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P2P is a game-changer, but banks can respond

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It is clear the emergence of peer-to-peer lenders is no fad. At our P2P conference on 11 June, 70% of you said marketplace lending was set to be a game-changer in the way businesses and consumers borrowed. I wholeheartedly agree.

The sums peer-to-peer players lend today might be tiny compared to the incumbents, but there are good reasons to believe they will not only succeed in reshaping the industry but also rapidly eat into the incumbents' market share. For established banks, they represent a threat, but if handled correctly, also an opportunity.

Peer-to-peer platforms are significant because they hold an edge over traditional banks in the five key areas where lenders must excel to succeed. These are the five Cs: customer experience, credit risk, culture, cost and capital.

> "I expect far more collaboration between incumbents and P2P players. Their models are complementary."

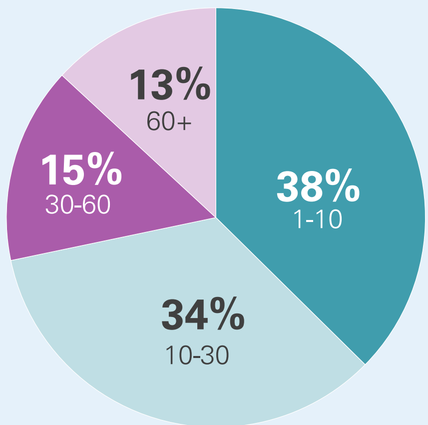
James Daunt, the man who has turned around booksellers Waterstones, perfectly encapsulated the key to the first of those: **customer experience**. "Everything we do must ultimately go towards creating a better bookshop and be appreciated by our customers," he said. Daunt's business faced the perfect storm – not only the arrival of Amazon in 2000, but also the emergence of the e-book five years later.

By focusing on the customer experience, the business has bounced back. And by acting now, the incumbent banks may have the opportunity to avoid their own 'e-book moment'. A survey from Nesta, the innovation thinktank, showed that 86% of existing P2P borrowers thought they would be 'likely' or 'very likely' to approach alternative finance platforms first in the future, even if a bank offered them similar terms. As Hugh O'Reilly, head of customer experience at KPMG, made clear banks have now put customer service their priority and are investing heavily. It will take time to move the dial however. Not one of the big five are currently in the KPMG Nunwood 2014 customer experience survey[a] .

Perhaps the most fundamental change P2P platforms bring is in the way they assess **credit risk**. I met P2P players in the US recently who are changing their credit scoring algorithms every day. By contrast, UK banks typically do so every month or quarterly. Their use of borrowers' social media data is also a radical departure. Both of these innovations are possible thanks to IT systems that are the envy of most incumbent banks.

But is this a revolution, or as Rob McElroy from British Business Bank Investments suggested, an evolution that hones the accuracy of a borrower's credit profile. It will help lenders, but as Michael Baptista warned, it inevitably raises the question of fair access to credit to those who, for example, have underachieved at university. What if lenders went further, as Cambridge University's Robert Wardrop asked, and started to use biometric data? These are big questions for lenders – and regulators – to wrestle with.

How many peer-to-peer platforms will be operating and profitable in the UK in 2020?



Source: (a) http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Advisory/kpmg-nunwood-uk-final-report.pdf

Culture is the difficult issue for incumbent banks to mimic. Peer-to-peer lenders are clearly more dynamic and entrepreneurial in their approach. For James Daunt, culture was the bedrock on which Waterstones' recovery rested: "you have to take your staff with you". Clearly, for incumbents it is more difficult to change culture in an organisation of thousands – identifying those who will and won't travel on that necessary journey of change. P2P players, by contrast, start with a blank slate. The challenge for peer-to-peer lenders is not to lose this edge as they scale up in size.

> "I see all the main banks with captive peer-to-peer platforms in five years' time."

On **cost**, the P2P advantage is obvious. No branch network, no old expensive IT systems, far fewer staff, less compliance and regulation, no legacy conduct costs and far greater automation. In a prospectus, Lending Club estimated it had a 425 basis point cost advantage over traditional banks. That money can be passed back to borrowers via more competitive rates, and to investors in the form of returns.

What is more, the costs for P2P players are likely to fall over time. Right now, half the costs of some peer-to-peer lenders will go towards advertising. However, as brand recognition grows, they may be able to dramatically shrink that number.

