ACCELERATING ENTRY INTO THE DIGITAL UNSECURED LENDING MARKET

Create new and enhance existing unsecured lending offerings to increase revenue now and grow your business for the long term.

CAPCO

THE FUTURE. NOW.

DIGITAL UNSECURED LENDING: A QUICK DEFINITION

Digital unsecured lending refers to using online, digital platforms to originate unsecured loans directly to customers (typically consumers and small to medium-size enterprises). Online loan origination platforms automate some or all steps in the loan application process, including electronic data and document capture, automated underwriting and managing eSignatures. Advanced analytics models automate credit decisions for faster, more precise and targeted underwriting.

This automation can be delivered through a bank technology platform or sourced from a third-party vendor (residing on the bank's IT infrastructure or accessible from the cloud via a secure software-as-a-service offering). With any of these methods, automation provides the critical ability to deliver loans more efficiently while maintaining traditional underwriting, pricing and compliance practices.[1]

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[1] American Bankers Association, The State of Digital Lending (2018)

WHY DIGITAL UNSECURED LENDING?

Banks will not be able to grow in the long term and meet their customers' increasing expectations if they continue to rely on traditional processes and channels. Customers want the speed and ease of doing business with online retailers, fintechs and other new competitors eager to serve them.

Unsecured lending is a source of new business that many institutions have not exploited. Meanwhile, digital technology continues to make it more attractive for both the customer and the bank. Now is the time for traditional banks to enter the digital unsecured lending market or enhance their existing offerings to offer consumers personal, student and small business loans.

Unlike credit card products that don't make money until customers carry a balance, unsecured loans start generating revenue immediately. Interest charges begin on day one, as soon as a bank funds a new loan. Banks accelerate revenue generation by taking in deposits and lending money at higher interest rates over shorter payment windows.

In the past few years, the unsecured lending business has transformed into a fast-moving marketplace with strong and steady growth. Balances are rising and delinquencies are falling due to the strong economy, low unemployment and increasing use of big data in underwriting.

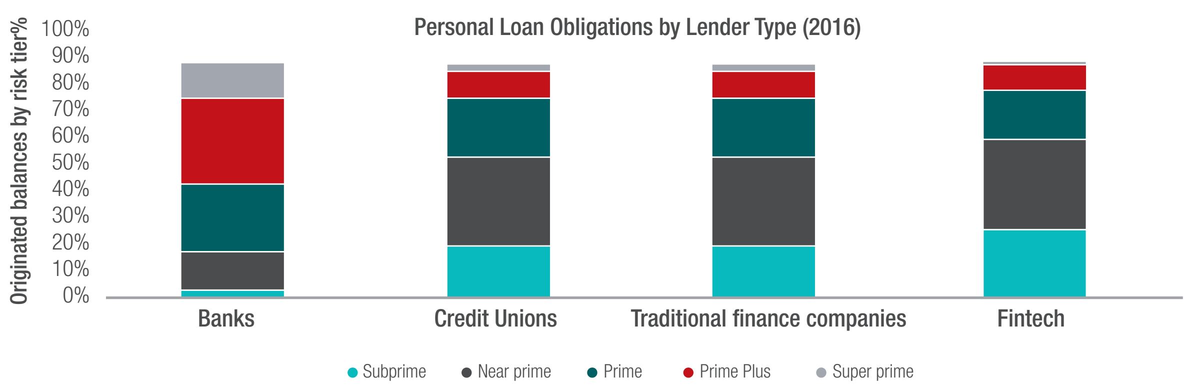
There are three key reasons why traditional lenders should act now:

1. **Unsecured lending is a growth opportunity.** Most major banks and credit unions have not aggressively pursued unsecured lending beyond credit cards, missing out on significant growth in the past few years. There are now nearly three million more consumers with personal loans compared to two years ago, and the quality is improving: prime and above-prime originations increased by double-digit percentages between Q2 2016 and Q2 2017.[2]

2. **The rise of fintechs.** Fintech lenders have become the largest originators of personal loans, capturing over 30 percent market share, up from three percent just five years ago.[3] These non-bank lenders are creating and meeting a significant new demand in areas not traditionally served by banks, focusing on non-standard credit profiles that expand the market for borrowers.

