Rethinking the Lending Value Chain

- Charu Gupta

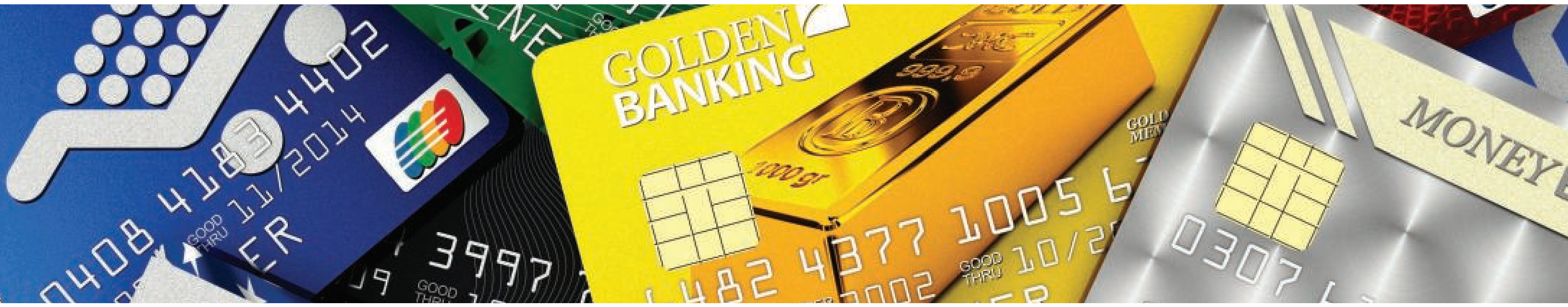
The lending value chain is witnessing unprecedented churn.

Dynamic macro-economic trends along with other factors viz., connected markets, product & technology innovation, accelerated rate of technology adoption by users, push for data-driven decision-making, and evolving regulatory requirements - are disrupting and demolishing traditional models of lending. This paper examines these developments and their impact on the future business and technology landscape that lenders must to adapt to in order to stay ahead in an increasingly competitive marketplace.

Credit Rebound around the Corner

Globally, a strong credit rebound is expected due to favorable macro-economic conditions. 2014 saw an upswing of half a million mortgages in the USA compared to the previous year. According to Freddie Mac, the US economy is well poised to sustain a growth rate of around 3% in 2015, which is expected to drive a credit surge. Lending in Australia reached the highest level in six years as consumers took advantage of inexpensive financing, following a sequence of eight rate cuts by the Reserve Bank of Australia (RBA) since 2011. Lower energy costs will provide another trigger for increased consumer lending and business investment. According to The Economist, a $40 per barrel price for crude oil will shift US $1.3 trillion from producers to consumers[1].

All of the above will fuel the global economy as well as job growth leading to an increase in construction and home sales as well as consumer spending. At the same time, however, loan defaults are on the rise even as lenders offer credit at aggressive interest rates in a highly competitive market.



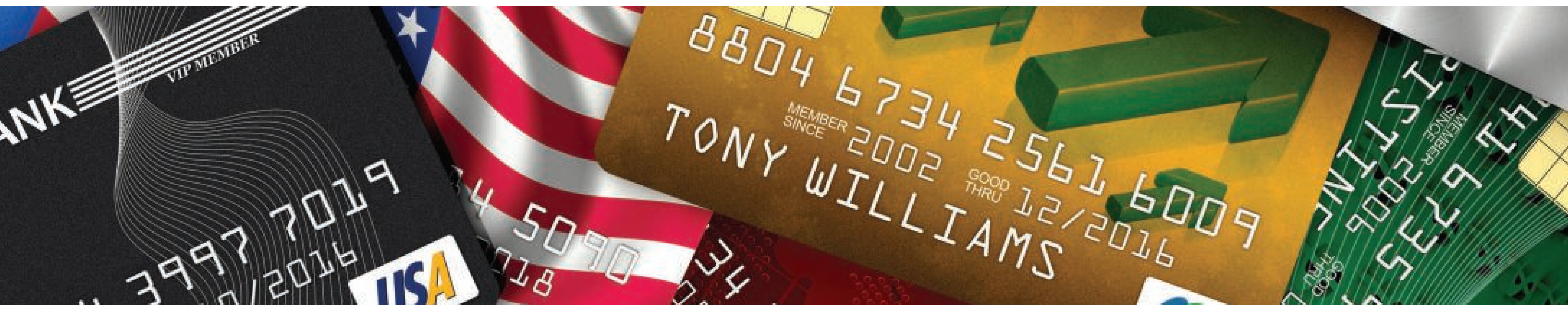
Technology Disruption

The new generation of connected, mobile consumers are driving lenders to invest in sophisticated, state-of-art technologies to provide a consistent and superior omni-channel experience from the perspective of origination as well as servicing. Lenders are leveraging search engine marketing and lead acquisitions from lead generation platforms. Start-ups, especially those that facilitate lending by investors to consumers and small businesses, are now analyzing the 360-degree online footprint of consumers. Going beyond the traditional, simplistic indicators of credit risk such as an applicant's assets and FICO score, they are building more comprehensive and dependable credit profiles. This big-data, machine-learning-based approach enables processing of thousands of attributes from a person's education to a restaurant's Yelp reviews to rate the credit-worthiness of borrowers seeking loans on lenders' platforms.

As data explodes, the challenge going forward will be to manage and exchange this data effectively across the complex and integrated maze of stakeholders that form the lending ecosystem. Fannie Mae and Freddie Mac are working together in the US under the direction of the Federal Housing Finance Agency to implement the Uniform Mortgage Data Program (UMDP) to define a common data reference model formalizing the voluntary industry Mortage Industry Standards Maintenance Organization (MISMO) standard. Similar initiatives are expected to be undertaken in other geographies for effective data management and exchange.

