A New Paradigm in Loan Marketing

HARLAND CLARKE®

TABLE OF CONTENTS

INTRODUCTION

Growing a financial institution's loan portfolio is an ongoing priority for bankers. But reaching those lending goals is more challenging than ever, as banks and credit unions grapple with a financial industry that, having survived the financial crisis, is now being transformed by technology, the imperatives of big data, and the emergence of new and non-traditional players on the lending landscape.

Consumers, having experienced the digital revolution in other industries, expect their banks and credit unions to step up and meet their evolving preferences. Across the board, financial institutions are expected to invest in digital solutions that drive loyalty and engagement.

A strong economy is driving consumer confidence levels to their highest point in almost 20 years. That means consumers are in the market for loans and other credit products. Banks and credit unions are in good financial shape with generally healthy loan portfolios. They're ready to lend, but marketplace competition today is different — and it's intensifying.

As a result, loan marketing has changed considerably just in the past few years.

The financial crisis of 2008-2009 was a major inflection point surrounding the level of trust consumers place in traditional financial institutions. The crisis helped open the door for smaller companies to serve businesses and consumers who may not have previously trusted "startups" with their money.

Alternative lenders, notably in the technology sector, were able to take root and begin taking real market share in loan origination. And it started eroding the traditional model of using one bank or credit union for all financial needs, something financial institutions have relied on to drive revenue and maintain competitive advantage.

Thousands of new non-traditional startups are challenging banks and credit unions by innovating on both price and service — using data and analytics to provide "always on" targeted loan offers to more consumers at competitive prices.

Yet incumbent lenders are not on the verge of mass extinction. For financial institutions to succeed in today's consumer lending marketplace, the answer is mass adaptation.

Adaptation in the form of a new model, or paradigm, for loan marketing, using the latest in technology and data analysis to automate, target and assess risk, allowing banks and credit unions to be in the loan marketplace continuously, with the right value proposition for the right audience at the right time.

CHAPTER ONE

Consumer Lending: A Priority for Financial Institutions

Loans are the lifeblood of a financial institution.

For most banks and credit unions, lending is the principal business activity, with the loan portfolio usually holding the status of largest asset and predominant earning stream. Serving as a source of credit to businesses and consumers is vitally important to the health of the financial system and the economy as a whole.

On the consumer side, today's lending environment is more dynamic and competitive than ever. The lending marketplace is active again after years of low demand. After the financial crisis and the banking retrenchment and recovery, banks and credit unions are operating from a position of strength and eager to be active players in the lending market.

However, there are some signs of underwriting caution amid intense competition from both traditional banks and credit unions and online lenders that are making this market more challenging.[1]

Ten years removed from the depths of the financial crisis, how important is consumer lending to the health of financial institutions?

By all accounts the worst is behind us, with capital positions improved at financial institutions of all asset classes. And with expectations for a loosening of federal banking regulations, as well as the recent passage of tax reform and rising interest rates, U.S. banking could very soon be back to pre-financial crisis returns on equity — with loan growth playing a key role.[2]

For financial institutions, the 2017 tax law has the potential to free up capital that will ultimately be put back into the economy in the form of loans and credit products.

And while the cost of compliance is significantly higher than before the financial crisis, potential rollbacks to parts of the Dodd-Frank Act, such as those approved by the House of Representatives in May 2018, are welcomed news for community banks and credit unions, who have struggled to meet many of the same requirements as their larger counterparts.[3]

Even prior to these latest developments, though, a look at financial institutions' balance sheets reveals that consumer lending is showing renewed strength.

[1] Independent Banker, "Consumer lending: Tough competition, niche opportunities," Jan. 2, 2018
[2] American Banker, "Six Takeaways from FDIC's 4Q Report on Banks' Health," Feb. 27, 2018
[3] The New York Times, "Congress Approves First Big Dodd-Frank Rollback," May 22, 2018

CHAPTER ONE

Consumer Lending: A Priority for Financial Institutions

The total number of consumer loans issued by banks and credit unions has risen in every quarter since mid-2013, with more than 20 million consumer loans added to the books from the fourth quarter of 2016 to 2017, and loan balances are rising.[4]

Interest income is making a bigger contribution to banks' strong earnings performance. FDIC-insured institutions reported aggregate net income of $47.9 billion in the third quarter of 2017, up over 5 percent from a year earlier, mainly attributable to a 7.4 percent increase in net interest income.[5]

For the fourth quarter of 2017, the FDIC reported higher loan growth, higher net interest margin, fewer "problem banks," and continued growth in the Deposit Insurance Fund. For community banks, net interest income was up significantly as net interest margins improved and their loan growth outpaced that of the overall industry.[6]

As loan growth intensified, financial institutions took proactive steps to manage their portfolios. Banks set aside 8.9 percent more in their loan-loss provisions in the fourth quarter of 2017 from a year earlier. And banks also charged off $1 billion more in delinquent loans during the fourth quarter.[7]

On the negative side, net charge-offs rose 8.6 percent in 2017 from a year earlier, led by higher credit card balances, which offset declining charge-offs for C&I loans, home equity and mortgage loans. This marked the ninth consecutive quarter that net charge-offs increased.[8]

But industry economists saw sustained strength in the availability of bank loans in 2018 and beyond, and expected delinquency and charge-off rates to remain near historical lows.[9]

Community banks — which represent 92 percent of insured institutions — reported net income of $6 billion in the third quarter of 2017, up 9.4 percent from a year earlier. Year-over-year profitability grew on gains in net interest income, driven by growth in higher-yielding loans.[10]

Both quarterly and annual loan growth rates for community banks continued to exceed those of the industry as a whole. Small-bank loan growth overall outpaced loans at bigger banks midway through 2017, with community banks reporting a 2.7 percent increase in loan balances from the previous quarter. Loan balances overall at community banks increased by nearly 8 percent from 2016.[11]

The nation's federally insured credit unions also turned in a strong performance on the lending front. In the fourth quarter of 2017, aggregate net interest margin widened by 10.9 percent year over year. Total loans outstanding increased by just over 10 percent for the year, and total assets were up by almost 7 percent. With a watchful eye, the credit union system's provision for loan and lease losses rose almost 26 percent in the fourth quarter of 2017 from the same period in 2016.[12]

