small-business owners left their banks behind entirely. During the crisis, many companies flocked back to the safety of the federally insured deposit system. Online marketplace lenders may augment but never replace those kinds of relationships.

Another advantage large banks have is a strong tie with local businesses. While online lenders can respond quickly to application requests with the latest digital efficiency, their capacity to forge direct relationships is often limited to the term of their outstanding loan. Once repaid, they must restart the cycle to convince clients to borrow again.

Banks, on the other hand, offer dozens of products and services that can help small business owners manage everything from business finances, household purchases, retirement savings, auto loans, safe deposit boxes, etc. Most online lenders offer a shorter product list, with options intended to serve a specific customer demographic.

Perhaps the most significant advantage banks carry is their degree of flexibility. While online marketplace lenders can leverage the many benefits of a digital platform, there is often only one way to apply for a loan. Many online lenders lose business when an applicant falls outside their parameters.

Finally, banks offer flexibility to negotiate around certain conditions or requirements that may bear consideration of alteration. There are people at various levels who can waive some rules or make exceptions when warranted.

Given their similarities (looking for business among the same customer prospects) and differences (average loan size, structure and underwriting), banks and online marketplace lenders have the perfect opportunity to forge cooperative arrangements to exchange business.

Imagine there is a bank president with a 50 percent loan-to-deposit ratio who is starved for a larger book of earning assets. Perhaps he needs assets from some areas that came up weak in his Community Reinvestment Act (CRA) examination? Maybe his loan product mix is too heavily reliant on big Commercial Real Estate (CRE) loans, but he struggles to book small credits profitably due to the boarding cost?

What if he could go to a trusted online marketplace dashboard and search for loans to buy based on a transparent credit grading matrix, with adequate returns commensurate with the risk? Maybe he could even target specific ZIP™ codes to invest funds in places he is lacking market presence. Small-business loans, consumer loans, student loans — they're all there, and more lines are on the way.

Online lenders are nonbank entities that finance much in the same way as banks. A considerable portion of their capital must be invested in their proprietary digital capacity, so when lending grows, many are scrambling for funding. Most of them fund this volume with either revolving lines of credit, securitization or by selling off loans/portfolios to investors.

The interesting part is that nothing should stop a commercial bank from participating in any of these activities.

There are plenty of opportunities for banks to engage with the marketplace for profitable results with manageable risk. Banks can buy portfolios or loans, refer loan applicants, use the online lender's proprietary technology to underwrite and fund certain loans, or participate with lender finance, which has been a common practice for alternative lenders for decades.

Each type of financial institution has its own inherent advantages. However, playing to the strengths of the online marketplace and banks alike enables both types of entities to open new pockets of opportunity — a situation that may lead to a faster path for economic growth.

Chapter 6

Game Changer

How Marketplace Platforms Are Bringing Financial Institutions Back to Small-Business Lending

By Gavin Harding

In the wake of the Great Recession, numerous entrepreneurs began to use online platforms to offer capital funding programs, short-term loans and other business-to-business (B2B) credit plans to small-business owners who were otherwise unable to do business with traditional banks. Today, much has changed, and "marketplace lending" has grown with loans coming in a wide variety of types, sizes, lengths and terms.

The characteristics marketplace lenders tend to share include:

- An easy application process facilitated by Web-based platforms
- Fast approvals, often within 24–48 hours
- Higher-than-normal Annual Percentage Rates to compensate for the market's higher risks
- The absence of state or federal regulation

The borrowers also share similar characteristics:

- They are often small, relatively young companies (between one and five years in business)
- ACME Many are retailers, such as stores and restaurants, or B2B service companies, such as marketing and advertising agencies
- They have strong cash flow

As an industry, marketplace lending has enjoyed considerable success over the past five years. In some entrepreneurial circles, names such as Lending Club, Fundera, Creditera and Funding Circle are as well-known as Citibank, Bank of America and Wells Fargo. According to a recent report from Morgan Stanley, in 2014 marketplace lenders issued a combined $12 billion in loans in the United States and more than $24 billion worldwide. Morgan Stanley expects that activity to grow to $122 billion and $280 billion, respectively, by 2020.

Granted, such numbers are modest compared to the $15 trillion controlled by the total U.S. financial sector, but the market is large, fast-growing and has gained the attention of many "traditional" financial institutions. Many full-service banks see these newer online platforms as opportunities to increase their own efficiencies as well as a way to capture future long-term customers.

Union Bank Partners With Lending Club to Expand Opportunities

MUFG Union Bank N.A, a large financial institution that operates 398 full-service branches throughout California, Oregon and Washington, recently partnered with Lending Club, the San Francisco–based peer-to-peer lending company founded in 2006.

