Online marketplace lending: an alternative to bank financing?

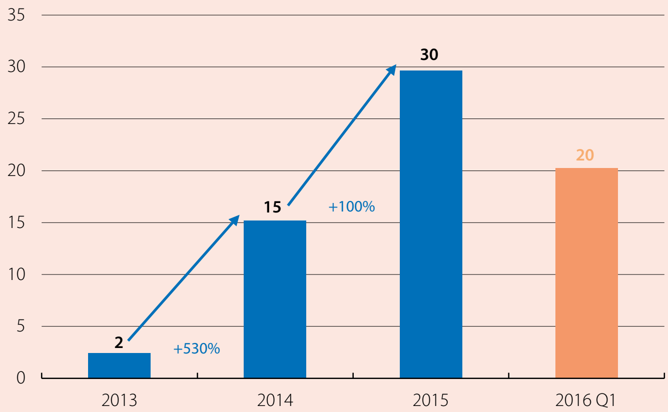
Online marketplace lending[1] is a new form of intermediation with the potential to replace or complement the traditional financial system. These 100% online platforms provide direct contact between lenders and borrowers and offer services to screen loans, assess creditworthiness, manage servicing and collection, and recover non-performing loans. This is partly a kind of fintech whose aim is to use technology to offer financial services with a particular, although not exclusive, focus on market segments that may not be profitable for traditional banks,[2] especially consumer credit niches and financing for micro and small firms.

These fintechs are developing very quickly in China, the USA and the United Kingdom, as shown by the fact that, in 2015, platforms financed by venture capital attracted more than 3.5 billion dollars in capital in these three countries.[3] Such investments, associated with high interest on the part of individual and institutional investors looking for higher returns, are expected to provide a strong boost for growth in these markets. Some analysts, for instance, estimate that the volume of loans in these three countries could increase by almost 75% annually in the coming years and go from 89 billion dollars in 2015 to 467 billion dollars in 2018.[4] Should these predictions come about, online marketplace lenders will have demonstrated its potential to become a significant alternative to bank financing.

That said, the market is still in its infancy in Spain. It is estimated that the volume of online marketplace lending totalled approximately 30 million euros in 2015,[5] still representing a very small proportion of the sector's total credit.

Spain: estimated online marketplace lending

(Million euros)



Source: *CaixaBank Research, based on data from Indexa Lending, Arboribus, Circulantis, Comunitae, Funding Circle, Growly, LoanBook, MytripleA and Zank.*

The most innovative fintechs aim to differentiate themselves from traditional banks by reducing operational costs, developing new risk models and improving the customer experience. The advantage of operational costs comes from a business model based on granting credit (which is not held on balance sheet), distribution exclusively via digital channels and automated processes. Moreover, as these institutions do not hold deposits, they do not have to meet the same regulatory costs as banks (see the article «The (r)evolution in the regulatory and supervisory framework resulting from the crisis» in this Dossier). The second strategic pillar for such platforms consists of developing new credit risk models based on exploiting a large amount of data,[6] including non-traditional sources such as social media and information on the speed with which a credit application is made. This innovation may help to reduce fraud and refine solvency assessments insofar as these new sources of data could improve the predictive ability of these models. Lastly, such differentials help to speed up the process of evaluating loan applications, a key aspect of the customer experience.

Nevertheless, there are also a number of considerations that represent serious challenges to the marketplace lending business model. On the one hand, the predictive ability and accuracy of some of the new risk models cannot be validated until different stages in the credit cycle have occurred.[6] Another aspect to bear in mind is volatility in fintech financing. In a downward phase of the cycle; i.e. in an environment with high levels of non-performing loans or higher interest rates, these platforms could see their financing flows reduced as a result of less investor interest.[7] Similarly, unlike banks which fund loans with deposits, fintechs depend on an investor base that demands much higher returns than the average cost of funds for a bank. It is estimated that the lower operational costs incurred by online marketplace platforms are actually offset by a higher financing cost, so that the

1. Also known as peer-to-peer (P2P) lending or crowdlending.
2. Due to certain regulatory requirements (such as to prevent money laundering and the financing of terrorism) or credit policies.
3. See KPMG, CB Insights (2016), «The Pulse of Fintech, 2015 in Review».
4. See Citi (2016), «Digital Disruption, How FinTech is Forcing Banking to a Tipping Point».
5. For estimates of the market in 2013 and 2014 see AltFi or University of Cambridge, EY (2015), «Moving Mainstream, The European Alternative Finance Benchmarking Report».
6. See U.S. Department of the Treasury (2016), «Opportunities and Challenges in Online Marketplace Lending».
7. See McKinsey & Co (2015), «The Fight for the Customer. McKinsey Global Banking Annual Review 2015».

total costs of banks and these platforms are not so dissimilar.[8] Lastly, in a relatively small market such as Spain it may also be difficult for online marketplace lending to attract investors.

In addition to these considerations regarding the business model, fintechs must also operate in a complex and highly competitive environment. In Spain, with the aim of protecting small savers, legislation governing platforms limits the volume of individual loans, the maximum investment a non-accredited investor can make and the investment a platform can keep on its balance sheet.[9] Moreover, the proliferation of fintechs, in addition to the advances in digitalisation made by traditional financial institutions, increases the competition in a sector in which achieving economies of scale is crucial insofar as this helps to add more information on borrower behaviour in order to develop models and invest in innovation and security. Many fintechs may also find it difficult to keep up the high growth rates observed to date, as shown by the slowdown that is starting to be recorded by investment in online marketplace lending in Europe, especially that of limited scale.[10]

In this respect, traditional banks also possess a number of advantages over fintechs (economies of scope and scale, more stable sources of funding and integrated multi-channel distribution networks) which allow them to bear both the regulatory costs and also investments required in technology and security. Given this situation, the theory of disruptive innovation[11] suggests that the incumbent organisations will accelerate their innovation to face new rivals, which can initially offer better products or services to their current clients. In short, the risk is high for those institutions that are slower to respond in terms of innovation.

Ultimately, the major challenge for any company, whether it is a fintech or a traditional financial institution, is to offer a good value proposition and to gain the trust of clients and investors. It is too soon to know how the online marketplace lending business model will develop over the next few years but we can predict that not all institutions will successfully overcome this challenge, be they incumbents or fintechs.

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8. See Deloitte (2016), «Marketplace Lending: A Temporary Phenomenon?».
9. Online marketplace lending in Spain is supervised by the Bank of Spain (collection and payment) and the Securities and Investments Board (CNMV) (marketplace lending). Each project can attract up to 2 million euros, except for those aimed exclusively at accredited investors (5 million euros). Non-accredited investors can invest up to 3,000 euros in the same project and up to 10,000 euros in all the different marketplace platforms within a period of 12 months. A platform can use its balance sheet and invest up to 10% of the target funding for each project.
10. See KPMG, CB Insights (2016), «The Pulse of Fintech, Q1 2016».
11. See Christensen, C., Raynor, M. and McDonald, R. (2015), «What Is Disruptive Innovation?», Harvard Business Review.