Capital is the fifth, and perhaps the greatest, advantage P2P platforms have over incumbent banks because they do not have a credit, or liquidity, risk on their loans. To illustrate, a UK bank with a mixed £1 billion loan book might need to hold £80 million-worth of capital while for the same loan book, a peer-to-peer lender would only need to hold some £900,000. Even if the government tighten regulation on the P2P sector in time – as I expect – this will remain a massive advantage.

THE BANK RESPONSE

The emergence of marketplace funding is a sobering challenge for incumbent banks who are already facing higher regulatory hurdles and new high street and digital challengers. So can they fight back? Absolutely.

Banks know that they too have important and inherent advantages. They have an established distribution network, scale, access to a huge customer database (valuable both from a marketing and credit data perspective), recognised brands and strong customer recognition. Not to mention huge financial resources. On each of the five Cs – customers, credit, culture, costs and capital – incumbent banks can respond to the P2P challenge.

On **customer experience**, we should firstly recognise that banks don't necessarily want to get into a fight for many of the customers that the peer-to-peer players pick up. The big five are volume machines: set up to cater to borrowers with good credit history, those who already bank with them and those with assets against which loans can be secured. They need customers to conform to those customer templates, keep costs down, and I don't see them shifting focus from that prime customer.

But I do think in those core markets, the banks will get better at serving customers. First – and despite all the charges – they still have very deep pockets. One of the largest has announced it is spending £2 billion on digital. Compare that to a lot of peer-to-peer platforms, which might be spending £5 million in the same area, and you would expect a certain amount of catch-up, possibly even leapfrogging of some peer-to-peer lenders, as they innovate around the customer experience. Who was the first financial services provider with an app for an Android smartwatch? It wasn't a challenger or a peer-to-peer lender. It was Nationwide, a long-standing player.

Banks could transform the customer's experience through intelligent use of customer data at their fingertips. They might be able to see that a customer is spending too much on his heating bill for instance, and they could transform that relationship by connecting them to a cheaper gas utility.

On **credit risk**, some of the banks are already raising their game. For example, using API technology to suck in other data from other accounting systems. The question for them to wrestle with now is just how far down the road they want to go in using new tools like social media.

86% of respondents agreed that within three years, the major UK banks will have their own captive marketplace platforms

As I have already mentioned, **culture** is, and will remain, a challenge for the banks. A potential, and I think neat solution, is to mimic peer-to-peer players in small stand-alone incubators, run at arms' length from the parent bank.

Some banks already have innovation labs or 'garages' – taking people out of the business and putting them into a test site where they can invent and innovate safely. If the ideas work, transfer the idea back into the parent bank or, alternatively, migrate clients to the new platform. Twenty five years ago the then Midland Bank took exactly that approach. That project was known as First Direct – now the UK's most trusted brand in Nunwood's survey.

On **cost**, incumbents will make slow steady progress but it will be a generation before they catch up with P2P. Peer-to-peer lenders suffer neither the cost of the Financial Services Compensation Scheme, nor the UK banking levy. Regulation aside, the solution goes back to my previous point on culture: if the banks want to reduce costs and be in a position to compete with P2P, they will need to set up new ventures, with new IT, simpler processes and no branch estate.

Lastly, regarding capital, this is less an issue of what incumbents can do, than what will happen to peer-to-peer lenders. I suspect that as they grow in scale and become more systemically important, the regulator will become more cognizant of customer expectations that their money is protected and increase the capital requirements upon them. That burden is unlikely to reach incumbent bank levels, but peer-to-peer lenders will see their advantage eroded.

> "We are likely to see at least one regulatory-driven event that will test this fledgling industry."

So while banking may well be facing its 'e-book moment', I believe the outlook for incumbent banks now is better than it was for booksellers in the mid-2000s. Banks must think hard about what they can learn from peer-to-peer lenders, both to respond to their emergence and to innovate to make themselves more competitive in the established market. They must accept that the playing field is uneven in areas like regulation and legacy infrastructure, but they should take the best of the peer-to-peer model and not forget that they still have an edge in important areas.

MY PREDICTIONS

So where do I see the P2P market five years from now?

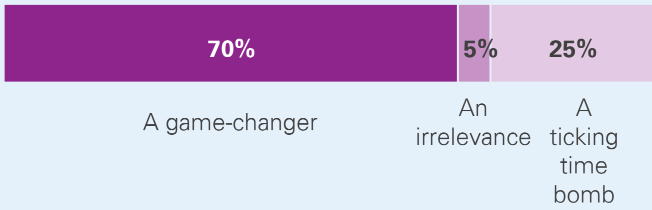
First, and most importantly, I see far greater collaboration between incumbent banks and peer-to-peer players. Why? Because their models are complementary. While P2P lenders are agile, entrepreneurial and capital-light, the banks are stronger in their customer base and brand recognition.