"Our relationship started as an investment," said Donald Stroup, Chief Credit Officer for MUFG Union Bank N.A. Retail Banking group. "We have not been in the credit card business for many years and have had no exposure in auto finance or student lending. Lending Club offered us an opportunity for diversification, for expanding our banking services and for products that could help us broaden our household penetration."

James Francis, Executive Vice President for MUFG Union Bank, N.A. Consumer Lending Group, also noted, "Online lenders are still very small players relative to the overall market, but they're growing fast. Banks have a great deal of flexibility when it comes to working with marketplace lenders. Investors, such as banks, can pick and choose where they want to play; for example, we decided to purchase high-end consumer paper from Lending Club. Because it operates throughout the United States, we can purchase from Texas and New York, and not just the West Coast. Lending Club is very transparent with its criteria, so we know where the loans originate."

Both Francis and Stroup believe that full-service banks can learn from marketplace lenders when it comes to speed, convenience and electronic applications. This is particularly true when it comes to working with millennials, many of whom are far more comfortable with the online environment than they are with brick-and-mortar establishments.

"Businesses may begin by shopping for cheap loans online, but once a business reaches a certain size and complexity, it looks to one provider to handle all its needs," Francis added. "In addition to simple capital lending, this can include cash management, investments, liquidity, stock ownership plans, estate planning, etc. Online marketplace lending companies can't provide that broad array of services and relationships. It takes a traditional bank to do that."

While acknowledging the success marketplace lenders have had connecting with a segment of the market that for a time was underserved, Francis remains concerned about its resilience and longevity.

"This is still a largely untested business model," he noted. "Having been born out of the Great Recession, marketplace lending hasn't gone through a complete business cycle. It will be interesting to see how these lenders perform in a down cycle. I suspect that, in a down market, these lenders will have a harder time funding loans. Investors may get skittish when they see the lower returns that will inevitably occur."

Despite their concerns, both Stroup and Francis remain open to exploring further opportunities in marketplace lending.

MUFG Union Bank N.A. is just one of many large financial institutions now exploring partnerships with online lending concerns. We expect these alliances to become increasingly common over the next two to three years, with new synergies creating more markets and opportunities, for borrowers and lenders alike.

Chapter 7

Marketplace Matchmakers

How Loan Aggregators Bring Borrowers and Lenders Together

By Gavin Harding

Marketplace Matchmakers

Marketplace lending has become a dynamic source of small-business financing. In 2013, marketplace lenders funded customers to the tune of about $3 billion, twice the volume from the previous year. These numbers are expected to continue to rise steeply throughout the rest of the decade as customers become increasingly comfortable with the concept.

Operating almost exclusively via the Internet, these fintech companies can be particularly helpful to newer, less-established retailers, such as restaurants and B2B service companies that don't have the documented track record that most traditional banks prefer. These alternate financing sources also can be an excellent resource for smaller loans in the $5,000 to $200,000 range. Larger banks often are reluctant to consider smaller business loans.

Business owners looking for quick access to capital have a wide variety of sources to choose from:

- Nonprofit lenders
- Invoice financing
- Online business loans
- Loan aggregators
- Peer-to-peer financing
- Crowdfunding

But how can potential borrowers locate these new lenders? When it comes to matching small-business borrowers to the most appropriate lenders, a new breed of marketplace matchmaker or loan aggregator is finding success bringing the two parties together. Aggregators compare the needs and qualifications of borrowers with lenders in their network matching their target criteria. Think of it as speed dating for business financing.

Organic Online Searches

Not surprisingly, many online lenders rely on technology to find potential customers. Common online marketing tactics include pay per click and search engine optimization (SEO).

"Most of our customers come from the Internet itself," confirmed Meredith Wood, Editor in Chief of Fundera, an aggregator for about 30 individual marketplace lenders. Founded in early 2014, Fundera has helped more than 1,200 small businesses acquire loans totaling more than $60 million this year. "We do paid acquisition and also use content to generate organic searches. We rank well for competitive terms like 'business loans.'"

Nav (formerly Creditera), founded in 2012, is another successful fintech company, offering an array of commercial financial services, including credit cards, credit card processing and small-business loans. Like Fundera, Nav relies on SEO for many of its leads.

"Of all the lead channels we have, SEO organic is the most difficult to get going," said Levi King, Founder and CEO of Nav. "You're competing for attention with millions of other people. But while it's the slowest channel, it also tends to yield leads of super high quality. The people who find us organically are looking for what we offer."

Social Media

Social media is one tool being used more frequently in Web-based marketing. Using advanced algorithms, marketplace lenders can target ads directly at businesses that fit a specific profile.

