2016 – How Banks Will Survive the Lending Revolution

CLOUD LENDING SOLUTIONS
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The convergence of new technologies, the rise of alternative lending models, and evolving consumer behavior signal a chance for banks to evolve, grow, and thrive. Alternative finance (AltFi) creates new opportunities for banks. Agile new platforms and strategies such as marketplace lending and peer-to-peer lending, supported by new technology solutions, allow banks to stay competitive. Forward-looking banking institutions are developing partnerships with these alternative finance companies to grow their markets, share fundamental capabilities, and expand their expertise.

As astute banks leverage the latest advances in cloud technologies to modernize and simplify their organizations, they are delivering innovative digital experience that meet the expectations of today’s tech-savvy customers while improving responsiveness to deal with market uncertainty. This whitepaper proposes four strategies that banks can adopt to prosper in light of the rising success of alternative finance and peer-to-peer lending. It concludes by explaining how cloud technology can help banks leverage innovative marketplace lending models to achieve growth and success.
Today’s banks face numerous challenges. Along with ongoing demands to reduce costs to meet tight budgets, banks face new competition from alternative finance companies, high expectations by today’s digitally connected borrowers, and stringent requirements from government regulators towards capital withholdings. Forward-looking banks see these challenges as opportunities to transform their strategies. We see the following trends:

The Rise of Alternative Finance
New forms of lending bypass the core functions of traditional banks. Banks face increasingly heavy competition from new players such as online lenders, peer-to-peer lenders, and marketplace lenders. Within these open marketplaces, borrowers can interface with investors without the involvement of a traditional bank. Marketplace lenders rely on efficiency, a superior customer experience, transparency, and trust to satisfy customer demand.

High Borrower Expectations
Highly connected users demand more immersive experiences from the organizations they do business with. Led by Millennials, these users are motivated by liberating experiences with social media, online commerce, and the steady digitization of content. Advanced mobile devices set the bar for new functionality as consumers look to technology to make their lives easier, ushering in a wholesale consumerization of many traditional information systems. Most banks trail the market in their ability to give customers a rich, interactive borrowing experience.
New Regulations
Regulations have a tremendous impact on today’s banks. Since the financial crisis of 2008, stricter lending standards have dramatically impacted the ways banks work. Pressure from customers—especially the taxpayers who bailed out these financial institutions—has led to an over-reaction in regulation. Legislations such as Basel III, Dodd-Frank Reform, and Consumer Protection Act have lowered the equity returns for certain products while increasing the capital reserve requirements. A recent survey released by the American Bankers Association found that small banks in the U.S. have been deeply impacted as a result of tougher measures.

Higher Operating Costs
Banks have higher operating costs as a percent of loan balances versus marketplace lenders due to operating inefficiencies.¹

P2P is the ‘Walmart’ / ‘Ryanair’ of financial intermediation; with costs 60% lower than banks

Cost base comparison 2015e: Banks vs. Lending Club (cost as % loans outstanding)

Source: McKinsey/Lending Club

Banks are operating with existing legacy systems that make responding to competitive pressure from alternative finance companies costly and time consuming. Legacy banking systems are siloed and not well integrated, impacting the overall customer experience. Alternative finance companies operate on a cloud-based, single system of record technology platform that results in stronger know-your-customer capabilities and superior user experiences. Furthermore, banks are further disadvantaged by their reliance on legacy systems that automate core operations and ensure regulatory compliance. These extra burdens, not experienced by alternative finance companies, increase banks’ operating costs.

¹P2P Lending: Opportunity & How to Invest”, McKinsey / Lending Club
The Emergence of AltFi

Alternative finance is thriving as new technologies expand the options available to consumers and lenders. The latest online business models are fueled by the emergence of technologies that make it easy to lend and borrow—anytime, anywhere. A noteworthy example is marketplace lending, which is part of the peer-to-peer lending phenomenon. Peer-to-peer lending involves lending money to individuals or businesses through online services that match lenders directly with borrowers. Those borrowers can meet investors in a virtual marketplace without the involvement of a traditional bank.

According to Autonomous Research, alternative finance companies are gaining market share across the lending landscape. Digital Lending has taken off and many industry experts expect it could double again before 2020, reaching $100 billion in loan origination volumes between the United States and Europe. While marketplace lending currently represents only 1 percent of unsecured consumer and SME lending in the U.S., Morgan Stanley believes it can reach 10 percent by 2020.²

We estimate a $2 trillion addressable market in the US and Europe. At $100bn in volume, digital lenders could have a 10% market share by 2020.

Source: Autonomous Research. Assumes a 2-year average loan duration.

² “Digital Lending: The 100 billion dollar question”
Driven by non-banking companies that are tech savvy and digitally focused, today’s AltFi firms have pioneered alternative lending strategies that feature web-based, cloud-based, or SaaS-based loan origination systems. These alternative lenders typically use cloud-based strategies to offer innovative solutions, better interest rates, and greater transparency. Their nimble lending practices attract consumers and businesses, challenging the established order. With a cost advantage of over 400 basis points, AltFi companies outcompete banks on price and offer better rates to investors and borrowers.