[4] TransUnion, "Consumer Credit Origination, Balance & Delinquency Trends: Q4 2017," Feb. 28, 2018
[5] FDIC, "FDIC Quarterly 2017 Volume 11 Number 4," Jan. 11, 2018
[6] American Banker, "Six Takeaways from FDIC's 4Q Report on Banks' Health," Feb. 27, 2018
[7] Ibid.
[8] Ibid.
[9] ABA, "Bank Economists See Solid Economic Growth Supported by Tax Reform," Jan. 19, 2018
[10] FDIC, "FDIC Quarterly 207 Volume 11 Number 4," Jan. 11, 2018
[11] Ibid.
[12] NCUA, "NCUA Releases Q4 2017 Credit Union System Performance Data," March 5, 2018

CHAPTER ONE

Consumer Lending: A Priority for Financial Institutions

That's not to say there aren't challenges ahead. Banks are facing weakness in commercial lending, while credit unions are being challenged in the mortgage and auto lending sectors. That's reflected in one survey that noted bankers' concerns about the interest rate environment, and the related cost of funds — both issues jumped in terms of importance for banking CEOs in 2018.[13]

But overall, the generally positive outlook on banking performance and lending has bankers in a bullish frame of mind, with nearly three quarters of bank and credit union CEOs optimistic about 2018 and the years ahead.[14] A recent global survey of bankers found that the majority expected revenues and profit to improve in the near term (12 months – 3 years).[15] And while bankers are optimistic about performance, they also believe that "driving growth and profitability," will be one of their top challenges, according to a third survey.[16]

Financial institutions have regained their footing in terms of performance, with loans playing a major role. But continued growth of loan portfolios is not a given. The consumer lending outlook is positive for banks and credit unions that can manage both growth opportunities and potential headwinds.

[13] Cornerstone Advisors, "What's Going On in 2018"
[14] Ibid.
[15] EY, "Banks Shift Priorities Toward Growth Digitization and innovation," Jan. 16, 2018
[16] CSI, "Banking Priorities Executive Report 2018," Jan. 22, 2018

CHAPTER TWO

Economic Growth Spurs Consumer Lending

American consumers finally put the Great Recession behind them, once and for all, in 2017. The U.S. economy grew slowly but steadily throughout the year, and as the nation's longest economic expansion entered its ninth year, signs pointed to continued positive performance.

Taken together, the leading economic indicators showed overall strength in consumer lending, and opportunities for financial institutions to provide a range of credit products across the consumer-lending spectrum.

Overall, the economy continued to grow steadily. The GDP growth rate was expected to remain between 2 to 3 percent in 2018, comparable to 2017, with estimates of it reaching almost 3 percent.[17] But with that good news came warning signs in the form of rising wages and higher producer prices, and the prospect of rising inflation.

Inflation, as measured by the Consumer Price Index (CPI), though slowly rising, remained manageable, with annual inflation rates from 2016-2017 averaging 2.1 percent. But it will be important for financial institutions to keep a close eye on how quickly inflation rises. January 2018's CPI jumped by .5 percent, higher than expected, and could lead to higher borrowing costs sooner rather than later.[18]

The labor market has been strong: new jobs totaled 2.1 million in 2017, compared with 2.2 million in 2016. As of mid-2018, economists considered the economy to be operating beyond full employment, putting further upward pressure on wages, supporting additional consumer spending. Forecasts predicted the unemployment rate would decline further by year's end, further accelerating wage gains.[19]

The 2017 tax reform law brought lower tax burdens on many households, in addition to tax cuts for businesses of all sizes, promising a positive domino effect on employees in the form of higher wages and bonuses, in addition to business investment that creates new jobs. More money in peoples' pockets gives buying power a further lift, supports consumer lending, and makes consumer debt more manageable.

Median household income (adjusted for inflation) has continued to recover and as of 2016 had inched up to $59,039, just above the last previous high achieved in 2009 at the start of the Great Recession.[20] Consumer spending in the fourth quarter of 2017 continued its upward trend, rising at the fastest pace since 2014.[21]

Taken together, these positive economic indicators have driven consumer confidence, and confidence is clearly on the rise.

In February the Consumer Confidence Index reached its highest level since 2000, based on consumers' perception of current business and employment conditions, and their expectations for the next six months.[22]

[17] The Conference Board, "The Conference Board Economic Forecast for the U.S. Economy," Feb. 14, 2018
[18] CNBC, "Consumer prices jump much more than forecast, sparking inflation fears," Feb. 14, 2018
[19] ABA, "Bank Economists See Solid Economic Growth Supported by Tax Reform," Jan. 19, 2018
[20] Associated Press, "American Household Income Up Over Pre-Recession Levels," Sept. 12, 2017
[21] Reuters, "U.S. consumer spending rises; savings drop to 10-year low," Jan. 29, 2018
[22] The Conference Board, "Consumer Confidence Index Increased in February," Feb. 27, 2018

CHAPTER TWO

Economic Growth Spurs Consumer Lending

Importantly for financial institutions, the primary motivation for consumers' purchase decisions has shifted from a focus on price discounts and interest rates, to increased confidence in their future job security and wage growth, as well as the growth in their overall financial assets. As of mid-2018, consumer assessment of their financial situation is at its highest since 2000.[23]

Consumer confidence is also a key indicator of how consumers use credit. Analyses of consumer credit habits by Experian showed that credit scores have been trending up; as of 2017 they were almost back to pre-recession levels, with the average score coming in at 675, just four points shy of the 2007 average of 679.[24]

Other important indicators of credit health (e.g., how much credit consumers are using, repayment trends) were also in positive territory. In addition, consumers have experienced historically low debt-to-income ratios, although aggregate household debt balances were up across lending sectors.[25]

It bears close watching as to whether consumer confidence and willingness to use credit will overwrite concerns about rising interest rates. With the Fed's decision to raise short-term rates in December 2017 — and with additional rate hikes expected in 2018 — consumers will have to factor the reality of higher rates into their credit decisions, as they consider new credit cards, mortgages, home equity loans and lines of credit, vehicle and personal loans.