   Fintechs are proving that financial institutions can use advanced data analytics and other digital tools to safely lend to near-prime and subprime borrowers. And consumers prefer fintechs for personal loans because of favorable terms, greater transparency, and faster approval and funding. Traditional lenders, with their antiquated policies and legacy systems, find it increasingly difficult to match the tailored, agile service of the new digital competition.

   The experience of Goldman Sachs, however, shows the potential for traditional institutions in this market. In just two years, its Marcus online banking platform made $4 billion in unsecured loans and took in more than $20 billion in deposits.[4]



Subprime=300-600; Near prime=601-660; Prime=661-720; Prime plus=721-780; Super prime=781-850
Source: TransUnion consumer credit database

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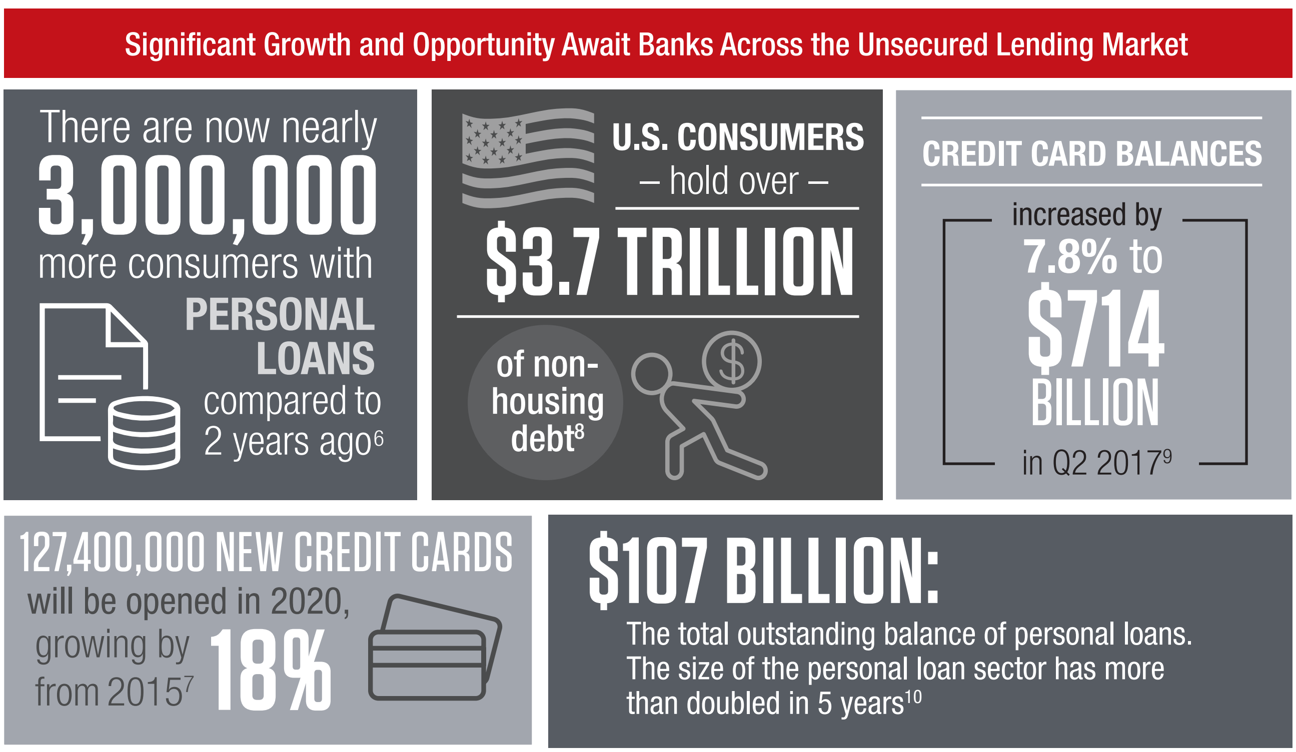
[2] TransUnion, Q3 2017 TransUnion Industry Insights Report (2017)
[3] TransUnion Consumer Credit Database (2017)
[4] DeNisco Rayome, Alison. "How mobile, AI, and omnichannel tech will revolutionize the future of banking." TechRepublic. 24 August 2018
Horowitz, Julia. "Goldman Sachs is serious about becoming a bank for everyday people." CNN. 31 August 2018.

