Future of Financial Services Initiative

London
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The Future of Financial Services

Marketplace Lending: the challenges and opportunities posed by alternative lenders

CONTENTS

INTRODUCTION

On June 16th The University of Chicago Booth School of Business (Chicago Booth) convened our inaugural Future of Financial Services Initiative forum discussion at our campus in London. In a group comprised of 40 senior bankers, leaders of newly established disrupter firms, academics and other thought leaders, we shared unique new data and research produced by the University of Cambridge and Chicago Booth on the growth and prevalence of marketplace lending in the UK and other areas of the world.   The ultimate objective of the session was to address the question: what is the future of marketplace lending?

The discussion was led by Randall S. Kroszner, Norman Bobins Professor of Economics at Chicago Booth and ex-Governor of the US Federal Reserve System, and Robert Wardrop, Executive Director of the University of Cambridge Centre for Alternative Finance. Marc Knez, Clinical Professor of Strategic Management at Chicago Booth, ably assisted Randy and Bob. Stephen Barter, Chairman of UK Real Estate Advisory at KPMG and Co-Chair of the Chicago Booth Global Advisory Board EMEA, chaired the event.

Input to our discussion was provided by two papers:

1 Pushing the Boundaries: The 2015 UK Alternative Finance Industry Report (University of Cambridge Centre for Alternative Finance)

2 The Future of Financial Services - how disruptive innovations are reshaping the way financial services are structured provisioned and consumed? Pages 84-97 (World Economic Forum)

This research informed our discussion about which new business models and strategies in alternative finance are emerging and what opportunities and challenges they provide. We discussed whether we as a group thought alternative lenders would provide a much-needed boost to the Small and Medium-Sized Enterprises (SME) lending supply around the world, which is vital for our economies to grow. Alternatively, we considered the possibility that this positive role would be undermined by adverse selection problems. Finally, we debated whether we thought these new entrants would effectively disintermediate traditional lenders, be absorbed by them, or continue to survive alongside them, serving complementary markets.

This was our first Future of Financial Services forum. The Initiative is based in London, the world's foremost international financial centre, and led by Chicago Booth London campus, the world-renowned leader in research and business education. In a series of private and open forums, we investigate what the future might hold for the financial services industry and how market participants can prepare themselves to compete and add value. We offer new perspectives and generate thought leadership that we hope will have a broad impact on the future of finance and business. With the involvement of a range of influential participants, we aim to play our part in improving their ability to compete and to improve the sector's impact on society.

This is a critical time for financial services – the shock waves from the credit and debt crises of the last decade are still reverberating across the world's financial centres and London in particular. The last 10 years and even the last few months have brought huge changes, sometimes seismic, in many factors affecting the industry, including:

Attitudes of the Public
Competition Dynamics
Demand Demographics
Disintermediation
External Dislocations
New Entrants
Profitability and Volatility
Regulation
Technology
Wealth Distribution

In future forums we aim to address questions such as what will be the role of commercial banks in the European financial system? And how can financial services firms of the future hire, motivate and retain the best and brightest graduates in an increasingly competitive market for talent?

Renu Kulkarni
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EXECUTIVE SUMMARY

The ultimate objective of the session was to address the question: **what is the future of marketplace lending?** Our discussion was first framed by identifying essential questions and then the group considered key findings from two benchmarking reports: "Pushing the Boundaries: The 2015 UK Alternative Finance Industry Report (University of Cambridge Centre for Alternative Finance) and "The Future of Financial Services" (World Economic Forum).

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A vote on the likelihood of each of three scenarios discussed came out 10:1 in favour of complementarity – meaning that both models would persist, working in parallel and together. This does not rule out either that some platforms will become forces in the lending market, or that others will be taken over.

The following provides a brief overview of the topics and major themes.

Framing the questions

- Transaction volumes for alternative finance in the US, Asia-Pacific and the UK multiplied 13 times between 2013 and 2015, reaching a total of $144bn. The dominant activity is marketplace, or peer-to-peer (P2P), lending to consumers and businesses. China is the biggest market, at $101.7bn in 2015.
- Growth has been driven by a hunt for yield by investors and by a post-crisis credit gap for borrowers, as banks have deleveraged.
- Rapid growth has brought some problems, including setbacks at a few high-profile marketplace lenders. Concern about lending standards has also surfaced over potential adverse selection risk – attracting the riskiest borrowers – and compromised diligence if volumes are chased.
- To diversify funding sources, institutions have been drawn in both as lenders through the platforms and as purchasers of securitised loans. This may dilute the "peer-to-peer" model, as has "auto-selection" – the platforms placing investor money – in a model that resembles asset management rather than banking.
- Alternative lenders enjoy lighter regulation than banks. But as the sector grows and faces more challenges, e.g. a downturn in the credit cycle, the question is whether this regulatory "arbitrage" can continue.
- The response of the incumbents is crucial. Will data analytics combined with their customer knowledge enable them to whittle down their new rivals' advantages?

Key Findings from the Benchmarking Reports

- In the US and the UK, growth rates have slowed, and even in China where growth has been largely unchecked, the impact of new regulation is likely to curb the pace.
- In the US, nearly 80% of the loans go to consumers, whereas in the UK 69% of alternative finance is business focused and in Asia-Pacific, 61%. Alternative lending of $5.61bn to US businesses in 2015 remains dwarfed by traditional credit flows of $445bn.
- In the UK, the share of loans to small businesses has reached a significant level, growing from 1% in 2012 to an estimated 13.9% in 2015, according to British Bankers' Association (BBA) data.
- In China, state-controlled banks have been slow to respond to the more diverse requirements of an increasingly affluent population, which is at home with e-commerce.
- Retail investors are the dominant source of funds in China and the UK, although institutional funding is growing.
- In the US, individuals provide only a fifth of funding for consumer lending and less than that in the business segment. A relaxation of restrictions, via the Jumpstart Our Business Startups Act, may encourage more retail investors to enter the market.

Emerging Themes and Questions

- **Auto-selection:** The lender is asked about his risk preference and return expectations, and the platform auto-selects the most relevant basket of loans. This puts more onus on the platforms to do due diligence and manage credit risk.
- **Adverse selection:** Researchers looked at the credit quality (rated A-E) of borrowers from one UK P2P platform, compared with the total SME universe. While banks were more focused on grades A and B, the most significant difference, was in the middling C grade, particularly expanding companies, where P2P lenders had a disproportionate share. This analysis was from one platform and may not be representative.
- **Risk retention:** If the bulk of loans were sold on risk, it was suggested this would reduce the incentive to do rigorous credit analysis. Should the regulator mandate a minimum level of retention, or 'skin in the game'? It was countered that the platforms had an economic and reputational interest in limiting defaults. Short-term gains from relaxing lending standards would be offset by the longer-term risk to viability.
- **Incumbents' response:** Resistance to change was attributed to siloed operations and legacy IT issues. It was suggested that banks might adapt better if they saw themselves as data analytics companies.