As of mid-2018, consumer credit totals continue to rise. It was up $13.9 billion during January 2018 (compared with $19.2 billion in December 2017) to $3.86 trillion, up 4.3 percent from a year earlier. Nationally, more than 50 percent of non-revolving debt is from student loans, and 40 percent from vehicle loans.[26]

Overall, credit quality throughout 2017 remained stellar, although analysts expected a slight deterioration in 2018. Looking at the delinquency rates of credit products, forecasts were that serious delinquency rates for unsecured personal loans would hold steady, while mortgage delinquency rates would drop in another steep decline. On the other hand, it's expected that auto loan and credit card delinquency rates would rise slightly.[27]

Late payments for both auto loans and credit cards hit their highest levels in four years in 2017, prompting a number of financial institutions to slow down growth in those areas. But at the same time, rising home values seemed to buffer home equity loans and lines of credit.[28]

Forecasts for consumer credit markets for 2018 were generally positive, though. The prime interest rate was still well below historic norms, at levels that can still be well managed by most consumers. As mentioned earlier, the growth in credit use was more a reflection of positive consumer sentiment, rather than an indication of consumers struggling to keep up with their obligations.[29]

[23] Bloomberg, "US Consumer Sentiment Tops Estimates on Jobs and Income, Feb. 2, 2018
[24] Experian, *State of Credit: 2017*, Jan. 11, 2018
[25] Ibid.
[26] ABA Banking Journal, "Consumer Credit Growth Continued in January," March 1, 2018
[27] TransUnion, "2018 Predictions: Consumer Credit, Balance and Delinquency Rates," Dec. 20, 2017
[28] Five Pivotal Questions for Banks in 2018, American Banker, Jan. 3, 2018
[29] Ibid.

CHAPTER TWO

Economic Growth Spurs Consumer Lending

Lending Trends and Opportunities

Auto Loans

As of mid-2018, over 90 percent of American households owned a vehicle, obtaining loans to purchase about 86 percent of new vehicles and 53 percent of used vehicles. On average, U.S. consumers have owned their cars for about 6.5 years.[30]

Auto lending is a weak spot for financial institutions, having reached saturation levels as a product offering at banks and credit unions. Concerns have been expressed about a lack of profitability due to overheated competition as well as lower used-car values. This is confirmed by growth in auto lending in 2017 of just 2 percent, the slowest pace of any reported lending category.[31]

Overall loan balances were at their lowest year-to-year from the third quarter of 2016 to 2017 since the same period in 2012. Serious delinquency rates were at their highest level in the third quarter of 2017 since the same quarter in 2009.[32]

Most experts agree that 2017 was the peak of consumer demand for new car loans, with demand since then leveling off. Additionally, longer loan terms and longer vehicle lifespans are changing consumer buying habits. Auto loans continue to lengthen, reflecting millennials' growing impact on the auto loan market.

On average, Americans have extended new car loans over 69 months, while the average used vehicle loan has a term of just over 64 months. Prices of new vehicles rose more than 10 percent from 2013-2018 as consumers bought more trucks and SUVs. Higher interest rates also contributed to longer loan terms.[33]

NADA projects that 16.7 million new cars and light trucks will be sold in 2018, slightly down from 2017.[34] Analysts also expect to see a shift to more used car sales to offset the slowing demand for new vehicles. The sector should also see a larger push from manufacturers' captive lenders in offering financial incentives for new car sales, combined with rebates to keep production levels consistent.[35]

Banks are showing signs of either retreating from or strategically restricting credit in the auto market. Credit unions have continued to gain market share in this sector, but not at the same pace as they did in 2016-2017.[36]

Personal Loans

Personal loan balances and consumer participation are experiencing continued growth, as the market has rebounded strongly from the Great Recession, with performance driven primarily by the rise of fintechs.

Although the rate of growth has cooled in 2018, the number of personal loans has steadily increased in recent years. Total outstanding balances rose from about $45 billion in 2012 to $106 billion in 2017.[37]

[30] CFPB, "CFPB Report Finds Sharp Increase in Riskier Longer Term Auto Loans," Nov. 1, 2017
[31] Federal Reserve, *Community Banking in the 21st Century*, October 2017
[32] CFPB, Nov. 1, 2017
[33] CNBC, "Americans borrow record amounts for auto loans even as interest rates rise," March 2, 2018
[34] NADA, "NADA Forecasts 16.7 Million New-Vehicle Sales in 2018," Dec. 1, 2017
[35] Credit Union Journal, "Will Credit Union Auto Lending Shift Gears in 2018?" Jan. 29, 2018
[36] Ibid.
[37] TransUnion, "FinTechs Taking Larger Share of Personal Loan Market," Nov. 2, 2017

CHAPTER TWO

Economic Growth Spurs Consumer Lending

Fintech lenders continue to gain market share while maintaining their portfolio risk-return performance. At the end of 2017, fintechs represented 30 percent of all personal loan balances, compared to 4 percent in 2012 and less than 1 percent in 2010.[38]

Consumers are largely using personal loans to consolidate debt or perhaps fund an unexpected event or purchase. Since the Great Recession, the second quarter has been the peak period for personal loan originations: consumers overspend during the holidays and face other end-of-year expenses. With bills coming due in the first quarter, and with high APRs on revolving cards, many consumers turn to personal loans to consolidate debt and lock in more reasonable rates.[39]

In addition, the growth of online lenders has attracted millennials, who don't typically have the home equity for a secured loan, in need of funds to consolidate debt.

Expectations are for continued growth in this sector, especially among prime and above borrowers. The share of personal loans issued to sub-prime borrowers has dropped in recent years, and as of the third quarter of 2017 stood at 26.3 percent.[40]

Delinquencies should remain steady, as originations skew toward lower risk consumers, shifting from an expected 3.37 percent at the end of 2017 to 3.36 percent at the close of 2018.[41]

Despite the growth of fintech market share, no one expects banks and credit unions to cede ground willingly. Consumer lending is no longer a sector that can be grown with little effort — by anyone. As competition heats up, fintechs and traditional financial institutions must work harder to be successful.

Credit Cards

The credit card market continues to expand, although at a slower rate than in recent years, spurred by steady consumer spending and solid job gains.