3. **Opportunity to build lasting business relationships with desirable customers who prefer digital products and services.** Millennials are an obvious target for digital unsecured lending. Bank customers typically form strong and long-lasting relationships with products and brands when they are aged between 25 and 34.[5] This is when consumers are beginning to advance professionally and amass wealth. Millennials are also small business owners and entrepreneurs, and unsecured lending is an entry to long-term business relationships. For traditional banks to form lifetime relationships with this generation of customers, they need to match the digital customer experience and offerings of fintechs and peer-to-peer (P2P) lenders.

Capco believes banks can accelerate growth in digital unsecured lending by targeting customers with credit card balances and current borrowers, including above-prime, near-prime and subprime.



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[5] TNS, Direct Banks and the Future of Consumer Banking (2013)

[6] TransUnion, Q3 2017 TransUnion Industry Insights Report (2017)

[7] TransUnion, Consumer Credit Origination, Balance & Delinquency Trends: Q1 2017 (2017)

[8] NCLC Digital Library – Fair Debt Collection (2017)

[9] TransUnion – Consumer Credit Growth, Balance & Delinquency Trends: Q2 2017 (2017)

[10] Federal Reserve – Changes in U.S. Family Finances (2017)

UNCOMMON INSIGHTS FROM THE FRONT LINES: HOW TO BUILD A DIGITAL UNSECURED LENDING BUSINESS

When creating and launching digital unsecured lending products, there are several important lessons to take into consideration to help accelerate every stage of the design, build, test and launch process, all the while controlling risks:

LESSON #1

Jump-start a winning position by partnering with fintechs.

Banks don't have to compete with fintechs, they can partner with them. With no or minimal upfront investment, banks can make the most of fintechs' modern, agile software and technology-driven product offerings to quickly go to market with their own digital lending solutions.

When entering into a relationship with a fintech, banks must apply sound risk management practices (as they are fully responsible for third-party vendor actions). Banks need to seek and evaluate fintech partnerships to quickly get up to speed and catch up with the market. Next, the bank should perform product due diligence to ensure that the fintech's technology will integrate with the bank's core systems, comply with legal and regulatory requirements, map to the bank's operational procedures and provide superior customer experience.

LESSON #2

Mitigate fraud risk with digital identity systems.

Despite progress in underwriting via data analytics and new kinds of data, unsecured lending remains exposed to fraud, especially via digital platforms. A critical step in identifying and addressing potential vulnerabilities is to change the bank's operating structure to ensure the credit risk and fraud teams are working collaboratively and not in silos.

To mitigate fraud risk across threat vectors, including online synthetic identity fraud, it is imperative to have a defensive strategy to detect and preemptively strike against malicious activities. Establish robust digital identity processes, sound data security and analytics practices, and a governance framework to manage, map, and safely share the right data with the credit risk and fraud teams. Mitigating the fraud risks during loan origination allows the credit risk team to focus on assessing the applicant's credit-worthiness.

As a proactive measure, create a playbook of 'what if' scenarios or breaches and lay out the corresponding protocols for each. By thinking through scenarios in advance, a bank can implement procedures, for instance, to quickly defeat a bot attack on its website or to clean up after a mail scam (by cancelling and reissuing direct-mail prequalification codes that have been compromised).

