Why FIs Shouldn't Ignore Marketplace Lenders

By Susan Griffin, Strategic Initiatives Analyst

Traditional financial institutions (FIs) such as banks and credit unions have been challenged by new entrants into the lending market from as far back as the early 1900s when finance companies, like Household Finance, introduced an alternative way for consumers to borrow money. Fast-forward a hundred years, and FIs are still faced with "disruptors" looking to serve the consumer and business markets by fundamentally changing the way borrowers seek out and apply for loans. Whether you call them "fintechs" or "marketplace lenders," they are making their mark on traditional lending.

How Marketplace Lenders Evolved

The new fintechs have developed technologies that expedite and enhance the credit analysis and fulfillment processes related to lending and are offering their services online. With little experience as lenders, they initially started out using a peer-to-peer (P2P) business model in which they were an intermediary linking investors to borrowers. The timing was good for new lending sources to emerge as FIs had all but stopped lending in order to reduce further risk during the 2008 financial crisis. As the economy started to stabilize and investors' interest began to waver, some marketplace lenders revised their business structure by utilizing a balance sheet model, or a hybrid of both balance sheet and P2P lending, to better ensure a sound capital position. This included seeking funds from institutional investors, which were more dependable sources of capital. Thus began the efforts of the marketplace lenders to partner with FIs. The FIs valued the innovative technologies the fintechs possessed, and the fintechs received access to the FI's customer base and an additional source of capital.

Changing Market Dynamics

Traditional FIs still maintain a majority of the market share related to both consumer and commercial lending, but the marketplace lenders have experienced rapid growth over the past few years. With that said, their growth doesn't come without challenges. Besides the struggle to maintain a healthy balance sheet, many fintechs have limited knowledge of the underlying fundamentals of finance and the general accounting structure of financial institutions. They have yet to experience a full economic cycle, which typically ranges anywhere between seven and nine years. There is also chatter about regulatory scrutiny beginning to surface, and research investigations are being established in government agencies such as the Office of the Comptroller of the Currency (OCC) and Department of the Treasury.

Many industry pundits are comparing the saturated marketplace of online lenders to the Dot-Com Era of the late 90s. Therefore, it is predicted that only those with a sound business model and strong capital

Copyright © 2012. Jack Henry & Associates, Inc.® All rights reserved. ProfitStars is a registered trademark of Jack Henry & Associates, Inc.

backing, exercising best practices in credit risk management will survive. And a larger portion of smaller, less stable fintech businesses will be subject to failure within the next couple of years.

However, this doesn't diminish the struggles that traditional lenders are facing. They still need innovative and proficient solutions that will allow them to provide a desirable customer experience and maintain their dominant position in the market; and there will still be a substantial number of validated lenders in the marketplace competing for borrowers.

Recent political changes are likely to impact the lending environment. We have a new administration occupying the White House in January, along with a Republican dominance in the legislative segments of the federal government. Based on the campaign messages, there should be a large focus on small businesses and promotion of industry in the U.S. over the next four years. This will intensify the requirement for better commercial lending processes and technologies to support businesses' needs for capital and growth.

The Technology Solution

Lending platforms have needed improvement for a very long time, especially in commercial lending where loans require much more complex practices. Vendors have attempted to automate various phases of the process, such as onboarding, decisioning, and fulfillment. But few have provided a true end-to-end process that doesn't require manual intervention. One thing that many vendors touting their solutions to FIs have overlooked is the continued relationship with the business customer. This relationship and the trust factor that FIs enjoy, are the most significant advantages they have over the marketplace lenders or fintech providers. The Commercial Lending Center Suite™ offered by ProfitStars® has built a strategy encompassing this philosophy of engaging a complete relationship between the FI and its business customers.

Find a Partner or Go It Alone?

Large FIs have ventured out and engaged in partnerships with several of the marketplace lenders to take advantage of their technologies and/or ability to support a segment of loan portfolios that are not profitable for the FIs to support. This, in turn, provides marketplace lenders the funding and the access to customers they need.

The question of a financial institution going into a partnership with a third-party entity should never be considered lightly or without a huge degree of due diligence. A FI should be assured that the company they partner with holds the same standards of service and stability as their own. Otherwise, it presents another level of risk that FIs can't afford to take.

Community banks and credit unions do not have the economies of scale to apportion an entire segment of their loans out to another vendor. Nor do they particularly want or need to do so. They are also mindful of the need to retain the customer relationships they've worked so hard to acquire. However, they can't always meet a customer's loan request when it exceeds their credit boundaries. There are

Copyright © 2012. Jack Henry & Associates, Inc.® All rights reserved. ProfitStars is a registered trademark of Jack Henry & Associates, Inc.

lending technology providers that have established a network, or marketplace, of alternative lending solutions such as ProfitStars' LendingNetwork. Many smaller FIs are establishing a relationship with a network provider as a trusted source that has vetted and validated non-bank lenders. Through a network provider, the financial institution may distribute loan requests they are unable to fulfill to a network of alternative lenders. Having this alternative lending resource will allow the financial institution to keep and maintain the customer relationship by being the vehicle in which their borrowing needs are accomplished … quickly and simply.

So, FIs should not ignore the marketplace lenders. They have found their niche in the market and are here to stay. If marketplace lenders aren't included as a partner to meet the FIs' and borrowers' needs, then one can be sure they will be encountered as a competitor.

Copyright © 2012. Jack Henry & Associates, Inc.® All rights reserved. ProfitStars is a registered trademark of Jack Henry & Associates, Inc.