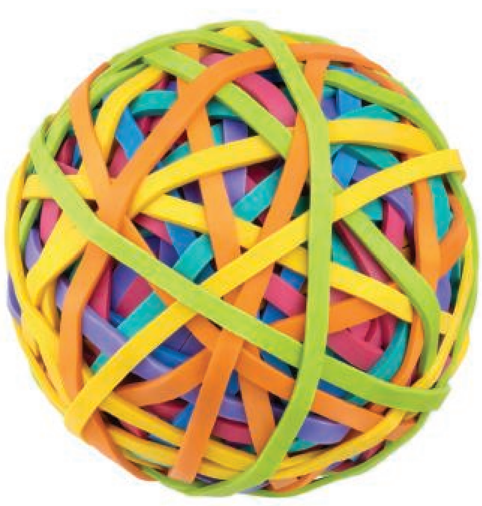
Closed Loop Operational Efficiency

Disruptive technologies like data collection, monitoring, benchmarking, and analytics are helping digitize lending business operations, enabling increased efficiency and effectiveness. Business transactions are being streamlined so that data flows seamlessly across the enterprise. Precise portfolio analytics can offer real-time insights into borrowers, loans, assets, and collaterals. This internal data overlaid with the market reference data can help lenders set up sustainable credit risk management policies and improve their underwriting accuracy. Predictive analysis is being increasingly used by lenders to make data-driven decisions about the customer and up-sell and cross-sell products. Lenders can reduce risks through automatic detection of loan fraud and IT-based combat strategies by deploying machine learning and artificial neural networks-based solutions. Traditional lenders, who have hitherto shrunk from investing in revamping their IT landscape, will need to act quickly so as not to cede this market opportunity to more nimble and aggressive new players.



Increased and Incessant Regulatory Scrutiny

While all of this is great news for participants in the lending ecosystem, there is continued evolution in the regulatory space, including new rules, changing operational requirements and increased compliance scrutiny across origination, servicing and secondary markets. August 2015 will see the implementation of new disclosure forms mandated by Consumer Financial Protection Bureau (CFPB) in the US. These disclosure forms with electronic signatures and documents sharing will pave the way for complete e-closing. But more importantly, the forms will have data mapped in line with the MISMO format, transforming static documents into dynamic data. This will allow federal regulatory authorities to maintain loan level electronic registries with the ability to review and assess loan data. Starting January 2015, the Basel III Capital Rules will influence the origination and servicing terms and see the shedding of mortgage servicing rights from banks to non-bank entities over the next 2 years[2]. Even as the role of the Government Sponsored Enterprises (GSEs) in the mortgage industry is being debated, the Federal Housing Finance Authority (FHFA) is moving ahead with building a new Common Securitization Platform (CSP) for the secondary mortgage market. This platform will be used by GSEs for data validation, issuance, disclosure, master servicing, and bond administration for their securities. The initiative should increase transparency and see the return of private capital to secondary markets. Overall, this increased and incessant scrutiny means higher cost of regulatory compliance for lenders and servicers – more reason to invest significantly in technology and look at other avenues to reduce the cost of their lending operations.



Engine of Globalization

In the last decade, investors, lenders and financiers have increasingly extended their operations beyond local markets. The opening up of developing economies has generated significant opportunities across the globe. Drivers such as diversification motives, improved profitability prospects and the search for different risk-return profiles have led many investors to add foreign assets or instruments to their portfolios. Investors need agile business processes and systems in order to acquire new assets in foreign geographies. Along with balancing geo-political risks, investors need a way to address the operational challenges of managing portfolios in multiple currencies and languages with local process and regulatory requirements. This calls for lenders to invest in global lending platforms that can operate seamlessly across geographies, regulations, currencies, and languages.

Innovative Products

There has been a steady rise in the non-traditional, less hierarchical ecosystem of lending marketplaces and players and 2015 will only see these becoming more mature, transparent and reliant. Peer-to-Peer Lending (P2PL) eliminates financial intermediaries and brings together lenders and borrowers on an online platform with interest rates being set by reverse auctions or platform scoring. The billion dollar IPO from LendingClub has re-focused the spotlight on P2PL. The equity version of P2PL – Crowdfunding – allows individual investors to participate in funding ventures and lending opportunities that earlier were not available to them.

Companies like Standard Treasury are offering banking services to be white-labeled for non-financial companies. This will enable even small retailers to offer myriad banking services and innovative loan products, e.g., offering loans at point of sale (POS). At the same time, lenders are moving closer to the moment of purchase – for instance, integrating with POS terminals to offer loans for purchase of luxury goods and leveraging mobile marketing to push offers to users as they walk past department stores. The rapid convergence and blurring of boundaries across different business lines has resulted in interesting business models and practices. One example is lending products being offered by solar energy equipment manufacturers in partnership with home builders in the form of energy efficient mortgages (EEM) or Green Mortgages[3]. Another emerging practice is that of credit card companies offering small business loans and working capital to merchants with repayment through accounts receivable on their credit cards. While taking competition to the next level, these trends further underscore the importance and need for visibility of information in the lending value chain.

Conclusion

As the lending industry re-shapes and evolves with of the collective impact of diverse macro-economic and disruptive technology trends, lenders need to urgently redefine business strategy, align operations, and re-examine data and risk management models. Further, they must adopt flexible and future-proof new-age technology platforms for competitive advantage and profitable return on their investments.

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