For the third quarter of 2017, the number of new accounts was at its lowest in more than six years. Similarly, the total number of open accounts rose 4.6 percent on a yearly basis, falling short of the previous year's 8 percent average annual growth rate.[42]

According to Experian, Americans are carrying 3.06 credit cards on average, which is up 1 percent compared to 2016. Credit card debt is at a record high for American consumers. The $786 billion in credit card debt in 2017 topped the previous record of $737 billion in 2008. It also represented a near 7 percent increase from 2016.[43]

Higher debt levels are a reflection of the rise in sub-prime and near-prime credit card originations in 2016 and the first part of 2017. However, the risk distribution of new accounts is stabilizing and has moved toward near prime and better.[44]

[38] Ibid.
[39] SuperMoney, "2018 Personal Loan Industry Survey," Jan. 10, 2018
[40] TransUnion, "2018 Predictions: Consumer Credit, Balance and Delinquency Rates," Dec. 20, 2017
[41] Ibid.
[42] ABA, "ABA Report: Credit Card Market Continued to Expand in Third Quarter," Jan. 30, 2018
[43] Experian, "Which States Have the Most Credit Cards?" Feb. 21, 2018
[44] TransUnion, Dec. 20, 2017

CHAPTER TWO

Economic Growth Spurs Consumer Lending

Consumers have shown to be spending responsibly. Balances remain low when compared to disposable income. And delinquency rates are much lower than at the height of the Great Recession.[45]

There is a warning sign for smaller banks, with reports in the first quarter of 2018 of rising losses over the previous year. Charge-off rates hit 7.2 percent in the fourth quarter of 2017, up from 4.5 percent in 2016, according to Federal Reserve data.[46]

As a product offering, credit cards have grown in importance for smaller banks in recent years, although there is a modest dollar amount of lending associated with them — less than 1 percent of total loan portfolios. (As contrasted with the 10 percent of lending portfolios for banks with total assets over one billion).[47] So close monitoring of this sector is warranted going forward.

Credit unions also have opportunities to grow their credit card portfolios. According to TransUnion, 43 percent of members don't carry a credit card with their credit union, and the risk distribution among these members is in the prime and above risk tiers.[48]

Mortgages/Home Equity Loans

2017 didn't turn out as expected in the housing market. Predictions of higher interest rates, a higher rate of housing starts, and moderate price growth failed to materialize. Instead, inventory tightened, mortgage rates barely moved, and, though new home construction picked up at the end of the year, it wasn't at the starter home price points where inventory is needed most.

As of early March 2018, mortgage rates had been on the rise for nine consecutive weeks, up to 4.46 percent, the highest level since January 2014.[49] Rising rates, as well as the continuing struggle with low supply levels, led to a decrease in home sales in January 2018 of 4.7 percent compared to December 2017, according to the National Association of Realtors. It was the lowest point in nearly four years and was felt especially hard in the lower end of the market.[50]

Despite these challenges, experts predicted underlying demand for homes in 2018 would remain strong, as consumers enjoyed a strong job market and the best year for wage growth since the Great Recession. While potential buyers may delay home buying decisions as they figure out the impact of the 2017 tax law on their purchase plans, pent-up demand from renters who stayed out of the market could win out as the year progresses.

Of course that assumes there will be houses for them to buy. The general consensus is that inventory will pick up slightly in 2018, although the standard assumption that demand and strong prices will prompt more construction did not hold true in the first half of the year. Home prices were expected to continue to rise in 2018, but the rate of increases should slow.[51]

[45] Experian, Feb. 21, 2018
[46] Wall St. Journal, "Credit-Card Losses Surge at Small Banks," March 4, 2018
[47] Federal Reserve, October 2017
[48] Ibid.
[49] Freddie Mac, "Mortgage Rates Push Higher," March 8, 2018
[50] CNBC, "Housing Weakness Deepens Nationally," Feb. 28, 2018
[51] Forbes, "Housing Outlook 2018: 6 Predictions From The Experts," Jan. 3, 2018

CHAPTER TWO

Economic Growth Spurs Consumer Lending

Mortgage delinquencies were expected to drop to 1.65 percent by the end of 2018, the lowest level observed since 2005. This positive trend was impacted by rising house prices and lower unemployment. Consumer mortgage delinquency rates have now declined almost every quarter since peaking at 7.21 percent in the first quarter of 2010.[52]

Freddie Mac is keeping an eye on three trends for 2018: increased purchase origination volumes, slower rates of re-fi activity, and borrowers tapping into home equity.[53]

While rising interest rates will likely slow down refinancing activity, with rising home prices there's an expectation that more homeowners will take advantage of their home equity. One forecast expected around 1.6 million HELOC originations in 2018 and about 10 million through 2022. This is a stark contrast to the previous five-year period, when less than half that number was opened.[54]

For smaller banks, mortgage lending remains a prominent activity, although the increased regulatory burden involved has caused frustration due to the difficulties in processing mortgage loans. Credit unions can also look to mortgage originations, where they have lagged non-credit union lenders in originations for first-time homebuyers.

HELOCS continue to be an important component of lending portfolios, offered by almost 80 percent of banks surveyed, and growing due to an expanding market and desire to meet the competition. However, they represent only about 4 percent of loan portfolios for community banks, with regulatory costs perhaps a factor in their limited presence.[55]

Overall, the growing economy, strong housing market and solid underwriting criteria, have led to an extremely low level of risk for mortgage and home equity lenders, and it's an area that should continue to be a focus for banks and credit unions as they seek lending growth.[56]

[52] HousingWire, "TransUnion: Mortgage Delinquency Rates Hit Lowest Point Since Recession," Nov. 5, 2017
[53] Freddie Mac, *Maintaining Momentum: 2018 and Beyond, Jan. 18*, 2018
[54] TransUnion, "Consumer Credit Market Expected to Remain Strong in 2018," Dec. 13, 2017
[55] Ibid.
[56] Federal Reserve, October 2017

CHAPTER THREE

Lending Competition Heats Up

A growing economy puts more consumers in the market for loans and other credit products, but how can financial institutions differentiate themselves in an increasingly competitive marketplace?

Competition in consumer lending has become fierce in recent years. Banks and credit unions are facing a new challenge in the form of non-traditional players in the lending marketplace, as fintechs — in particular peer-to-peer (P2P) lenders — have ridden the digital wave to new prominence with competitive loan products, meeting consumer demand for speed and convenience as part of the customer experience.

Lending was among the earliest segments of financial services to be disrupted by the technology revolution. Fintech lenders emerged in the wake of the financial crisis, and as traditional lenders were forced to the sidelines to regroup and conform to new lending rules, these market disrupters took advantage of the lending vacuum.

Backed by tens of billions of dollars globally in venture capital and growth equity, they've created business models that avoid the structural and regulatory formalities of traditional depository institutions.