Business Models and Strategies

The forum debated three scenarios for the future of alternative lenders:

1. Alternative lenders disintermediate traditional intermediaries.

- For this to hold, Alternative lenders would need to continue to be faster, cheaper and more user-friendly than banks; continue to benefit from lighter regulation; and retain investors' and borrowers' trust, allowing the best brands to create a network effect to drive volumes.
- Counter-points include: high-profile platform failures damage the sector's reputation, as trust in traditional banks recovers. This might prompt regulators to level the playing field, and banks would continue to enjoy the benefit of insured deposits.

2. Complementarity: Alternative lenders work in parallel with traditional intermediaries.

- For this to hold, the regulatory and cost advantages of the alternative providers will persist, but they and traditional banks cater for different market segments. They also work together: banks provide the balance sheets and the platforms are used as another channel. Leading alternative lenders stay independent and banks realise that takeovers risk killing their nimble, innovative approach.
- Counter-points include: a credit downturn exposes weaknesses in the platforms' performance; traditional banks catch up by improving their technology and user-friendliness, becoming aggressive competitors.

3. Alternative lenders are absorbed by traditional intermediaries.

- For this to hold: traditional lenders transform themselves, either by adopting the challengers' way of working or by taking them over. Alternative lenders fail to take significant share from traditional banks, and so fail to gain sufficient scale. Failures detract from the reputational advantage enjoyed by 'fintechs".
- Counter-points include: alternative lenders continue to enjoy a regulatory advantage; banks remain encumbered by cost concerns and fail to change because of legacy IT and process issues. They miss out on the opportunity to employ data analytics to serve a wider customer base more efficiently and effectively.

The Consensus

A vote on the likelihood of each of the three scenarios discussed came out 10:1 in favour of complementarity – meaning that both models would persist, working in parallel and together. This does not rule out either that some platforms will become forces in the lending market, or that others will be taken over.

Concluding Points

Given the laundry list of factors that emerged from the scenario analysis, we asked the group what they believe to be the Givens – future outcomes they are fairly confident will happen? And what are the Critical Uncertainties – future outcomes that will have high impact but are relatively uncertain?

The givens:

- Regulation will remain more onerous for banks than for marketplace lenders, who operate a capital-light asset management model.
- Demand will remain strong from under-served borrowers, in need of rapid decisions, and savers in search of higher yields.
- Alternative lenders will remain focused and data-driven; automation will help them contain costs and stay at the forefront of portfolio creation.

Critical uncertainties:

These come in two forms, the first to do with the marketplace lenders:

- Impact of the credit cycle: Will their lending models hold up in a downturn? Will a lack of discipline in credit risk management be exposed?
- Will alternative lenders' reputational advantage persist? Or will failures destroy the reputational advantage that they have enjoyed over traditional banks and provoke a regulatory backlash?
- Will alternative lenders get the funding they need, particularly from institutions?
- Will alternative providers maintain a lead over incumbents in technology and data analysis?

The second form of critical uncertainties relate to the response of traditional banks:

- Bearing in mind their wealth of customer information, will they use data analytics to provide a more user-friendly customer expereince?
- Will they leverage up the advantages of deposit protection and balance sheet reserves on the funding side, and data protection on the customer privacy side?

Finally, scale matters. The platforms need high transaction volumes to make their business models work and the winners can achieve this through network effects. For the incumbents, the issue is more how to minimise the diseconomies of scale wrought by siloed operations and a patchwork of legacy IT systems.

CHAPTER 1
Framing the Discussion

The benchmarking studies carried out by Chicago Booth, the Cambridge Centre for Alternative Finance and partners in the Americas, Asia-Pacific and Europe have shown explosive growth in alternative finance over the past three years. In 2015, total transaction volumes in the Americas, Asia-Pacific and the UK reached $144bn, up from about £11bn in 2013.

The definition of alternative finance followed in this series is: technology-enabled online channels, or platforms, that act as intermediaries in the demand for and supply of funding to individuals and businesses, outside the traditional banking system. This excludes platforms that facilitate payments, remittances and foreign exchange transactions.

Forms of funding covered include marketplace lending, and within that "peer-to-peer" (P2P) exchanges, balance sheet lending, various types of crowdfunding, and invoice trading. The dominant activity is marketplace/P2P lending to consumers and businesses, and that was the focus of Chicago Booth's first Future of Financial Services forum in London.

In macro-economic terms, the low interest rate environment – with falls in yields on safe assets accelerated by the financial crisis – has aided alternative lenders. The driving force has been a hunt for yield by retail investors, in particular, and increasingly by institutions.

The supply of funds has had a gap to flow into. Internationally, prudential regulators have increased banks' capital and liquidity requirements, squeezed them out of some business lines, imposed record legal settlements and generally added to the compliance burden. With the incumbents deleveraging and inhibited, those seeking credit – including riskier borrowers such as small and medium-sized businesses – have welcomed the chance to look elsewhere.

Nimble new entrants have fed on the frustration some bank customers feel over the time taken and bureaucratic process for opening accounts and getting a lending decision. In China and other emerging economies, customer dissatisfaction has been related to the slowness of state-controlled banks in responding to the diverse requirements of a population that is growing in wealth and has quickly become at home with e-commerce.

The blow to banks' reputations inflicted by the crisis, and by mis-selling and market manipulation scandals, has also diverted attention to other sources of funds. By contrast, online companies have benefited from investor and consumer enthusiasm for technology: "fintech" has become a buzzword.

Technology has indeed been at the heart of alternative finance. "Big data" analytics and business-model innovations have enabled disintermediation of traditional banks. The mechanism has been online marketplaces that provide relatively direct connections between savers/investors and borrowers or equity seekers.

But before the incumbents are dismissed as outmoded, it must be asked to what extent alternative providers can fully assume their special role as analysers of creditworthiness? There is, for instance, a particular synergy between deposit-taking and credit provision. Customer accounts are a rich source of customer knowledge and banks have retained trust in their ability to protect data and privacy.

The other advantage lies in deposits as a relatively stable source of funds. Marketplace lenders, which usually lack banking licences and, therefore, insured deposits, have had to diversify funding sources, bringing in institutions including banks, in order to grow and address the stability issue.

The rapid growth of marketplace lenders has brought its own problems. The US platform, Lending Club, was valued at \$5.4bn in its IPO in December 2014 and at nearly \$9.0bn soon afterwards. But the fabrication of some loan details in a securitisation and the departure of its CEO after a related party transaction triggered a slump in value earlier this year. In China, lending platform E'zu Bao collapsed after executives syphoned \$7.3bn from over 900,000 investors in a Ponzi scheme. In the UK, Lord Turner, former head of the UK's Financial Services Authority, warned in February of potential "big losses" in the P2P sector.

The concern is that adverse selection and moral hazard apply: the former in that, that P2P lenders are picking up riskier borrowers that have been turned down by traditional banks; and the latter when loans are fully passed through to investors, and thus there is a lack of 'skin in the game' to ensure that the originator's incentives are sound. Some policymakers are asking whether retail investors know what they are getting into.