LESSON #3

Implement an end-to-end digital experience to improve customer satisfaction.

Many traditional banks offer some form of digital capability to support lending, such as loan status, loan payments and basic account information. However, most banks' core lending processes - including online application, onboarding processes, underwriting and funding - have yet to be overhauled through technology. This means there is much room for improvement in productivity, closing more loans and increasing revenue per loan. To achieve these improvements and to meet customers' expectations, cheaper, faster and automated services are required. Non-bank lenders are already benefiting, but the majority of traditional banks are not there yet. In fact, most banks can handle just seven percent of products digitally from end-to-end, having only digitalized fragments of the process for marketing, selling and servicing loans.[11]

LESSON #4

Use big data and predictive analytics to target the best borrowers.

Fintech and P2P lenders have made inroads into banking markets by harnessing advanced analytics and non-traditional data to automate and finetune underwriting processes. Using big data analytics increases the chances of getting better returns and enables more aggressive pricing, giving these upstarts a marketing edge against traditional banks while allowing them to maintain a less burdensome administrative process and provide the quick decisions borrowers have come to expect in the online environment.

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[11] SAP Value Management Center-Bain Digital Lending Survey (2015)

Capco works with banks to design digital lending systems that will provide exceptional experiences for customers and back office employees. By digitizing the loan origination and servicing journey, we help banks fundamentally change the business case and experience. The time- and labor-intensive manual processes are eliminated. Customers can apply online through a website or mobile app anytime, anywhere. In addition, our design ensures that the journey steps are intuitive, guiding the customer through the process, and allowing them to upload any supporting documents (such as tax returns) in the app. Employees of the bank no longer need to manage the multiple exchanges of paper documents, freeing their time for more meaningful activities. Digital lending caters to more automated and cost-efficient features such as auto payments, e-statements and online chats.

Data strategies that provide insight on borrowers and loan performance will enable rapid decision making for banks and fintechs. The biggest advantage of big data and predictive analytics is enabling banks to set more precise borrowing terms and offer advantageous loan pricing to customers with low risk profiles. It also reduces the risk of taking on unreliable borrowers without setting appropriate terms.

LESSON #5

Cannibalization is not always a bad thing. Done properly it propels results.

Having a new product take sales away from an existing product may not seem like an attractive situation for a firm. Clorox, for example, saw sales of their bleach products suffer when they introduced laundry detergents with bleach as an added ingredient.[12] A new Starbucks franchise can cannibalize sales from another franchise nearby.

In financial services, many initiatives fail to make it to market because the benefit stream for the projects has already been allocated to other projects. This is referred to as cannibalization of business case benefits. To overcome this, banks must carefully manage the key performance indicators (KPIs) of their projects and think strategically about how to bundle enhancements to deliver the most value from their deployments. Sometimes it means working in differentiating elements that may not yield the highest hard dollar gains with practical business improvement measures.

For example, a bank may be unable to enhance its lending process through eSignature because in branch settings the benefits of reduced courier runs are already claimed and justified by deploying multifunction scanners to process loan collateral. The outcome for bankers and customers is not optimal - the hard cost savings are already realized, leaving the bank in a tougher position to justify the investment. Banks that find themselves in this situation should reframe the business case for eSignature by bundling it within sales and servicing enhancements, such as a customer relationship management (CRM) system deployment.

While cannibalization may seem very negative, truly innovative banks are willing to sacrifice or cannibalize their prior investments to defend themselves against the competition. Keeping with the eSignature example, if banks try to preserve the value of their investments in multifunction scanners, they risk being viewed as antiquated. Progressive firms explore and embrace cannibalization to remain ahead of the pack.

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SEIZING THE DIGITAL UNSECURED LENDING OPPORTUNITY

For financial institutions that are newly established or traditional banks that have not yet gone digital, there is opportunity to capture market share with an unsecured lending offering.