With varying funding models and risk profiles, what they have in common is a foundation built on technology, with a lending process that proves the customer experience bar set by large tech firms, such as Apple and Amazon, can be met in financial services.

Over the past decade, online alternative lenders have evolved from platforms connecting individual borrowers with individual lenders (P2P) to sophisticated networks featuring institutional investors, direct lending (on their balance sheet), and securitization transactions.

Banks and credit unions traditionally offered customer service to borrowers and were the lenders. Today, P2P fintech startups build platforms that match lenders and borrowers. While such issues as consumer privacy and risk management are essential parts of the process, fintech companies don't need to provide consumer loans on their own. These changes affect every aspect of the process, including how consumers engage with lenders, how profits are generated, how loan applications are assessed, and the underwriting process.

"Silicon Valley is coming," signaled JP Morgan Chase CEO Jaime Dimon in an annual letter to shareholders. "There are hundreds of startups with a lot of brains and money working on various alternatives to traditional banking."[57]

Online alternative lenders have experienced explosive growth since 2010, although their total volume of business is nowhere close to traditional lending. In 2015 fintech consumer lending reached $28.5 billion, 12.5 percent of total consumer lending.[58]

[57] McKinsey & Company, *Cutting Through the FinTech Noise: Markers of Success, Imperatives For Banks*, Dec. 2015
[58] Federal Reserve Bank of Philadelphia, *Working Paper No. 17-17, Fintech Lending: Financial Inclusion, Risk Pricing, And Alternative Information*, July 2017

CHAPTER THREE

Lending Competition Heats Up

According to a 2016 TransUnion report, in 2015 there were 51 more lenders that were generating at least 10,000 annual installment loan accounts than there were in 2010. In 2010, fintech lenders represented only 3 percent of the personal loans sector. Banks, credit unions, and traditional finance companies each had roughly one-third of the market. In 2015, fintech lenders became the biggest lender type in the personal loan segment with 30 percent share.[59]

No doubt, there have been ups and downs for alternative lenders. 2016 was a rough year, as two prominent fintech companies saw their market valuations drop, and others had to either temporarily stop issuing loans or cease business altogether. The industry as a whole has faced heightened skepticism about its long-term profitability and growth prospects.[60]

But while the initial predictions that fintech companies would achieve complete domination of the lending market were off-base, so are forecasts that foresee a major industry shakeout anytime soon. Reports have shown growth and stabilization in key metrics such as balances and delinquency rates.[61] And while more consolidation is expected, in addition to partnerships with traditional financial institutions, fintechs in the consumer lending space are not going away.[62]

Startups are entering the market daily with new models for a range of consumer loan products, including mortgage origination, short-term personal loans linked to specific retailers, home improvement project loans, and loans to sub-prime borrowers. With funding models that allow for zero interest, flexible repayment terms and low fees, they're providing consumers with credit in a far easier and seamless way than has been available in the past.

What's the secret to the success of these lending market disrupters?

Key priorities: speed, ease of use, transparency and the use of expanded data sources. The result: the ability to identify and ultimately increase the number of potential lending customers, and get funds into consumers' hands quickly.[63]

Regardless of the type of loan, fintech companies pride themselves on offering faster application, approval and funding times, especially compared to traditional lenders. Online lenders can approve and fund loans in less than 24 hours, and some companies are even faster.[64]

Fintechs utilize a massive number of data points to determine how likely the borrower is to repay the loan. Thinking beyond traditional loan origination guidelines and risk attributes like credit score and job history used by traditional lenders, they are accessing alternative data sources, including social media, medical and insurance claims, utility and cell phone data to predict risk.[65] This data can be collected and analyzed within seconds to create a snapshot of the borrower's creditworthiness and likelihood of repaying the loan.

[59] TransUnion, "Consumer Credit Growth, Balance & Delinquency Trends: Q2 2017," Sept. 12, 2017
[60] Entrepreneur, "Online Small-Business Lending Is Set to Bounce Back," March 22, 2017
[61] TransUnion "Consumer Credit Market Expected to Remain Strong in 2018," Dec. 13, 2017
[62] World Economic Forum, *Beyond Fintech: A Pragmatic Assessment of Disruptive Potential in Financial Services*, August 2017
[63] The Financial Brand, "Digital Borrowers Expect Money in Seconds…Not Days," Feb. 12, 2018
[64] Finance Monthly, "Personal Loans Market Biggest FinTech Threat To Incumbent Banks," Nov. 27, 2017
[65] Consumer Financial Protection Bureau, "Using alternative data to evaluate creditworthiness," Feb. 16, 2017

CHAPTER THREE
Lending Competition Heats Up

Of course, this level of data analytics also has a potential downside. Non-traditional lenders have been more willing to expose themselves to regulatory risk around using alternative data sources for underwriting or leveraging emerging technologies like machine learning in their underwriting algorithms.[66]

Contrary to what may be expected, delinquency and default rates on online loans are trending far below traditional norms. Some attribute this to larger loans taken by the most creditworthy consumers. However, research suggests that the key is the emergence of new financial technology that provides an unprecedented level of insight into consumer credit trends and behavior.

For example, in research done by the Philadelphia Federal Reserve Bank, they found that Lending Club's use of additional information not already incorporated in traditional FICO scores allowed them to enlarge the pool of borrowers by assigning better loan ratings and offering lower-priced loan products.[67]

In addition, they are using machine learning algorithms to implement customer engagement strategies based on behavioral principles that encourage cardholders to improve their credit by paying off their debt faster and avoiding delinquency. In addition to increasing the number of borrowers, this lending approach can provide real value to consumers with little or no credit history by helping them establish and maintain a positive credit record.[68]

Fintech companies are also automating the underwriting process. The automation approach extends to risk assessment as well, and this helps to speed up the lending process. Ultimately, automation lowers operating costs, allowing fintechs to offer loans with competitive rates to borrowers.