Better to address the challenges while the sector remains small and a period of reflection can help maintain a favourable regulatory environment. Even though regulators are aware of a need to promote innovation, they tend to come down heavily if something goes wrong. This tension can be seen in two countries trying a "sandbox" approach to allow experimentation by alternative providers. For the liberal UK regime, it acknowledges the risk in making new services available to the financially uneducated; for Singapore, where marketplace consumer lending and equity crowdfunding have met regulatory barriers, it is a sign of opening-up.

A recent (May 2016) white paper from the US Department of The Treasury, entitled 'Opportunities and Challenges in Online Marketplace Lending', spelt out some of the reasons for regulatory caution. These include that data-driven models might violate fair lending rules; that the new credit operations have not been tested through the cycle; and that small business borrowers 'will likely require enhanced safeguards'.

Nevertheless, as long as a gap remains between marketplace and banking regulation, an opportunity will exist for regulatory arbitrage. This may mean that banks themselves fund the challengers because they cannot offer the same fast and capital-light services themselves. But are regulatory advantages sustainable in a world where politicians and regulators are very sensitive to consumer attitudes and outcomes?

If the new entrants are exploiting technological advances in data collection and credit analysis, then why cannot traditional banks do that too, drawing on their wealth of customer knowledge? Will the incumbents fight back, by acquiring the challengers or adopting their methods? Similarly, can these large institutions pivot towards the fast, flexible and consumer friendly approach of alternative providers?

It may be that the best way for traditional banks to respond to the challenge is to change the way they see themselves: to act as technology and data analytics firms engaged in financial services, rather than as financial services firms simply using technology and data analytics.

In the end, what will determine the success or failure of the marketplace lenders is whether they are offering something substantively different in the consumer experience, the products they offer and their funding? And if they do have something new and sustainable, the question is will they be able to hang on to it? ■

CHAPTER 2

Key Findings from the Benchmarking Reports

The Cambridge Centre for Alternative Finance was established in January 2015 at the University of Cambridge Judge Business School. It is dedicated to the study of new financial instruments, channels and systems that emerge outside of the traditional banking and capital markets systems. The Centre has three core research themes:

1 Development of alternative instruments and channels

2 Alternative credit and investment analytics using new forms of data

3 Alternative payment systems, including cryptocurrencies

The Centre's most recent reports provided the input for Robert Wardrop's presentation to the group. Namely:

- Pushing Boundaries: the 2015 UK Alternative Finance Industry Report. Cambridge, Nesta, KPMG. February 2016

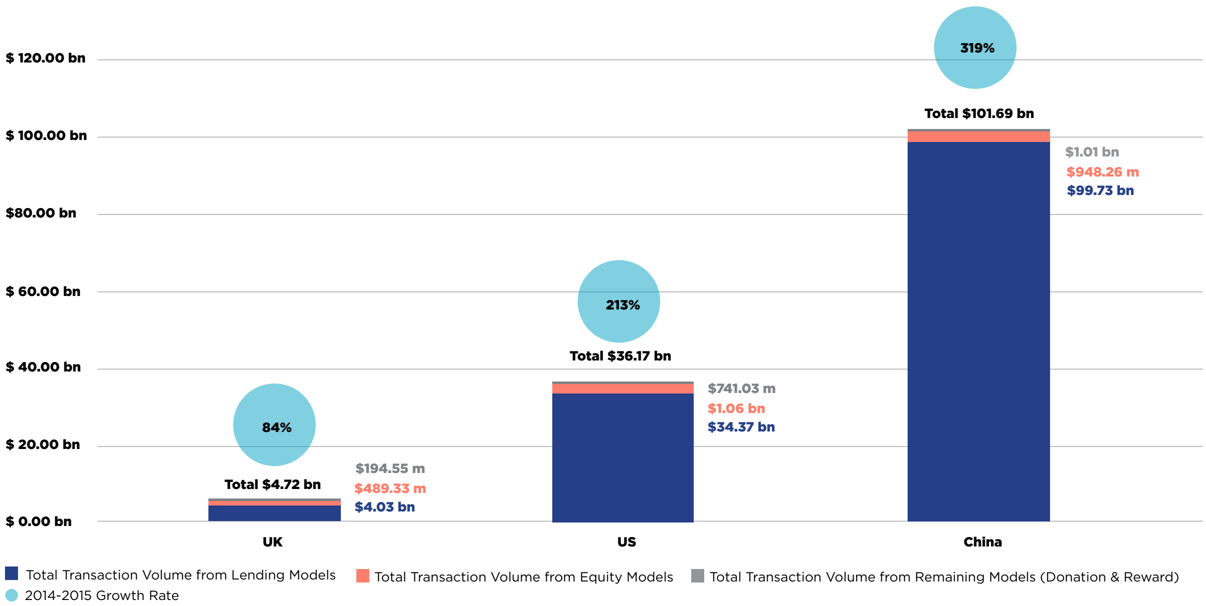
- Breaking New Ground: The Americas: Alternative Finance Benchmarking Report. Cambridge Centre for Alternative Finance, Cambridge Judge Business School, Chicago Booth Polsky Center. April 2016

- Harnessing Potential: The Asia-Pacific Alternative Finance Benchmarking Report. Cambridge Centre for Alternative Finance, Cambridge Judge Business School, Tsinghua University, University of Sydney Business School. March 2016

These Cambridge Benchmarking studies received financial support from CME Group Foundation, KPMG, the Association of Certified Chartered Accountants and the Inter-American Development Bank.

Total Alternative Finance Volume in Key Markets

UK, US, and China Transaction Volume in 2015 ($USD)



Source: Cambridge Centre for Alternative Finance

The total £144bn of transactions recorded in the benchmarking studies for the Americas, Asia-Pacific and the UK was thirteen times the level of 2013. Almost all of the activity is attributable to three big markets – China, the US and the UK. In those three, transaction volumes in marketplace credit amounted to $138.1bn in 2015, compared with only about $11bn in 2013.

While the main themes – a hunt for yield, gaps in credit provision and enabling technologies – are shared across the globe, each region has a variety of approaches to, and experience of, alternative finance. Asia-Pacific, for instance, includes China, where growth has been largely unchecked, and advanced economies such as Japan and South Korea where the sector has been held back by strict regulation. In Malaysia, Indonesia and Thailand, alternative provision so far is mainly in reward-based and donation-based crowdfunding.

In terms of aggregate sums of money, however, alternative finance is dominated by lending (or credit) models. Including real estate funding and invoice trading, marketplace lending accounted for nearly 97% of the $142.6bn alternative finance transactions seen in China, the US and the UK in 2015.

In the US and the UK, growth rates have slowed, but nevertheless between 2013 and 2015 total volumes increased by about eight times in the US and nearly five times in the UK. Volumes in China, the biggest market, reached $101.7bn in 2015, compared with less than $6.0bn in 2013. But even here the impact of new regulation is likely to curb the pace. Taken with the setbacks caused by high-profile failures and misconduct at a few of the platforms, a pause for thought is expected in 2016.

In the US, nearly 80% of the loans go to consumers, whereas in the UK 69% of alternative finance is business focused and in Asia-Pacific, 61%. US consumer loans from alternative sources totalled $28.8bn in 2015 – equivalent to an eighth of traditional consumer lending. The $20.5bn additional lending from alternative providers outstripped the $12.5bn added by traditional lenders.