“New digital lending startups have attacked the areas where banks are most vulnerable, making credit cheaper and easier.”

– Autonomous Research

Morgan Stanley expects China, the UK, and Australia to follow, helping the online lending industry to grow to between $150 billion and $490 billion by 2020.³

**We estimate global marketplace lending can reach $290 billion by 2020 (base case)**

**Global Marketplace Loan Issuance ($bn)**

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**Source:** Company Data, Morgan Stanley Research


⁴ Foundation Capital, “A Trillion Dollar Market By the People, For the People”, 2014.
A few essential characteristics differentiate these nimble AltFi companies from traditional banks:

- They have no branches. Instead they offer digital experiences for processing and servicing loans.
- They can set their own interest rates, service their own loans, and/or sell their loans to other investors.
- They collect lots of data to analyze market trends and discern customer behavior, rather than merely relying on FICO to build credit models.

Alternative lenders analyze relationship data to provide a differentiated experience to their customers. They expand the lending landscape by servicing consumer loans, student loans, real estate loans, and small-business loans. The strategies and technologies used by these AltFi competitors represent an opportunity for banks to evolve.

“The banks do not have the best reputation when it comes to innovation. Digital lenders create a competitive edge by using technology to their advantage.”

– Autonomous Research

The incentive for banks to modernize is likely to grow as tech-savvy Millennials, who have little loyalty to banks, begin to control progressively larger shares of the world’s financial assets. According to the Democratizing Finance Report, Millennials are ten times more likely than Baby Boomers to utilize peer-to-peer lending, and at least 14 percent of Millennials are already utilizing alternative, non-bank financing. A global easing of regulations has opened up the private investment market to a larger number of investors. As a result, the global alternative finance market was estimated to grow to $34.4 billion in 2015.5

AltFi offers an opening for banks to grow into new markets. Some of today’s alternative lending models are still relatively new but they are expected to quickly enter the mainstream as the cloud industry grows and matures. Thus smart banking professionals don’t see AltFi players as threats, but rather as opportunities to collaborate, and create new products and possibilities for their customers. “Lots of banks have such incumbency advantages that it is hard to see a startup beat them head on,” says Sam Hodges, co-founder and U.S. managing director of Funding Circle. “Instead we’re seeing more FinTech players and banks working together to deliver innovative solutions and superior customer experiences.”
Four Strategies for Staying Competitive

Here are four ways banks can take advantage of this opportunity to stay competitive in the new financial services landscape.

1. Implement Hybrid Lending Strategies

Hybrid lending enables banks to combine regular balance sheet lending with off-balance sheets through marketplace lending. With hybrid lending, banks create their own marketplace platforms and fund part of an otherwise unwieldy loan through the marketplace. This is especially attractive in sectors where the capital withholding, forced by regulations, are relatively high, such as when lending to small and medium-sized enterprise (SME) and real estate sectors.

Here’s an example of how hybrid lending works. A small business owner comes to a bank and files an application for a $100,000 loan for his business. Unfortunately he does not meet the bank’s strict credit and/or profitability criteria, so his application would traditionally be rejected. But with hybrid lending, the bank can sponsor a part of the loan on its balance sheet that is within its risk appetite while listing the rest on its online lending platform, where investors lend the money off balance sheet, at a slightly higher interest rate. This hybrid strategy helps banks improve the customer experience and expand their credit while managing their risk.

By starting their own marketplace lending platform and combining it with traditional forms of lending, banks can optimize balance sheets and avoid selling off assets to comply with Basel III and Basel IV solvency requirements.

2. Partner with Marketplace Lending Platforms

There are two ways banks can collaborate with AltFi marketplace lending platforms. In the first approach, these platforms can serve as a distribution channel for the bank. Banks can leverage marketplace platforms by sharing loan applications that do not suit their conservative underwriting standards. This mutually beneficial arrangement enables marketplace lenders to access more borrowers while banks can leverage the platform’s technology to screen their current customers for consumer loan refinancing. For example, BBVA has collaborated with OnDeck while BancAlliance has partnered with Lending Club.

In the second collaboration strategy, banks can buy loans from AltFi players. Some banks find marketplace platforms to be an attractive avenue for providing funding for loans since they allow them to economically diversify into segments where they don’t traditionally lend. For example, Citi and Union Bank are institutional investors on the Lending Club platform.
Banks can build public marketplace lending platforms to provide existing customers with quick access to credit and attract new borrowers. This approach can help banks operate without the burdens of legacy costs and fixed infrastructure, as well as to expand without opening new branches. Goldman Sachs has recently announced that it will launch a marketplace lending platform in 2016.

To compete effectively in these rapidly evolving lending markets, banks need FinTech technologies that are affordable, fast, convenient, and accessible. Simple loan-onboarding processes can guide consumers from application to funding in a few clicks. Unified lending platforms can easily integrate disparate applications, consolidate data, and allow decision makers to see the big picture. Having a cohesive lending platform removes complexity from the loan management process and improves visibility into lending operations.