Beyond Lending Club, which focuses on personal loans, other leading non-bank lenders include Quicken Loans and Lending Tree, two of today's top mortgage lenders. As of January 2018, Quicken Loans was the largest retail home mortgage lender — and the largest online lender — having overtaken Wells Fargo in the fourth quarter of 2017 with $25 billion in direct-to-consumer home loans, compared to Wells Fargo's $23 billion.[69] By the end of 2016, six of the nation's top 10 mortgage lenders were non-banks, while banks contribution to new mortgage loans fell to 21 percent.[70]

All told, a number of fintech consumer lenders — including Lending Club, UpStart, Prosper, SoFi, Kabbage, Avant, and one of the newest, Marcus, which was started by Goldman Sachs in 2016 and had loaned more than $2 billion by the end of 2017[71] — have become alternatives for consumers to easily access the funds they need when they need them. No matter what type and size of loan a consumer needs today, there are hundreds of online lenders that are convenient, always available, easy to work with, and fast when it comes to getting funds into borrowers' hands.

There is good news for banks and credit unions in that they don't have to cede the marketplace to these non-traditional lenders, but can apply fintech innovations (directly or through partnerships) to improve the customer experience, better manage credit risk, increase originations, and improve margins.

Fintechs may come and go, but the tools they use are here to stay. These and other alternative lenders can help banks and credit unions rethink how they compete. Understanding and adopting how fintechs deploy data and technology to provide consumers with best-in-class credit products can go a long way toward making financial institutions less vulnerable to future competitive threats.

[66] Ibid.
[67] Federal Reserve Bank of Philadelphia, Working Paper No. 17-17, *Fintech Lending: Financial Inclusion, Risk Pricing, And Alternative Information*, July 2017
[68] Ibid.
[69] San Francisco Chronicle, "Quicken Loans tops Wells Fargo to become No. 1 in retail home loans," Feb. 1, 2018
[70] Washington Post, "The mortgage market is now dominated by non-bank lenders," Feb. 23, 2017
[71] Digiday, "Goldman Sachs' Marcus is winning the personal loans arms race," Nov. 5, 2017

CHAPTER FOUR

The Transformation In Consumer Lending

As we've seen, there has been an influx of new players to the consumer lending marketplace. Some have staying power. Some don't. But all are taking full advantage of advances in digital technologies to meet consumer expectations. In the process, they have transformed the lending process.

The question is whether banks and credit unions will cede this ground, or make the changes necessary to remain competitive in the consumer lending space.

The fact is, despite rapid growth of online and mobile lending in recent years, many banks and credit unions are still just getting started. "It's not enough to just digitize the application or even digitize the process," says Youa Yang, Digital Banking Director at Barlow Research. "We have to transform the experience."[72]

Employing digital capabilities improves the borrower experience but also has benefits for lenders. Digital acquisition strategies and processes reduce costs, increase efficiencies and can lead to greater profitability.

What does today's borrower want from their lender, and how has the lending process evolved to meet their expectations in a way that is a win-win for both?

It's all about the interaction of technology and the consumer.

According to one survey, 70 percent of consumers feel that their relationship with banks today is transactional in nature, rather than "relationship-based."[73]

Millennials, especially, are feeling spurned. Having grown up in the digital age, this group is technologically advanced, focused on financial wellbeing and expecting personalized experiences and convenience from all industries. Yet, nearly half — 46 percent — don't think their financial institution markets products that are relevant to their future financial needs.[74]

For financial institutions, the road to profitable loan growth starts with a focus on the customer, not the product. A one-size-fits-all approach to lending does not work in today's market. Successful lenders are adopting new fintech tools that allow them to segment existing and targeted borrowers and design a customer experience suitable to each.[75]

Investments in data and analytics can be used to build ongoing engagement throughout the customer journey — in other words, understanding consumers and account holders in order to develop long-term, holistic relationships and not merely a series of one-off transactional processes.[76]

[72] American Banker, "Five Opportunities and Challenges in Digital Lending," Nov. 15, 2017
[73] Accenture, *2016 North America Retail Consumer Digital Banking Survey*, 2016
[74] American Banker, Nov. 15, 2017
[75] PwC, *Consumer Lending: Understanding Today's Empowered Borrower*, 2016
[76] The Financial Brand, "Banking vs. Fintech: A Business Case for 'Coopetition,'" Feb. 6, 2016

CHAPTER FOUR

The Transformation In Consumer Lending

Legacy systems were built around customer accounts, because they were meant to do transaction processing only. In today's financial services marketplace, migrating those systems from a transaction-based system to one centered on the account holder can enhance lending opportunities.

The data is there: loan data, transaction data, credit data — and other types of data can be incorporated (e.g., social media) in order to create a comprehensive profile of a customer. Analyzing that data can provide important insights across the customer base. For example, what's the average credit score of account holders? What is the average savings rate? How many of your members have a credit card or loan with a competitor?[77]

Analytics applied to data can help banks and credit unions further refine underwriting criteria — is it too narrow or too broad? Rates and rewards can be modeled to find what works best for both account holders and the financial institution. Match members with existing cards to those with features better suited to their usage needs.[78] Or leverage real-time data to take advantage of immediate opportunities when prospects are in the loan marketplace.[79]

A focus on the customer requires technology to deliver not only the right offer, but also to make the experience a positive one. Borrowers increasingly expect to interact digitally, and that includes receiving and responding to loan offers via multiple channels. Some borrowers still want to interact with a real person, especially in the case of complicated or unfamiliar lending transactions.

The takeaway is not to exchange one capability (digital) for another (call center), but to expand capabilities across all channels to provide a seamless and frictionless experience for consumers and account holders.

The fact is, consumers on the whole are wary about the lending process. According to one survey, 53 percent of borrowers expressed negative feelings about it, including 33 percent who said the loan process made them anxious.[80]

Many consumers remain confused and uncertain when trying to navigate the world of financial services and their own finances. While they may know the term "FICO score," they may have only a basic understanding of what it comprises, how their credit activity affects it, and what it will allow them to do. They don't have the knowledge they need to step forward into the loan marketplace with confidence.

In the past 10 years, credit-wary consumers have turned to new online sources instead of traditional financial institutions because they are comfortable interacting in that space. Sites like Credit Karma and Mint have changed how borrowers interact with lenders. They offer free online services, such as credit scores, credit monitoring, tax preparation and budgeting, and use the data from these tools to market tailored offers from lenders.