On the business lending side, alternative sources – providing $5.6bn in 2015 – remain dwarfed by traditional credit flows of $445bn. It is worth noting that US businesses have greater access to capital markets than most other parts of the world, where business finance is still bank dominated. The US banking sector was rapidly recapitalised after the financial crisis, restoring its capacity to expand lending. In absolute terms, just the 10% growth in loans provided by traditional sources in 2015 amounted to many times the total for alternative lending.

In the UK, P2P (which remains the common term for marketplace lending in this country) share of loans to small businesses grew from 1% in 2012 to an estimated 13.9% in 2015, according to BBA (British Bankers' Association) data. Government policy encouraged this via an SME referral scheme through partnerships with banks and the state-backed British Business Bank. A feature of the UK market is the proportion of P2P business lending going to real estate: £609m ($900m) of the £1.49bn lent in 2015, which was twice the 2014 figure. Consumer lending grew by 66% in 2015 to £909m.

In China, consumer lending is the largest market segment, with $52.5bn lent in 2015, followed by business lending ($40.2bn), which includes a balance sheet element, and real estate ($5.51bn).

Turning to the source of funds, retail investors dominate in China and the UK.

'Peer-to-peer' lending dates back to the 2005 launch of Zopa in the UK. The P2P description has stuck even though the direct nature of the original lender-borrower model has largely given way to "auto-selection" (see below) by the platforms. While institutional funding is growing in the UK, individuals still provide nearly three-quarters of the finance for P2P business lending and two thirds of consumer loans. The participation of individuals has recently received government encouragement with the launch of the Innovative Finance ISA, which allows P2P loans to be put into tax-free savings accounts.

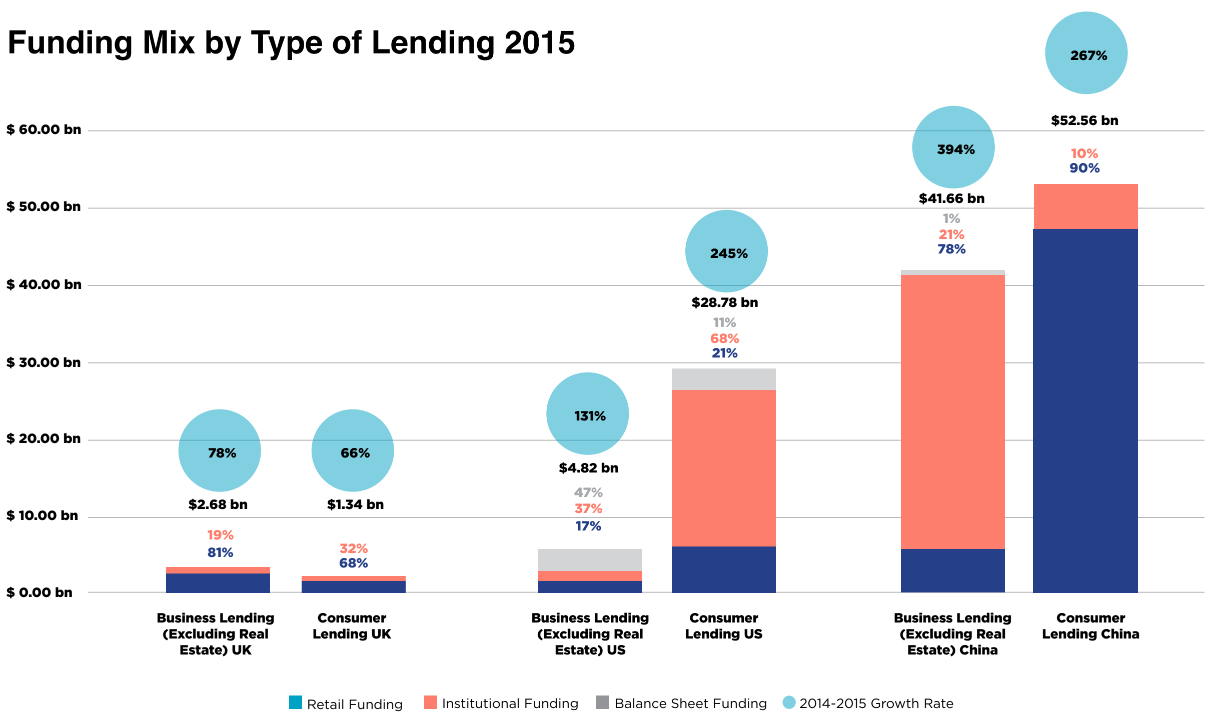
In the US, individuals provide only a fifth of funding for consumer lending and less than that in the business segment. Institutional providers of funds include banks, which have deposits coming in and capital to deploy, and so are looking for loans to buy through the securitisation market. The US alternative finance sector has a different history to that of the UK and China. Direct individual participation has been restricted to accredited, or high net worth, investors. Although Title IV of the Jumpstart Our Business Startups Act has relaxed the rules to some extent, minimum wealth requirements remain and the authorities encourage the involvement of brokers and advisers.

The attraction of mixed sources of funding is that it helps the platforms to manage the tension between borrower demand and access to funds for lending to those of the UK and China. A drawback for non-bank providers is the absence of deposits, hence the search for sources that are both stable and capable of growing.

The chart shows a high correlation of alternative finance volumes per capita with GDP per capita, which reflects the greater disposable income and capacity to save or invest in richer countries. The outliers are best explained by regulation, with largely unregulated China as the most dramatic example. Chile, New Zealand and the UK also have accommodating regimes. The US already has a sophisticated institutional market for managing other people's money.

Regulation reflects public policy. Despite the JOBS Act's loosening of restrictions, US regulators remain focused on investor and borrower pro-