Banks that have traditionally depended on legacy IT environments should consider adopting cloud-based configurable solutions that can transform the way they earn revenue and interact with customers. A cloud-based solution provides flexibility to respond to market opportunities, scalability to grow as business dictates, and multi-layered security to protect customer data.
How Cloud Lending Solutions Can Help

Today’s agile marketplace lending strategies, supported by peer-to-peer lending solutions, are launching banks into lucrative new markets. Forward-looking institutions have established partnerships with alternative finance companies to share fundamental capabilities and expand their core expertise. These banks have figured out the secret to success: they are leveraging the latest advances in cloud technology to expand their lending horizons and simplify their organizations. The cloud makes it easy to acquire cutting edge systems that ensure innovative digital experiences for today’s tech-savvy customers.

In order to develop a marketplace lending platform that is responsive and can compete with existing alternative lenders, banks need to partner with the right technology vendor. Cloud Lending Solutions offers a marketplace lending application called CL Marketplace™ that empowers banks to take advantage of all the strategies discussed in this paper. Because all of the products from Cloud Lending Solutions are offered as cloud-based services, they can be easily deployed and rapidly configured to meet individual needs. Rapid ramp up allows banks to keep pace with competitors and innovate with new channels and products while driving growth, efficiency, and transparency.

CL Marketplace for Marketplace Lenders

CL Marketplace is designed to manage complex marketplace loan cycles and multiple investor portfolios. Built natively on Salesforce, this fully integrated, cloud-based solution can help banks launch marketplace lending platforms in less than 90 days. Its open architecture enables lenders to quickly configure solutions that fulfill evolving market and regulatory needs. CL Marketplace also accelerates the delivery of capital, improves access to lending alternatives, and enhances the borrower experience.

Here’s How a New Alternative Finance Company Used Cloud Lending Solutions to Build a Lending Marketplace

Consider a new marketplace lender focused on an underserved industry. Their goal was to “bring a new economy to business financing” by creating a simple online lending experience, lowering barriers to entry, and unlocking capital for entrepreneurs. However, soon after launching the service, the lender faced a challenge that is familiar to many commercial lenders: getting to market fast with a solution that works for both borrowers and investors. They needed to establish a loan management system to service loans efficiently. Cloud Lending Solutions created a virtual marketplace that makes it easy to provide commercial loans.

Today, by connecting qualified borrowers, proven brands, and individual as well as institutional investors, this marketplace helps entrepreneurs start and expand their businesses, with loans up to $1 million. Its lending marketplace features sophisticated investor reporting. They win high marks from customers for their ability respond quickly to all loan applications. Thanks in part to comprehensive support from Cloud Lending Solutions, they got this lending solution up and running in less than 60 days, giving this company a first-mover advantage in a competitive market.
Cloud Lending Solutions can help banks set up marketplace lending platforms and take advantage of the latest cloud-based lending strategies. Our nimble cloud-based services have proven their ability to improve the customer experience, expand credit, and reduce operating expenses—all while mitigating risk. With a highly configurable and open architecture based on prevailing industry standards, Cloud Lending Solutions can provide an end-to-end loan management solution for marketplace lenders, from origination and underwriting to servicing and collections.

Cloud Lending Solutions has answers for each of the bank strategies outlined in this paper. Institutions can leverage new AltFi models such as marketplace lending to reach a larger customer base. Banks can join the peer-to-peer revolution by deploying the latest cloud-based financial technology (FinTech) solutions and partnering with alternative finance companies. Developing integrated partnerships to deploy FinTech solutions allows banks to cultivate new capabilities and improve their lending processes, even as they provide more immersive, interactive customer experiences. These proven online processes shorten the loan-close cycle while improving accountability, transparency, and efficiency. Providing better borrower experiences will also increase revenue and solidify loyalty among the customer base.

Whatever your lending strategy, Cloud Lending Solutions can help you seize exciting new opportunities in the new world of alternative finance. Our proven cloud-based platform powers more marketplaces than any other vendor. We offer the world’s leading cloud applications for loan origination, underwriting, servicing, and collections. Contact Cloud Lending Solutions to learn how you can seize the high ground in today’s rapidly evolving market for peer-to-peer lending services. Our overriding focus is on helping banks capture new markets for growth and success.
About Cloud Lending Solutions

Cloud Lending Solutions is a cloud-based, end-to-end lending platform delivering innovation to the global lending community. Unlike legacy technology platforms that are expensive to maintain and prevent agile response to market conditions, Cloud Lending Solutions’ clients take back control of their business by quickly implementing, extending, and digitizing the entire lending lifecycle. Cloud Lending Solutions’ single system of record is the market leading cloud solution supporting both consumer and commercial lending that scales for the needs of lenders of all sizes. Clients include banks, traditional finance companies, online lenders, and marketplace platforms.