Consumers, especially younger borrowers, may rely on these online services to provide the best loan offers because — thanks to their online tools — they understand the value of their financial data and in return are receptive to tailored, preapproved offers.[81]

[77] The Financial Brand, "The Five Habits of Successful Data-Driven Financial Institutions," Oct. 17, 2017
[78] CU Direct, "Increasing Loan Portfolio Profitability is About More Than Reducing Losses," 2018
[79] The Financial Brand, "33 Tech Strategies Banks and Credit Unions Must Implement Immediately," Jan. 8, 2018
[80] Fiserv, "More Consumers Feel at Home With Online Mortgage Origination," Feb. 27, 2018
[81] Blackline Advisors, "Full Circle: Technology Brings Loan Origination Back to Community Banks," May 5, 2017

CHAPTER FOUR

The Transformation In Consumer Lending

According to research, 47 percent of consumers would be comfortable applying for a primary mortgage online. In fact, most want to complete the entire process online, from researching to signing documents, a trend that continues to move toward more online interaction.[82] One survey found that a majority of consumers prefer to apply for any type of loan online, especially younger borrowers, although some segments still prefer human interaction for some parts of the process.[83]

In today's omnichannel banking environment, account holders and prospects expect multiple options for researching loan offers, responding to offers, and connecting with the lender. If consumers respond to an offer via a smartphone, for example, they expect to switch to a different channel — online, in the branch, or the call center — and pick up the application process where they left off without losing their information.[84]

And while more financial institutions are migrating to cross-channel or even omnichannel marketing strategies, according to research too much focus remains in the online channel, when most traffic is in the mobile channel.[85]

As smartphones and other mobile devices have become more widespread, more consumers than ever are online constantly: 26 percent of American adults. For younger adults the percentage is even higher: 39 percent. Of adults with mobile connectivity, 89 percent go online daily and 31 percent are online almost constantly.[86]

Consumers want the ability to lock in rates, compare products and calculate affordability of payments — all from their mobile device. The most important mobile feature that consumers cite: the ability to calculate the loan amount they can afford.[87]

Beyond the engagement and loyalty benefits, there are also cost reasons to accelerate development of digital channels for loan marketing processes: each mobile interaction incurs a variable cost that's a tiny fraction of the cost for a teller or call-agent interaction.[88]

Investment in online is good; investment in mobile is even better.

Other industries feature frictionless online marketing, purchasing, and customer service options. Online lenders adopted those traits and have further raised the customer experience bar: while in the past it might have taken four days to process a loan, with today's technology it can be done in four minutes. Consumers say overwhelmingly that the most important factor in a loan decision other than relationships and product features (rate and terms) is the speed of the process.[89]

The bottom line: a transformed consumer lending process driven by fintech developments doesn't have to be a threat to financial institutions. Instead, it can help them better serve their account holders, reduce costs and improve profitability, both by emulation and collaboration.

Banks and credit unions hold powerful cards in the lending game. For one, they can build deep, lifetime account holder relationships across a range of products and services. Relationships can't be bought. Technology can, and can enhance the depth and quality of data used to offer targeted loan products and enhance customer experience. Financial institutions that can deliver a more personalized and efficient borrowing experience via a dynamic blend of digital and human service can win in today's — and tomorrow's — loan marketplace.

[82] Fiserv, "More Consumers Feel at Home With Online Mortgage Origination," Feb. 27, 2018
[83] PwC, *Consumer Lending: Understanding Today's Empowered Borrower*, 2016
[84] PwC, *(Don't) Take It To The Bank: What Customers Want In The Digital Age*, 2017
[85] Efma & Backface, *Omni-channel Banking: The Digital Transformation Roadmap*, 2015
[86] Pew Research Center, "About a quarter of U.S. adults say they are 'almost constantly' online," March 15, 2018
[87] PwC, *Consumer Lending: Understanding Today's Empowered Borrower*, 2016
[88] Efma & Backface
[89] PwC, *Consumer Lending: Understanding Today's Empowered Borrower*, 2016

CHAPTER FIVE

Loan Marketing That Empowers Today's Consumer

Trends in the lending environment have been positive, with consumers and financial institutions taking advantage of a growing economy and improved financial positions. But competition is intensifying like never before as disruptors continue to make inroads, using fintech advances to target consumers with increasingly personalized offers.

The good news is that developments in digital lending technology are now available for financial institutions of all sizes, leveling the playing field in a market crowded with non-banking lenders. By combining automation, targeting and risk assessment, banks and credit unions can get in front of account holders and prospects at the right time.

Here are some questions for financial institutions to consider when evaluating whether their current loan marketing programs are meeting expectations in today's marketplace:

- Are you collecting and analyzing the right kind of data? Do your prescreened offers accurately target eligible account holders and prospects on a recurring basis with one or multiple loan offers that meet their borrowing needs?

- Are you providing a loan acquisition experience that's multichanneled? Does it provide loan offers where consumers are: depositing a check via their mobile banking app, in a new car showroom, going through their mail, monitoring account balances on their financial institution's website, checking email?

- Are you removing friction from the customer journey? Can they conveniently access and evaluate prescreened loan offers, respond with one click (and no application), and get a quick reply?

- Are enough qualified consumers responding to your campaigns, and is the process cost-efficient, enabling you to reach your ROMI goals?

To answer these questions, let's look at how the loan marketing process has evolved, and how traditional financial institutions can use technology to meet consumer expectations as well as their own profitability goals.

The traditional loan marketing model used by many banks and credit unions waited on the account holder or prospect to walk through the doors or land on the website looking for a loan. With the advent of the three nationwide credit bureaus and automated credit decisioning software, financial institutions became proactive in consumer lending, mailing preapproved credit card and loan offers to account holders and prospects who met the institution's general credit criteria, as well as doing instant prescreens with applicants in real-time at the point of contact.

CHAPTER FIVE

Loan Marketing That Empowers Today's Consumer

But many prescreened loan offers lack two important 'Ts': timing and targeting.

These loan acquisition campaigns send mostly untargeted promotions for a single product to consumers on a pre-determined schedule, perhaps quarterly, or driven by interest rates or traditional peak demand periods (post-holiday debt consolidation, spring home buying, etc.).

In addition, they fail to take advantage of consumer data that financial institutions have access to — both in-house and from external sources — that can provide deeper insight regarding risk assessment, pricing, and targeting, all of which can identify account holders or prospects likely to be the most profitable and interested in specific loan types.

Financial institutions can differentiate themselves in the marketplace with a new model, or paradigm, for marketing consumer loans that use data-driven technology to generate timely, personalized prescreened offers, simplifying the loan acquisition process for the institution while improving the customer experience.

