2 Alternative Lending: Product & Segment specialization

Entering into the market through specific targets

Lending product range is very diverse so, to be successful, alternative lenders have specialized in specific parts of the value chain, or they are offering specialized products to market niches.

Alternative Lending Landscape

Alternative lending is arguably one of the hottest topics in digital banking disruption today. This is because, for the first time, new non-banking competitors have started to successfully challenge a core competence of banks: lending, which amounts for a significant share of all banking profits. In this article we focus on the product and segment specialization approach taken by online alternative lenders, that is, lending business done by non-banks using Internet as main touch point with their customers.

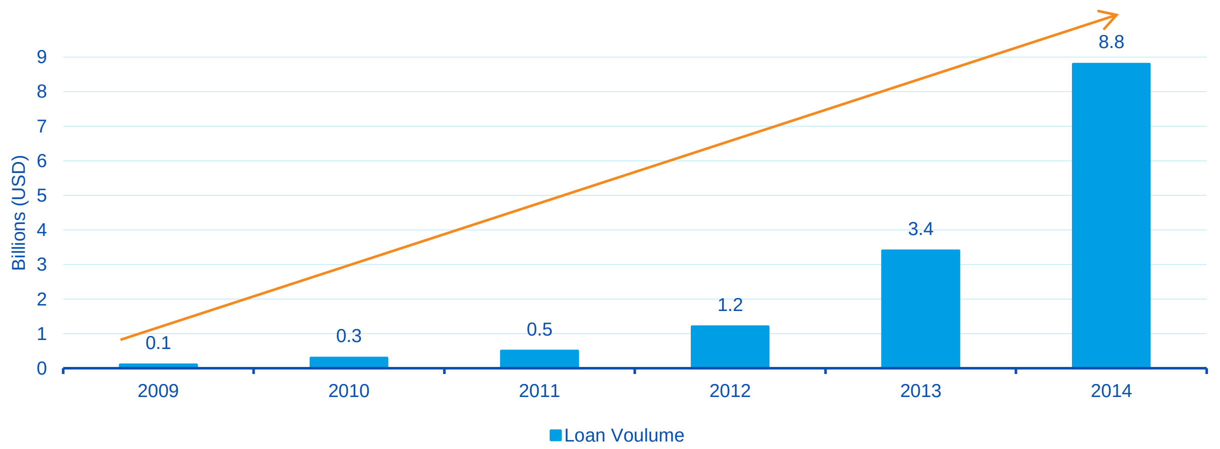
The financial crisis that the world entered in 2007 has impacted credit issuing as losses and new banking regulation required banks to increase and improve their capital levels, reducing credit profitability and sparking deleveraging during the last few years.

In addition, consumers and businesses are also evolving in their demands. The digital transformation that has affected other industries during the last 15 years, has also arrived to financial services. Almost all banking services could potentially be delivered digitally. In the case of lending, borrowers expect to be able to ask for a loan online through any of their devices, at any time, and obtain an approval or denial to their request in a short period, immediately if possible.

This context has facilitated the rise of new players entering the lending market. These new players are specializing in specific products and client segments, providing better user experience through online engagement and lower feedback time. In addition, they have focused on improving customer critical parts of the value chain, mainly on the origination processes, using new data sources, methods, and algorithms for credit decision.

Despite these new players are still small, in terms of total loan originations, some of them are growing fast with CAGRs of 130% during the last 5 years.

Figure 2.1
Alternative lenders growth, 2009-2014



Source: Lending Club, Prosper, Funding Circle, Zopa, RateSetter, Liberum

Some examples of product and segment specialization

One of the segments with high traction in alternative lending is unsecured consumer loans. Main players here are Lending Club and Prosper in the US, and Zopa and Ratesetter in the UK. They offer term loans of 3 to 5 years, with an average loan size around $15,000. They usually target good borrowers with prime FICO scores (US) to offer them debt refinance or consolidation (mainly credit card debt) at lower rates. Frictionless customer experience is also one of their key value propositions, with all the origination process managed through online channels.

The single product where alternative lenders are getting more market share is payday loans. This type of products are usually short term loans (less than 2 months) and low value (less than $600). They are oriented to subprime customers that are not able to get approvals from traditional banks, so lenders apply huge yields, sometimes more than 1300% APR rates. Main players in this space include LendUp, Kreditech, and TrustBuddy, among others.

Another niche where alternative lenders are being successful is student loans, mainly in the USA, where college education is expensive. Alternative lenders use student performance and other complementary data like job history to assess risk so they could refinance government or college loans offering better terms and conditions to students. One of the main players in this space is SoFi and additional players include Upstart, Prodigy Finance, Pave, and CommonBond.

Other alternative lenders are focusing on SMEs. Bank credit, through term loans, is one of the main sources of external financing for small businesses and is key to help them maintain cash flow, purchase new inventory or equipment, hire new employees, and grow their business. There are a broad range of alternative models emerging in commercial finance, including receivables purchases and innovations in specialized lending by verticals. Alternative lenders are still small (around $7B of $700B outstanding small business loans in USA) but they are growing fast, registering triple digit year-over-year growth rates. Some of the main players here are OnDeck, Kabbage, Funding Circle, and CAN Capital.

Mortgages used to be one of the biggest lending pools dominated by banks. New digital lenders have not been very active in this space until now. But a few months ago SoFi entered into mortgage market and is looking to do $1B of business by the end of 2015. Other non-bank originators, like Quicken Loans, PennyMac Financial or Freedom Mortgage, have been offering their services for a while. In fact, non-bank originators accounted for 38% of the $1.2tn mortgage origination market in the US in 2014 up from a 27% the year before.

These are only some examples of how new online lenders are entering into the market, focusing in one specific customer segment or product at the beginning, and later on diversifying to other products for the same customers, so has done SoFi with mortgages; or extending customer reach as Lending Club, who began in the consumer segment and now offers loans to small businesses too. We will see in the coming years how these alternative lenders evolve.

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