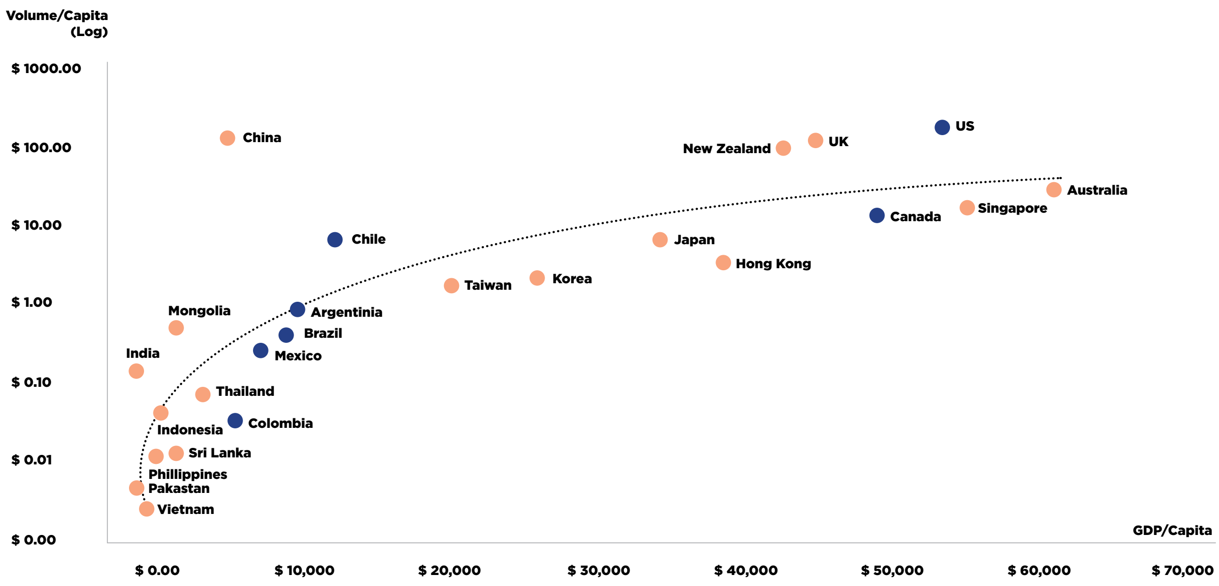
Funding Mix by Type of Lending 2015



Source: Cambridge Centre for Alternative Finance

Alternative Finance Volume Relative to the GDP

GDP per Capita Versus Alternative Finanace Volume per Capita in 2015 ($USD)



Source: Cambridge Centre for Alternative Finance

tection. Although the UK has had an open-access approach to investment, the platforms need to seek authorisation from the Financial Conduct Authority. The emphasis is on ensuring that investors have clear information about the risks and the underlying loans. Client money must be protected and firms must meet minimum capital standards and have resolution plans in place.

China's new Internet finance policy framework requires platforms to hold borrower and lender funds in custodian accounts with registered financial institutions. These accounts act as the fund transfer mechanism between lenders and borrowers. As well as raising the barriers to entry, this requirement could prompt consolidation of operating platforms.

Elsewhere, such as in Japan and South Korea, opinion surveys indicate that regulation is regarded as being too strict. An example of recent softening in response came in the Financial Services Commission of Korea's Financial Policy Roadmap for 2016: crowdfunding was emphasised within the goal of 'Financing Innovative Start-ups and Venture Companies'. ■

CHAPTER 3

Emerging Themes and Questions

The slowing pace of growth, combined with some high-profile setbacks and greater regulatory attention, has allowed a pause for thought. Common questions include:

- Has the 'peer-to-peer' model successfully developed into an automated process for connecting lenders who do little, or no, due diligence with borrowers selected by the platform?
- Does the growing presence of institutional funders, buying securitised packages of loans, crank up an originate-to-distribute model where the platform does not retain sufficient risk?
- Do marketplace lenders only get the borrowers that banks reject? What happens to those riskier borrowers when the credit cycle turns?
- Without deposits, how can the platforms consistently match the supply of funds to borrower demand? Is a balance sheet model better?
- When and how will the incumbents respond?

Some comments and answers emerged during the debate that followed the presentation of key findings, which covered both auto- and adverse selection. Others were explored in the discussion of future scenarios (see Chapter 4).

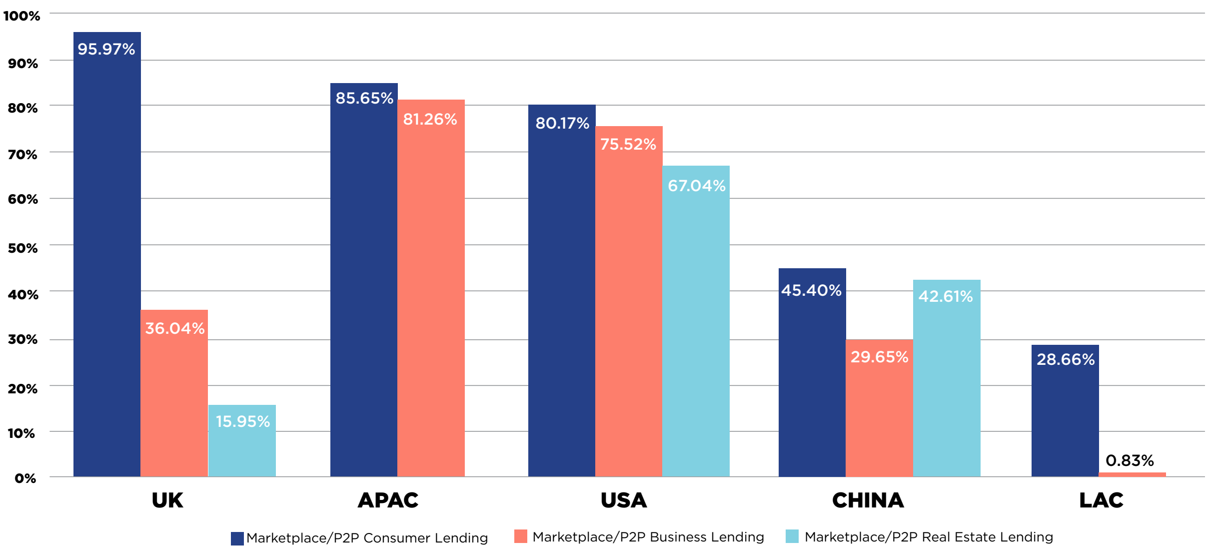
In the early days in the UK, the image was of retired accountants poring over each loan. Now hardly anyone looks at an individual's credit information. Instead, the lender is asked about his or her risk preference and return expectations, and the platform auto-selects the most relevant basket of loans. This resembles the asset allocation element of robo-advising.

For business loans, a significant proportion of investors still examine the underlying business. For real estate, where the loans are larger and the proposition easier to understand, it remains common in the UK and China, and to some extent the US, for the investor to look through to the underlying assets.

The trend is towards a larger proportion of people saying 'build me a portfolio' – like a collective investment scheme – so the model resembles asset manage-

Investor Auto-Selection in Lending Models by Market

UK, US, China, LAC and APAC Percentage by Lending Model in 2015 ($USD)



Source: Cambridge Centre for Alternative Finance ment rather than banking. Asset managers are taking an interest and a potential response from banks is to position themselves along these lines.

Auto-selection puts more of an onus on the platforms to do due diligence and manage credit risk, while being transparent about the portfolios and loan performance. It also brings custodial responsibilities such as the segregation of client assets.

Adverse selection risk was described as 'the elephant in the room' at Chicago Booth's London forum. This was why the Cambridge Centre, as a follow-up to the benchmarking studies in the UK, decided to question the conventional wisdom that alternative providers get 'the garbage that banks don't want', especially in business lending.

It first conducted a survey of 323 borrowers from UK P2P platforms, asking whether they had tried to raise funds from other sources before approaching a P2P lender. As the chart shows, 79% had gone to a bank first but fewer than one in three of them – 22% of the sample – had received an offer. This apparently supported the adverse selection charge and contrasted with survey results for individual borrowers. They also tended to approach another source first, but almost 90% had had an offer. They chose to go with a platform for reasons of speed and customer friendliness.