"We use Facebook, Twitter, LinkedIn — anywhere small businesses are showing up and you can target them effectively," King explained. "Small-business owners behave a lot like consumers. Their business and personal communications are almost identical. While social media is a great way to connect with this market, it's definitely not the way you'd market to enterprises."

Referrals

Referrals are another significant and valuable source of customer leads and tend to come from one of two principal sources:

- Other funding sources — Often, a lender, such as a bank, that is unable or unwilling to write a loan for a small business will refer that business to an alternative lender with more flexible requirements. Banks generally refer customers only to companies they have worked with before and have established credibility in terms of reputation, integrity and professionalism. Lenders that make referrals under these circumstances usually do so as a courtesy and receive no fee or other consideration for their efforts. Their intent is to cultivate good relationships with customers who may someday migrate to more traditional banking services.
- Satisfied customers — Perhaps the most valuable referrals are those that come from other business owners who already have received loans from a particular marketplace lender. Getting referrals from friends, relatives and business acquaintances sets a customer's mind at ease and helps the customer overcome the hesitation and anxiety sometimes associated with dealing with a new company.

Partnerships and Aggregators

Many marketplace lenders have developed formal partnerships with companies or with other lenders that provide them with customer referrals. Unlike the casual referrals discussed above, these often involve fees or other consideration as part of a contracted business arrangement.

For example, Fundera works with FTD® to help their florists find financing.

"Borrowers complete one aggregated application that we send off to various lenders," said Wood. "We present the offers we receive to the borrowers and work through them together so they understand what each offer means, what they really cost, etc."

The Future of Online Lending

Not surprisingly, both Wood and King are bullish on the future of marketplace lending. Wood in particular sees the option as being very attractive to young people who have some experience in the business world and now are ready to start companies of their own.

The online marketplace lending industry is growing by leaps and bounds. Fintech companies continue to rapidly innovate, developing niche products and efficient data-driven marketing approaches. At the same time, the banking sector remains the dominant source of funding for small businesses, with close community ties and deep customer relationships. Fintechs and banks are beginning to explore ways to work together to make the most of what each brings to the small-business funding market. Regulators are engaging with the online marketplace lending industry and considering factors related to disclosure, transparency and lending practices. The outcome for small businesses is increased choice, information and access. That is good news for them and for the economy.

Chapter 8

New Frontiers

What's Next for Online Marketplace Lending?

By Gavin Harding

Simply put, online marketplace lending is here to stay. Virtually unheard of just 10 years ago, Web-based companies that offer funding options beyond traditional bank loans have grown considerably. Small businesses — drawn by the easy application process and flexible repayment terms — have become increasingly comfortable working with online lenders, which offer rapid access to capital, a wide array of niche products and a low-friction customer experience. The lack of regulation and higher-than-market interest rates that often accompany these "alternative" loans have not deterred borrowers from trying this new source of business financing. Despite their growth, however, online lenders still make up only a small segment of the overall small-business loan market.

While that paints a clear picture of the current online marketplace lending environment, what does the future hold? How is the industry, still in its infancy, likely to change as it responds to pressures from competitors, borrowers and regulators?

Here are some trends we can expect to see over the next several years:

Growth

As online lending becomes more mainstream, look for the industry to expand exponentially. In 2014, online lenders combined to issue loans totaling about $12 billion in the United States. In a recent report, Morgan Stanley said it expects the U.S. number to grow to $122 billion by 2020 and the global number to surpass $280 billion in the same time period.

"Online marketplace lenders are still very small players relative to the overall market, but they're growing fast. They could be very disruptive or an entirely new [source] of capital for both small businesses and consumers that aren't necessarily serviced by larger banks."

– James Francis, Executive Vice President, Consumer Lending Group, MUFG Union Bank N.A

Participation

Exponential growth likely will be fueled by the growing acceptance of online lending by small businesses, especially those run by millennials comfortable with virtual transactions. As the customer base grows, look for competition to increase as both new and established lenders fight for the attention of this attractive market segment.

"Small-business owners in general are increasingly turning to online options to seek capital. According to a recent study by the Fed, 20 percent of small-business owners sought a business loan online during the first half of 2014. Small businesses are using new technologies to manage their customers, process payments, handle point-of-sale — it makes sense they'd turn online for capital as well."

– James Hobson, Chief Operating Officer, OnDeck

Innovation

New, even more efficient ways for borrowers to secure business loans — not to mention the nature of the financial products themselves — will continue to appear as competition drives innovation. Look for lenders to develop:

- Faster, more user-friendly interfaces along with algorithms that further accelerate the review and approval process
- Frictionless access
- Improved customer engagement and experience
- Platform and product innovation

"Certainly there are more players in the space today, which is great because it pushes not only us but the category as a whole to generate more awareness, more credibility and better platforms to help small businesses. The category as a whole has been built on this idea of making things a little bit more simple and easy. We're always asking, 'How can we provide our offerings in a frictionless way and time-sensitive manner?'"

