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Strategic Choices in Digital Lending

Nearly every industry pundit these days is raising the threat to banks posed by “marketplace lenders” and the adoption of digital online lending technology. Many say banks need to “build, buy or partner” with such lenders or else technology will leave them behind.

A better understanding of the landscape shows that some financial institutions (FIs) are already incorporating digital lending technology into their lending “ecosystems.” Digital lending technology enables banks to differentiate previously monolithic lending processes into specific delivery technologies by market segment, from mortgage to small business, for improved efficiency, service and revenue.

The strategic question for banks is not whether to “build, buy or partner” but how to target and configure digital lending technology to serve specific customer *market segments*. This choice is reflected in recent announcements. New York City’s JPMorgan Chase and **BankNewport** in Rhode Island, for example, struck partnerships with non-bank lenders OnDeck and Lending Club to improve their service to some of their small business and consumer lending segments. Others, like Paris, Ky.-based **Kentucky Bank** and **Centier Bank** of Merrillville, Ind., are choosing to install their own digital lending technology to totally own their small business and consumer lending market segments. To appreciate these strategic choices for how an FI will serve its customers, let’s begin with defining the digital lending terms that are frequently used with overlapping meaning:

Marketplace Lenders: This is the pairing of borrowers and lenders through the use of an online platform without a traditional bank intermediary. Examples are Lending Club and Prosper.

Alternative Lenders: Companies that underwrite and deliver loans outside traditional bank pricing and underwriting of debt capacity and coverage ratios. Alternative lenders have existed for some time and some have partnered with banks for years. They may or may not be online “marketplace lenders.” Marketplace “alternative and online” lenders include Kabbage and OnDeck, which can deliver loans online with alternative underwriting and pricing.

Digital Lending Automation: This term refers to loan processing platforms that may include some or all of the components of online applications, such as e-sign, cloud operations, enhanced processes, simplified underwriting, electronic data and document capture and management. This automation can deliver loans more efficiently with traditional bank underwriting, pricing and compliance.

Banks are actually well down the road enhancing lending processes using some or all of these digital automation tools with vendors and core providers, including e-sign and cloud operations. For example, mortgage online lending occurs frequently at community banks today and loan automation processes from multiple vendors are automating commercial lending. Core providers are providing more digital automation tools, and even **comprehensive, full cloud-based lending platforms are available**. FIs may need to increase their adoption and investment in these new technologies, as consulting firms like **Bain and Company** and **McKinsey** recommend, but the technology is increasingly available for their own lending ecosystems, where they can control the relationships, loans, underwriting, compliance and pricing.

With these definitions, we can see the major partnerships with firms like Lending Club and OnDeck aren't just about digital technology deployment, but rather a choice about how banks choose to serve the specific market segments of small business and consumer loans. Jamie Dimon was unabashed in saying Chase's partnership with OnDeck was designed to allow OnDeck to serve Chase's small business customers and **"to do the kind of stuff we don't want to do or can't do."** The largest banks have largely given up the small business lending market segment for loans under \$1 million to community banks which have 40% of these loans today according to the FDIC. It makes sense, then, that Chase and other large banks are choosing to serve the small business market indirectly through partnerships with companies such as OnDeck. BBVA Compass, for example, reported that its average loan in its **OnDeck partnership was \$43,000**.

Community banks, meanwhile, have largely given up the consumer unsecured loan market to credit cards. Fortunately, digital lending and marketplace lenders can provide consumers an alternative to credit cards. Leland Merrill, Jr., chief lending officer for BankNewport, says his institution partnered with Lending Club in unsecured consumer credit because **"we can't compete."** Other community bankers say partnerships represent the quickest and simplest method to serve their customers. As Jonathan Morris, director of Dallas-based Titan Bank, says, **"It's a small income source, but any income is good in this market, and it could help the customer otherwise find a solution."**

Beyond such partnerships, turn-key digital lending technology is also available today for regional and community banks, providing them full control over their small business and unsecured consumer lending. This technology can profitably serve these segments where the FI controls the brand, the loans, the underwriting and pricing, all within bank compliance standards. Louis Prichard, CEO of Kentucky Bank, says, "We have been watching closely the emerging digital lending space and have been evaluating options. Our new 'responsive design' technology will allow customers to set up loans in minutes and access the lending site using any computer or mobile smart device." **Centier Bank** is targeting small business loans up to \$50,000 that can be made in minutes with Centier's own digital lending platform.

Banks today own the customer relationships and have many options for leveraging digital technology from many sources to best serve their customers. Their strategic choices begin by defining which market segments they will target to fully own or share ownership. Small business and consumer lending have historically been strengths for community banks and digital lending technology today allows them to serve these customers and grow new revenues efficiently whatever their choice.