By using new ways of thinking about customers, aligning modern architectural foundations with their needs, and deploying the latest methodologies and technologies, banks can quickly and flexibly deploy effective unsecured lending products.

AGILE CASE STUDY

Using an agile framework to accelerate delivery of a brand new digital personal loan product.

A large multinational bank wanted to quickly bring a new personal loan product to market, aimed at new and existing customers across the United States and delivered via a digital channel. Capco supported all elements of the product development including mapping the customer journey, financial modeling, operations design, testing, product marketing strategy, training and project management.

To foster success, Capco started by collaborating with over 25 stakeholder groups to identify, document, assess and finalize requirements for the development plan. During development, the project-management structure was enlarged and agile methods, such as multi-level scrums, were implemented in three-week long sprints for development and testing to keep the effort on track.

The overwhelming advantage of using the agile methodology over 'waterfall' in this case was speed. With this approach, the bank's objective for rapid contribution to the bottom line was met, taking the new product from conception to rollout in a short timeframe. Not only was the agile approach considerably faster than the waterfall method, it also gave the bank a system that was better tailored to their needs.

In addition, Capco helped navigate regulatory hurdles and supported multiple development teams, both internally and at third-party loan origination and processing vendors. The results were increased profitability, improved financial metrics and increased engagement across existing customers as well as attracting new customers.

PARTNERSHIPS CASE STUDY

Partnering with a fintech to expedite development of an end-to-end digital lending solution.

A large multinational bank wanted to offer an unsecured personal loan product via a new digital channel. Capco helped the bank move quickly and successfully into the market by defining a structured approach to perform due diligence on a fintech organization that would offer a third-party software-as-a-service (SaaS) digital lending solution. This white-label solution provided the bank with a modern, agile platform without having to invest in infrastructure or technology.

The bank relied on Capco to manage daily interactions with the fintech vendor based on a proven track record of remaining objective and working efficiently alongside third-party organizations. The Capco team engaged with multiple stakeholder groups to review the abilities of the vendor and assess alignment with the bank's needs.

The bank can now offer a branded end-to-end digital lending solution to customers while maintaining full control over the origination process. As a result, the bank expanded its customer base through new loan originations, increased profitability, provided better customer experience and enhanced its competitiveness with peers in the personal lending space.

In 2018, the unsecured lending industry will trend toward a streamlined lending process, better interest rates and more transparent lending criteria. In fact, some brick-and-mortar banks are only recently returning to this kind of lending after the subprime mortgage crisis.[13]

DIGITAL-FIRST CASE STUDY

Mitigating risk while building a digital-first lending platform with assisted channel capabilities.

A large regional bank asked Capco to design and build a new personal lending platform using a digital-first approach. Capco built the digital channel, added the new lending process to the bank's workflow, and extended the look and feel of the online offering at the bank's call center and branches. During development, Capco helped the client mitigate risk by managing a complex multi-vendor program, including vetting, selecting, and integrating the third-party vendors that provide prequalification and identity verification services throughout the loan application and servicing lifecycle.

The new platform required more than 20 integration points with the bank's existing interfaces and back office systems. This involved integrating new technology as well as data flows, such as credit scores, credit bureau insights, and income verification information.

Relying on Capco's expertise across various risk disciplines, including fraud, compliance and information security, the bank built tight controls to limit its exposure during the phased launch of the new loan product into the mass market. The bank is now in a position to expand its credit business, while effectively managing the risk associated with unsecured lending.

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[13] SAP Value Management Center-Bain Digital Lending Survey (2015)

THE CAPCO APPROACH

Capco has a strong record and a proven approach to launching new digital unsecured lending offerings in in the United States and Canada. We typically perform a strategic analysis at the beginning of engagements and deploy a skilled execution team to design, build, test and launch new unsecured lending products. Through our work experience, we have built a comprehensive tool kit of methodologies and techniques that accelerate a bank's entrance into a market as well as enhance existing offerings.