– Jason Rockman, Vice President, Brand Marketing, CAN Capital

"There are a lot of lenders offering similar products to the same customers. There will be more competition to offer more products, which is better for borrowers."

– Meredith Wood, Editor-in-Chief, Fundera

Consolidation

Industries often go through a period of hyper expansion followed by a period of consolidation as larger, better-financed players acquire smaller competitors and underperformers go out of business. One hundred years ago, more than 100 companies were making automobiles in the United States alone. Today, there are fewer than a half dozen. Twenty-five years ago, scores of companies were making personal computers. Today, a handful of brands dominate 90 percent of the market. We can expect the online marketplace lending sector to experience similar consolidation.

Spillover

As online lending becomes increasingly mainstream, look for traditional lenders — particularly commercial banks — to enter the fray. Some forward-looking banks already are working directly with online marketplace lenders, referring customers based on their needs and qualifications or re-creating the frictionless look and feel of online lenders. Look for the dramatic differences between "traditional" and "alternative" lenders to blur in the coming years.

"There are several key reasons why banks would want to partner with online lenders. The first is to drive customer retention. A bank says yes to small-business borrowers roughly 20 percent of the time based on their lending criteria. What happens to the other 80 percent? Banks don't want to lose those customers. Partnering with marketplace lenders is one way to retain those customers and create a good user experience.

Customer loyalty is another driver. Access to capital does more to build loyalty than any other product or service. Finally, the biggest motivator is access to new technology and data, especially for institutions forward thinking enough to recognize that there are opportunities for them to monetize their existing data as well as learn from the data analysis and data science that some of the more sophisticated marketplace players are executing."

– Glenn Goldman, CEO, Credibly

Regulation

Regulation is on the horizon for the online lending industry. While the absence of regulation has facilitated rapid growth and innovation, this lack of oversight also has led to an environment in which some borrowers have complained of unfair lending practices and a lack of transparency.

Most leading online lenders believe some kind of regulation is good for the industry. A set of rules and standards defines the playing field and provides the confidence and consistency the industry needs to grow sustainably.

"Some government oversight is going to happen. It's just a matter of time," said Levi King, Founder and CEO of Nav (formerly Creditera), which was founded in 2012. "Small businesses are not sophisticated. There's a lot of predatory lending extended to small-business owners, who are, as a rule, not sophisticated enough to know what's happening."

"We believe it's important to foster greater transparency in business lending marketing," said Rebecca Shapiro, Director, Brand & Strategy, Funding Circle. Along with Fundera, Lending Club, Opportunity Fund and Accion, Funding Circle recently helped craft the Online Borrowers Bill of Rights, which attempts to establish ethical standards the industry can use to police itself. "We don't assume the bill can replace government regulations. We do believe that, by encouraging responsible regulations, we'll have a model for what the government should do," said Shapiro.

The Future is a Bright One

Customer engagement, access, frictionless applications and a wide range of product choices are at the heart of the online marketplace lending industry. The mainstream banking industry is starting to take note, looking externally at possibilities for collaboration and internally at ways of updating systems and processes to improve the customer experience. Ethical standards and regulations will increase transparency, accountability and consistency. If these trends continue, both the small-business owner and the economy will reap the benefits.

About the Authors

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During his 20-plus years in banking and finance, Gavin has held a number of senior leadership positions, gaining experience in commercial and small-business strategy, Small Business Administration lending, credit and risk management, and sales. He has guided organizations through strategic change initiatives and regulatory challenges. Gavin now works as a Sr. Consultant with Experian's online marketplace lending and banking clients on all aspects of small-business lending and engagement, from strategic planning and business model development to customer acquisition, underwriting and risk management.

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David Huizinga is Director of Data Strategy for Experian Business Information Services in North America. His responsibilities include identifying growth opportunities and associated data sources, maintaining a data road map to align the organization, and identifying potential partners and acquisition targets. Through his work, David regularly interacts with Experian DataLabs, Information Management, Decision Analytics and Product Management.

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Charles Green is Managing Director of the Small Business Finance Institute, which provides professional training to commercial lenders for banks and nonbanks alike. He has written extensively about the marketplace lending sector, including the recent Banker's Guide to New Small Business Finance (John Wiley & Sons, 2014). Earlier in his career, he founded and served as President/CEO of Sunrise Bank of Atlanta.

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