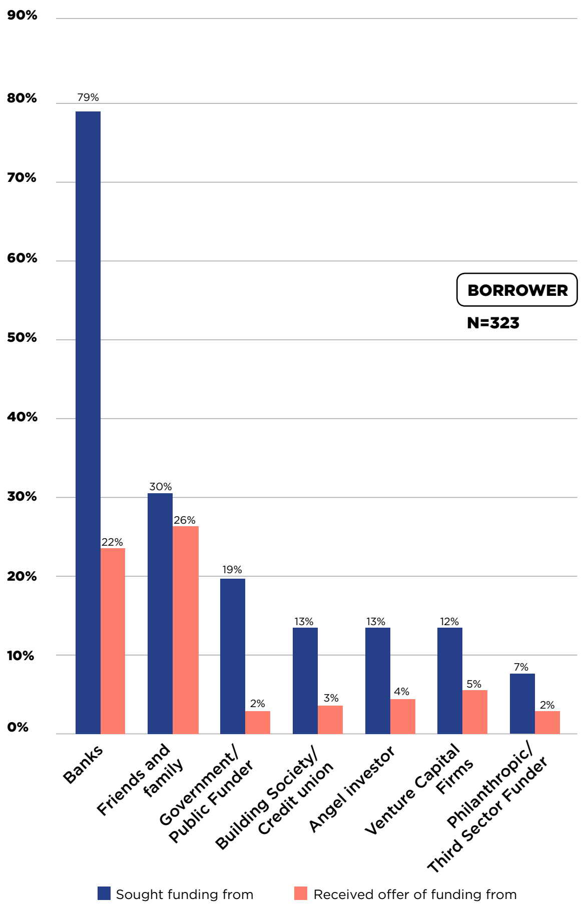
To further examine P2P business lending quality, Rolf Hickmann, a veteran of the credit-scoring company pH Group, now part of Experian, analysed the portfolios of UK P2P business lenders and compared them with the SME borrowing universe.

Rolf Hickmann is a Research Fellow at the Cambridge Centre for Alternative Finance, although he carried out this research independently. The data comes from ThinCats customer base. As ThinCats is one specific platform and other platforms have different focuses, the following results may not be representative of the UK P2P market.

Hickmann assigned financial stress scores Experian pH (FSS) in risk grades descending from A to E to the underlying borrowers. Within the total SME universe, the banks were, as expected, focusing on grades A and B – although these borrowers still accounted for less than

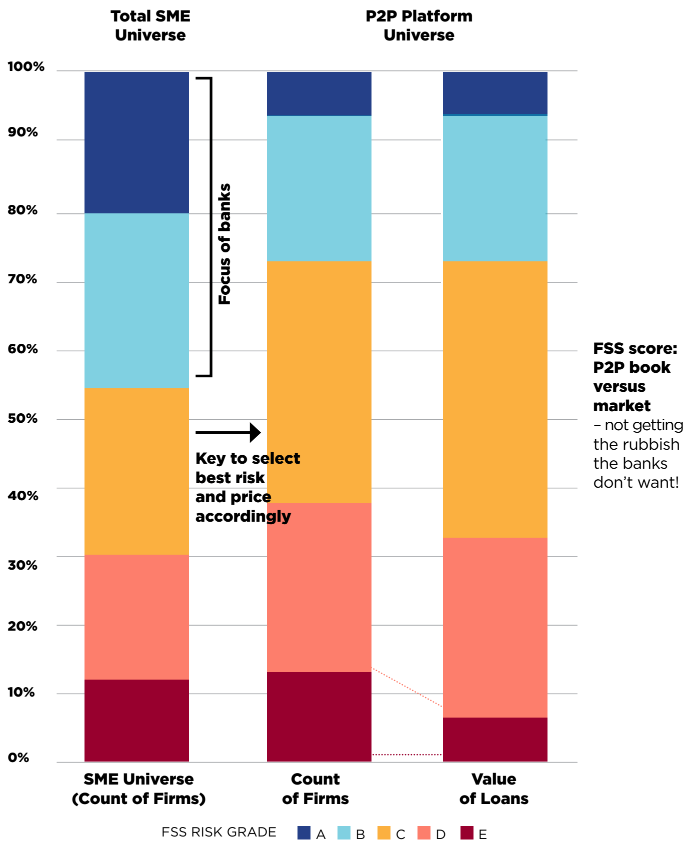
Adverse selection risk in UK P2P loans?

Did you try to fundraise from the following sources before approaching P2P business lending?



Source: Cambridge Centre for Alternative Finance, data: Experian pH, and ESF/ThinCats

Analysis of P2P Loan Book Profile



	Expanders	Non-expanders
P2P Book	42%	58%
SME Universe	27%	73%

Source: Rolf Hickmann, Cambridge Centre for Alternative Finance, data: Experian pH, and ESF/ThinCats half their portfolios. Also as expected, P2P platforms had a smaller proportion of A-B borrowers. The most significant difference, however, was in the middling C grade where P2P platforms were more prevalent. P2P platforms actually had equivalent proportions of poorest risks, or E grade loans, by loan value than the banks.

This points to an opportunity to lend to an under-served cohort of SMEs with satisfactory FSS profiles. In particular, Hickmann's analysis found that banks tended to neglect expanding companies with relatively good risk/return characteristics. P2P lenders had gained a disproportionate share of these and could charge them rates attractive to investors.

Is this sustainable? It has helped attract institutional capital into the market but, as the Lending Club case suggests, the additional pressure to find suitable borrowers may eventually have an adverse impact on the lender's conduct. ■

Incentive

Risk retention, or 'skin in the game'

It was suggested that 'blow-ups' were inevitable if 100% of loans were sold on, because of a reduced incentive to do sufficient due diligence and credit monitoring. One solution put forward was that the regulator should require 30%-50% of loans to be retained on the lending platform's book. Another was for platforms to have hybrid models with some on-balance sheet lending.

Yet if the platforms' model resembles asset management, 'skin in the game' is not an inherent part of it. It was pointed out that marketplace lenders made money in two ways: from origination fees and the ongoing book of loans. The latter was dependent on performance, giving an economic interest in limiting defaults.

Chasing volume/threat to credit quality

A further concern was that a young company with only a small back book would be more dependent on chasing new business, which might lead to short-cuts in credit analysis. The potential fall-out would be aggravated by a turn in the credit cycle – current levels of loan losses are generally very low.

The counter argument was that relaxing lending standards might lead to short-term gains but would threaten long-term viability. Credit analytics and quality of underwriting were best in class at many platforms, which was why banks were trying to replicate them.

Because of transparency at loan level, changes in performance were immediately apparent.

The P2P platforms rely on reputation and trust. The potential 'collapse of one or more of the well-known platforms due to malpractice' was seen as a high or very high risk by 57% of those surveyed for the UK report.

It was suggested at the forum that the platforms should be seen as curators of the marketplace, keen for both borrowers and investors to get a fair deal. This might mean following the example of more mature exchanges, with rules or codes to promote high standards among participants.