Capco's flexible approach gives clients a choice of services, ranging from program support to program leadership and full delivery of a market-ready product. When clients work with Capco, they have the trust and confidence that we can quickly help them enter the digital unsecured lending space with a market-ready strategy aligned with their vision and brand and tailored to practices in their country.

Here is a typical template of what Capco does:

INTEGRATING VISION AND STRATEGY

We begin with a strategic focus. Working closely with you, we establish a deep understanding of your enterprise vision and your brand's standing in the marketplace. We jointly define a digital vision and a suitable strategy for making it real.

Next, we assess the current state of the bank, your risk appetite, and target customer base. With the business requirements gathered, we create a model to transform the current state into your future state and develop a holistic approach for designing and implementing an end-to-end solution.

Using this analysis, we work with you to define the products and services that target customers want and need, and the consistent digital experience the bank wants to offer across all channels. A key question guides our validation of your digital vision: What aspects of your business model need to change to realize your digital vision and opportunities?

MAPPING THE CUSTOMER JOURNEY

The next phase is to envision every step of the customer journey. Knowing where digital journeys will begin and end and opening new pathways helps rethink and re-engineer processes and identify outdated systems that need a digital refresh.

A clear understanding of the targeted customer segments is essential to creating the desirable customer experience. Capco helps clients gain a deeper insight into the most promising customer segments through demographic research, focus groups, customer interviews and other techniques.

DESIGNING AND BUILDING THE UNSECURED LENDING OFFERING

Taking what we've learned from our strategic assessment and evaluation of the customer journey, we begin the structural business design process with an overarching target operating model that enables us not only to articulate the structure details but also to apply theoretical testing.

This approach has several advantages. The use of the target operating model instills a common approach and discipline which flows into a set of business services. It also clearly identifies beginning and end points of each banking process. Because this model is repeatable and reusable, it's a key element in our arsenal of tools – those proven templates that Capco brings to clients to accelerate the launch of a new digital product.

LAUNCHING THE NEW UNSECURED LENDING OFFERING

As the new digital unsecured lending product is rolled out, Capco tracks the benefits being realized and helps clients pivot from monitoring legacy performance measures to modern ones, achieving even more aggressive goals. For example, by identifying and prioritizing profit drivers, we can evaluate the type and level of investment needed to achieve the maximum impact on:

- Operating cost
- Loan balance growth
- Customer acquisition
- Customer experience

Our methodology for deploying next-generation technologies and new business models enables clients to rapidly attain their strategic vision. We shape winning, market-ready strategies that embody your vision of your brand in the marketplace. We guide you through critical decisions, apply rigorous logic to rethinking business processes, and bring your bank to the forefront of the digital landscape.

CAPCO DELIVERS VALUE TO CLIENTS

CAPCO IMPROVES SPEED TO MARKET COST-EFFECTIVELY:

Results are accelerated by leveraging Capco's knowledge, hands-on expertise and templates to develop the required strategy and execution artifacts to properly approach the unsecured lending market.

CAPCO DELIVERS AN INVENTORY OF CUSTOMER JOURNEYS:

We develop these to enhance customer experience while creating definition and bringing substance to the target operating model. This methodology is effective and proves useful for future initiatives at the bank.

CAPCO BUILDS AND MAINTAINS AN AGILE ENVIRONMENT:

Capco practitioners are current on the latest agile delivery methods and work hand-in-hand with clients to deploy iteratively to meet business objectives. Agile training and migration to legacy staff is a core offering.

When you engage Capco, in the United States or globally, we will work with you to define your strategy to enter the digital unsecured lending market or enhance your existing offering to make it more competitive. Capco will help you select customer segments and journeys, and identify ways to engage the right fintech partners to achieve your strategic objectives.

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ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivaled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward. Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize in banking, capital markets, wealth and investment management, and finance, risk & compliance. We also have an energy consulting practice. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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