We have already seen Metrobank and Zopa working together, and Santander and RBS have arrangements with Funding Circle. Three years from now, at least one of the main banks – and the challengers – will have captive peer-to-peer platforms as an integral part of their distribution strategy. And to my relief, 86% of you who we survey agreed with me. I don't see this as a case of banks cannibalising their own business. This gives them an *additional distribution* avenue. Rather than say to customers "no, you don't fit our standardised model" they will be able to serve them via a P2P platform. Does that risk banks cherry picking and loading their P2P platform with riskier assets? That's certainly a challenge that needs to be addressed.

My second prediction is that **institutions** – not retail investors – will supply the lion's share of capital to P2Ps. That is already the case in the United States and I think it is an inevitable – and a necessary – development on this side of the Atlantic if the sector really wants to mature and grow. Eighty eight percent of those at our conference agreed.

From the platform's perspective, a switch to institutional money enables them to raise capital very quickly and relatively cheaply. Lending Club has more than doubled in size every year for the past three years and now lends around $1.6 billion a quarter[b]. A big part of that growth is the result of institutional money.

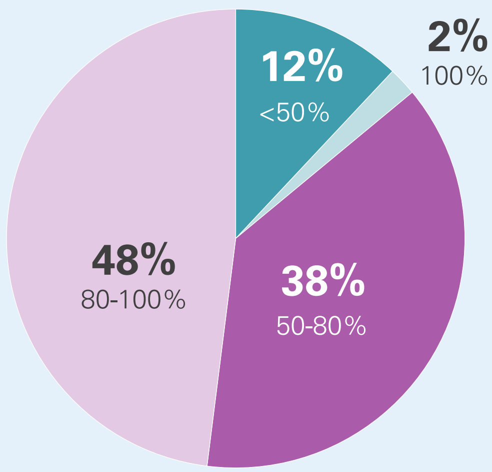
Marketplace lending is…



So institutional investment gives the market scale. It also moves P2P down the risk curve because institutional investors typically have a higher risk appetite than individual investors. As a result, the UK should move from a very narrowly focused prime P2P market to one open to a far broader range of borrowers. What happens to the retail investors? I believe those who still want to invest in P2P will gravitate towards investment funds rather than lend directly through P2P platforms. Many of you expressed a contrary view on this point – time will tell.

Third, the move towards an institutional investor base will drive a serious amount of **consolidation** in the next five years. Today, we have around 60 peer-to-peer platforms in the UK. By 2020, I think that number will be closer to three or four big scale players, each lending billions of pounds a year. Thirty seven percent of you agreed with me – based on conference voting – that there would be 10 or fewer P2P platforms that are profitable in the UK in five years' time. Yes, institutional investors are looking for investments that will return a decent yield, but they are also looking for places to park hundreds of millions of pounds at a time. As a result, there will be a natural gravitational pull towards the biggest players, making them bigger still and squeezing out smaller rivals.

What proportion of investment in P2P platforms will come from institutional investors by 2020 in the UK?



Source: (b) https://www.lendingclub.com/info/statistics.action

That does not mean I am predicting mass extinction by the way: there will remain an important role for P2P specialists in niche areas.

My fourth prediction is again linked to the entrance of institutional investors. I predict the creation of a **secondary market** in peer-to-peer debt in the UK. Institutional investors want a liquid market, a way to easily increase and decrease their exposure. Once more, the US provides us with a crystal ball: Sofi has already completed three securitizations in the past 18 months[c], with the institutional market very much in mind.

I also think that peer-to-peer lenders will start moving into the longer-duration assets such as mortgages once they have proper institutional backing. In these circumstances, securitization becomes even more important.

Fifth and last, I think we have to be realistic and acknowledge that we are likely to see at least one **regulatory-driven event** that will test this fledgling industry. As the sector grows, the media are scrutinising P2P players more closely. And I suspect that if we see a rash of bad news stories about retail investors losing money, pressure will grow in the regulator to act, particularly while retail investors remain the main source of funding.

These kinds of challenges are inevitable as the sector matures. However, they will not change the fundamental impact that peer-to-peer lending is already having on the way we borrow here in the UK, and around the world. Consumers, businesses, and even incumbent banks, should welcome its arrival.

Source: (c) https://www.sofi.com/press/sofi-completes-303-mm-rated-securitization-refinanced-student-loans-marketplace-lender-achieves-rating-sp-a2-moody/

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