Banks and balance sheets

Institutional investors understand the traditional banking model of on-balance sheet lending and the traditional banking relationship with SMEs. This led to the following questions: How could marketplace lenders attract the large number of companies with good credit records that were satisfied with their banks? And how patient would the alternative providers be in difficult times?

It was suggested that lenders might offer mezzanine-style finance with features such as warrants or pre-packaged bankruptcy arrangements. In continental Europe, 'participating bonds' had some of these features, e.g. Swiss genusschein and German schuldschein.

Are the incumbents smart enough?

Incumbents' problems were characterised as siloed operations, legacy IT systems and lack of IT knowledge at board level, all of which made them resistant to change. It was argued that this was why they found it difficult to emulate the nimbleness of the platforms. Yet it was pointed out that banks had a wealth of data and sophisticated models – so why had they failed to exploit these resources fully?

The solution might be for them to think of themselves as data analytics companies that happen to be in finance, rather than as banks. ■

CHAPTER 4
So, What's the Future of Marketplace Lending?

The diverse background and expertise of the attendees, along with the data and insights offered so far, provided the basis for the group to next consider what the future holds for marketplace lending. Specifically, the objective of the last portion of the session was twofold:

1 Identify the most critical factors that will determine the future of marketplace lending.

2 Given these factors, determine the degree of consensus or disagreement about the future of marketplace lending amongst this diverse set of experts.

The process for extracting the groups' perspectives entailed the examination of the following three distinct scenarios concerning the future of alternative lending provided in the WEF report, The Future of Financial Services:

SCENARIO 1 **Disintermediation of traditional intermediaries:** Alternative lending platforms move upstream to serve risk-averse savers and low-risk borrowers. The incumbents are held back by legacy systems and capital requirements. The challengers remain leaner and more consumer friendly.

SCENARIO 2 **Complementarity:** Alternative providers work in parallel with traditional intermediaries. Although the incumbents lose some ground, the marketplace lenders cater mainly for different classes of investors and borrowers. Some partnerships form between the two for customer referrals and for the traditional banks to deploy capital to address unmet customer needs.

SCENARIO 3 **Absorption:** Traditional intermediaries transform themselves, either by adopting the challengers' way of working or by taking them over. The incumbents serve high and low risk borrowers, and build on renewed customer trust in their reliability, as has happened with online banking.

The group was divided into six small teams, where each team was assigned one of the three scenarios (each scenario was assigned to two teams). Half the teams were asked to identify the most important factors that would need to hold for their assigned scenario to occur. The other three teams were asked to identify the most important factors that would need to hold for their assigned scenario not to occur. While these three scenarios created artificial boundaries around the factors that each group would identify as important in analysing the future of alternative lending, they provided an effective way to anchor the discussion. At the end of the session we opened the discussion up to a broader set of possibilities and perspectives, which are incorporated into the discussions below.

Output from Scenario Analysis

An analysis of the teams' output (provided in the Appendix) reveals three broad themes, along with a set of critical questions underlying those themes:

1 Longer-Term Viability of the Marketplace Lending Business Model

- Is the business model viable under higher interest rates?
- Will new regulations neutralise existing advantages of the alternative lenders?
- Will alternative lenders need to take balance sheet positions in order to address adverse selection and moral hazard concerns?

2 Long-Term Outcome of Lending Competition (given viability of business model)

- Will the marketplace industry remain fragmented, or will a small number of large players emerge as winners?
- Will large consumer platforms enter the alternative lending business (e.g., Google, Amazon) as is already happening in China.

3 Banks' Ability to Compete in the Alternative Lending Market

- Will regulatory conditions be more onerous for banks?
- Is it possible for banks to adapt their operating models and cultures to compete against the alternative lenders?
- Will banks (eventually) have a brand advantage in the alternative lending market, or will they be at a disadvantage?
- Will banks face a cost-of-funds disadvantage in the alternative lending market?

Long-term perspectives

Given the laundry list of factors that emerged from the scenario analysis, we asked the group what they believe to be the Givens – future outcomes they are fairly confident will happen? And what are the Critical Uncertainties – future outcomes that will have high impact but are relatively uncertain?

The givens

Regulatory environment more onerous for banks: While regulation will continue to change, the assumption was that it would remain more onerous for banks than for marketplace lenders, which have different funding models. Deposit-takers and balance-sheet lenders are inevitably subject to tougher capital, liquidity and consumer protection regulation. This assumes that P2P investors understand that their capital is at risk and that the alternative providers (even if they do some balance sheet lending) develop as asset managers rather than as banks.

Demand for marketplace lending will persist: Under-served borrowers and savers in search of higher yields will continue to use the alternative lending platforms. Because the new entrants lack the legacy systems of banks, they will continue to offer more rapid decision-making to would-be borrowers. Lower operating and capital costs in the marketplace model will continue to enable them to offer attractive rates to investors, especially in a low-interest-rate environment.

Marketplace lenders' focused strategy will be an advantage: Marketplace lenders have no intent on becoming universal banks. Not only will this allow them to avoid the regulatory compliance challenges that arise in large banks, it will also allow them to avoid silo issues, complexity and dilution of purpose. They are data-driven by nature and that is the key to future success in lending and the creation of credit portfolios, particularly when dealing directly with retail or SME customers.

Critical uncertainties

Impact of credit cycle: When interest rates rise and/or there is another recession, the alternative lenders will be put to the test. Very few have proven themselves through an entire credit cycle. When defaults mount it will not only be the weaker players that suffer; investors will be nervous about the whole sector. The lack of 'skin in the game' for a non-balance sheet lender, operating auto-selection of loans on the part of investors, will raise questions about incentives for due diligence and the rigorous monitoring of credit quality. Hence, how the existing marketplace lenders do in this context is uncertain.

Persistence of marketplace lenders' reputation advantage: At some point the business model advantage marketplace lenders currently enjoy over traditional banks since the financial crisis will be tested (e.g. LendingClub in the US). In particular, will individual firms be able to verify the quality of their operation to both regulators and customers? If not, there is the risk of a political and regulatory backlash that could bring down the entire marketplace lending sector.

Role of institutional support: It is assumed this will come in a variety of ways. In the absence of a deposit base, alternative providers need diverse sources of funds. In the US, more retail investors will be drawn in as restrictions are relaxed, but generally institutional support looks necessary both as direct providers of funds to lend and as purchasers of securitised loans. Institutional backing might also be needed for mezzanine, or hybrid, products. A different type of institutional involvement might help the platforms maintain their independence. For example, a market for insuring against some of their risks, such as fraudulent losses, may arise.

Technology: Alternative providers present themselves as leaders in data analysis and automation. Can they continue to maintain an edge over traditional banks? Will the incumbents respond, exploiting the rich set of data that they have on their customers? We should note that there was a general pessimism by the group that the banks would be able to catch up on the requisite technology capabilities given their cultural and legacy system challenges.

Customer experience: Banks are making an effort to improve their cultures, notably the treatment of customers. Sometimes compliance requirements get in the way but they are equipped to cope with them. Will this ability to handle regulation, e.g. on knowing the customer and client asset protection turn to banks' advantage? A similar question can be asked about privacy, on which banks may be more trusted than technology companies.