Harland Clarke's LoanEngine and Shopper Alert are complementary turnkey solutions that analyze credit profiles, identify the right candidates, communicate prequalified loan offers via multiple channels, and convert preselected leads to affordable loans.

Delivering tailored prescreened loan offers eliminates the hesitation that some consumers have when they see a loan offer that appeals to them. They don't have to worry about whether they qualify for the loan products or under what terms. It's all spelled out for them in the offer. The stress and anxiety this alleviates is similar to the "no haggle pricing" that has earned auto dealers such as Carmax high marks in customer service.

For example, Shopper Alert lets financial institutions know when prospects and customers are in the market for a particular type of loan. By keeping tabs on credit bureau loan inquiries on a daily basis, the system can then screen identified borrowers' creditworthiness against a financial institution's underwriting criteria.

A prescreened offer for the loan product the consumer is shopping for is communicated within 24 hours via multiple channels.

Consider the typical car-buying scenario. Most new car buyers devote a lot of time and energy researching the vehicle they want to buy, giving less attention to how they are going to pay for it. Then they endure the car-buying experience itself, which is fraught with high-pressure sales tactics, lack of pricing transparency, and often misleading verbal and written agreements. It's no wonder the typical consumer has little energy left to search for the best financing option, often going with the dealer's recommendation instead.

CHAPTER FIVE

Loan Marketing That Empowers Today's Consumer

On average, 60 percent of borrowers commit to a loan offer within one week of initiating their search.[90] Armed with the knowledge that a consumer is in the market *now* for a new car loan, financial institutions can deliver a preapproved auto loan offer at the very moment when a consumer is ready to act.

Javelin Strategy and Research has reported that banks and credit unions are more likely to achieve primary financial institution (PFI) status with their account holders by offering credit when it's needed most.[91] Instead of trying to engage a consumer with a prescreen offer they have no current interest in, lenders can be seen as a valuable financial partner when it matters most to the consumer.

Of course this type of trigger program doesn't fit all lending scenarios. The fact is only 3 to 5 percent of consumers are shopping for a loan in an average month.[92] In addition to loan marketing platforms based on consumer behavior, financial institutions can incorporate other technology-based solutions that proactively reach out to qualified account holders with a simple and convenient lending proposition.

LoanEngine takes a proactive approach, providing prescreened loan offers on a recurring basis to qualified account holders.

Using data streams from the financial institution and credit bureaus, account holders are prescreened on a recurring basis for multiple loan products. Starting with auto as the default criteria, products are added based on each institution's risk tolerance.

Thus, loan offers are targeted and vary according to account holder. New car purchase or refinance may be accompanied by HELOC, personal loan or debt consolidation. Offers can also include products that don't typically get a lot of marketing attention, such as RV and boat loans.

The result is a personalized set of preapproved offers — typically six to eight — that are unique to each account holder's financial profile, and the institution's risk tolerance and product portfolio. Offers are relevant — for example, a non-homeowner wouldn't get an offer for a HELOC — and include preapproved loan amounts, interest rates, and term length.

The platform then manages the communication of these offers across all of the institution's channels, including online, mobile app, direct mail, email, and within the branch and call center, offering a consistent customer experience with "one-click access" at all touchpoints.

Consumers save time because offers are available in whatever channel they choose, 24/7. They don't have to take the time to hunt through websites or visit a branch. Consumers can review their loan options and click to accept without fear of rejection. It's an easy process for digital consumers to understand as they can review and model loan options via simple visuals and interfaces.

The omnichannel capabilities of this type of loan marketing solution are consistent with higher response rates,[93] with the mobile and online delivery components being especially attractive to today's digital consumer.

[90] Harland Clarke client data, 2015-16
[91] Javelin Strategy & Research, "Convert 'Silent Attrition' into Banking Engagement and Profits," February 2015
[92] Harland Clarke client data, 2015-16
[93] Harland Clarke, Best Practices and Next Practices for Consumer Loan Growth Webcast, July 21, 2016

CHAPTER FIVE

Loan Marketing That Empowers Today's Consumer

With an emphasis on today's preferred digital channels, the consumer's ability to "click-to-accept" the offer can maximize loan processing efficiencies. It's no secret that the costs of processing in-branch transactions far outweigh the costs of processing the same transactions online — by more than 400-to-1.[94] When processing loan applications, the costs are even higher.

With a few taps, the consumer agrees to the loan they want and selects any other available options, giving them control over a loan process that turns out to be simple and convenient. The customer experience is a positive one.

Receiving these types of prescreened offers and having them continually available will shift the account holder's perspective and change the dynamic of the banking relationship.

Their financial institution is providing valuable transparency by showing them what their credit is worth. The institution is available to the buyer at the point of purchase, building a positive and more holistic customer relationship.

As account holders are continually rewarded with relevant loan offers, over time they'll come to expect their bank or credit union to have those loans available when they are in a specific purchasing market, further solidifying the primary banking relationship.

For financial institutions, optimal loan marketing strategies are those that deliver data-driven, personalized customer experiences that drive loyalty and engagement. By offering "always on" one-click consumer lending platforms, banks and credit unions can enjoy economies of scale that lower loan acquisition costs, increase return on investment, and provide an appealing way for account holders to interact with the institution.

[94] Javelin Strategy & Research

CONCLUSION

Banks and credit unions must contend with not only running their institutions but also transforming them to grow in a sustainable manner. These goals must also be balanced against an environment that is changing daily.

There are multiple challenges for financial institutions that want to grow their consumer lending business, from constantly shifting regulatory and compliance requirements to the impact of political events and macroeconomic developments. New competitors are hastening the introduction of technology-focused, data-intense analytics that can identify, target and convert consumers more quickly than ever, and do it with increasing cost efficiencies. Consumers themselves expect simple and convenient digital interactions with the companies they do business with, including their bank or credit union.

A new paradigm in consumer loan marketing that provides personalized, "always on" preapproved loan offers to digital consumers can be the win-win solution that provides account holders and consumers the convenience and transparency they demand at the scale and cost-efficiency to drive financial institution growth.

Banks and credit unions that identify and understand the challenges their loan marketing programs are facing from both outside and inside the institution, and find solutions that are technologically-driven and customer-focused, will be able to profitably compete while delivering an excellent customer experience.