Consolidation in the marketplace market: Will networks effects and other scale factors lead to a small number of very large marketplace lenders to exchange very large volumes of loans, and to build global brands?

Conclusion

Finally, at the end of the session a vote was taken on which of the three scenarios is most likely to occur. No one believed the alternative lenders would be absorbed into the traditional intermediaries. Between the other two scenarios, the vote was 10:1 in favour of complementarity – meaning that both models would persist, working in parallel (perhaps focusing on different market segments) and together in partnerships that draw on complementary skills and strengths. This does not rule out either that some of the alternative lenders will become forces in the marketplace, or that incumbents will sometimes buy up challengers.

There may be a scenario 4, featuring Chinese P2P operators taking over platforms elsewhere in the world, and/or online retail giants, such as Alibaba and Amazon, moving into finance. On the traditional side, the most radical change would be for banks to break themselves up under market pressure, creating newly focused online savings and lending entities serving individuals and SMEs. ■

APPENDIX 1: TEAM OUTPUT OF SCENERIO EXERCISE

Scenario 1: Disintermediation of Traditional Intermediaries

Team 1
Factors Underlying Scenario

Occurring

- Platforms do things well and banks do things badly. Notably the marketplace lenders remain faster, cheaper, more user-friendly, better at credit analysis and more attractive to young talent.
- Cost of funds: the marketplace model requires minimal capital and keeps the cost of funds lower than for traditional balance sheet lenders, which are subject to tough post-crisis capital requirements.
- Trust: the successful platforms build trusted brands and, therefore, market share.
- Regulators continue to subject banks – but not the marketplace lenders – to tougher rules. They might even tackle banks' residual advantage by removing or reducing deposit insurance.
- Good quality platforms are sorted from poor ones through transparency of performance and proven good conduct towards both borrowers and investors. This leads to scale benefits for the winners.
- The low interest rate environment gives alternative lenders a chance to build scale before the credit cycle turns.

Team 2
Factors Underlying Scenario

Not Occurring

- High-profile failures cause the media to 'demonise' platforms. Politicians and regulators turn against them as people (voters) lose money. This could be part of a bursting of the 'fintech bubble'.
- Regulators level the playing field so that regulatory arbitrage will no longer occur.
- As P2P platforms succeed they will become mainstream – and create their own legacy systems and problems.
- Trust in traditional banks is restored as they evolve to meet customer needs. The incumbents recover as interest rates rise and they cope better than the alternatives with the turn in the credit cycle.
- Banks have an in-built funding advantage – insured deposits. Their cost of capital falls as performance improves and once their balance sheets are fully rebuilt, they will be able to take more risk.
- Banks will take out the new firms by acquisition.

Scenario 2: Alternative Lenders Will Complement Traditional Intermediaries

Team 3
Factors Underlying Scenario
Occurring

- Regulation of the alternative lenders remains less onerous than for banks, giving them a continuing competitive advantage.
- The platforms continue to have lower operating costs and lower costs of capital than banks. They will be strong enough to persist as independent operators.
- There is a continued appetite to invest via the platforms, especially in a low interest rate environment, so banks have to work with them. Similarly, borrowers want choice, speed and convenience.
- Competitors become complementary as the market matures.
- Banks provide the balance sheets and alternative lenders become another channel for deploying capital. Traditional providers realise that acquiring a fintech company might kill it, so prefer to partner.

Team 4
Factors Underlying Scenario
Not Occurring

- Lending is a good business.
- The opening for alternative lending was based on the economic cycle (banks retreated) and technological change, enabled by new entrants.
- As the economic cycle changes, banks will come back. They have access to the same technology as the start-ups and their culture will adapt, even if slowly.
- As alternative lending increases market share, banks will compete more aggressively and/or buy platforms.
- Regulation will intensify for all firms. Banks are better equipped to deal with this.
- Millennials are tech-savvy but conservative and they like global brands, so the assumption that they will avoid traditional banks will prove false.

Scenario 3: Alternative Lenders will be Absorbed by Traditional Intermediaries

Team 3
Factors Underlying Scenario
Occurring

Platforms are moderately successful but will sell out.

They are dependent on 'fast money' but need stable funding, which comes from insured deposits; and their backers need exits.

Scale needed because of regulation – banks become the regulatory champions. Complex criteria for investors limit growth.

Banks' reputation for reliability is a plus and alternatives will be hit by reputational problems.

Banks have the capacity to aggregate services for customer convenience.

If the niche is mezzanine finance for companies, the platforms will need to partner with banks; the securitisation model for fund-raising also means that the platforms need institutional support.

Team 4
Factors Underlying Scenario
Not Occurring

- New entrants have a long-term vision to change the world and so will not be for sale.
- They also maintain their independence by deciding not to 'white label' their user experience and data analytics to incumbents.
- They continue to avoid the heavy regulation imposed on traditional banks.
- Millennials and talented people more broadly prefer to work in agile, disruptive 'New Bank' environments.
- Banks remain encumbered by cost concerns and continue to focus on fixing immediate issues. Their shareholders do not have the patience for long-term investment.
- Banks don't want to disrupt themselves: legal, IT and process issues make them resistant to change. They have insufficient focus on data analytics and lack incentives to align their services 'end to end'.

APPENDIX 2: LIST OF PARTICIPANTS

Alexey Ananiev	Co-owner and Chairman of the Board, Technoserve
Stephen Barter	Chairman Real Estate Advisory, KPMG in the UK
Tam Basunia	Member of the Board of Directors, Promsvyazbank
John Battersby	Head of Communications , Rate Setter
Olivier Bouteille	Chief Operating Officer, Natixis London Branch
Keith Breslauer	Managing Director & Senior Partner, Patron Capital
Michael Cohrs	Chairman, Investment Advisory Credit Committee, EQT
Giles Cuthbert	Managing Director, Chartered Banker Institute
Jane Delbene	Director External Relations, Chicago Booth
Jasper Ehrhardt	Managing Director, Funding Knight
Rupert Froud	Capital Markets, Syndicate Room
Jane Fuller	Co-director, Centre for the Study of Financial Innovation
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Cindy Levy	Partner, McKinsey & Company
Stuart Lewis	Member of the Management Board, Deutsche Bank
Arnold Longboy	Managing Director, Executive Education, EMEA & APAC, Chicago Booth
Daniel Marovitz	President Europe, Earthport
Graeme Marshall	CEO, Funding Knight
Douglas Monieson	Chairman of the Board, Hyde Park Angels, Chicago
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Henrietta Royle	COO, British Bankers' Association
Frits Seegers	Advisor, Intrepid Partners
Emily Shepperd	Chief Operating Officer, EMEA, BNY Mellon
Raj Singh	Managing Director UK, Avant
Edward Twiddy	Chief Operations and Innovation Officer, Atom Bank
Kenneth Volpert	Head of Investments, Europe, Vanguard
Robert Wardrop	Executive Director, Cambridge Centre for Alternative Finance
William Wright	Executive Director, New Financial
Mark Yallop	Board Member, Prudential Regulation Authority

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