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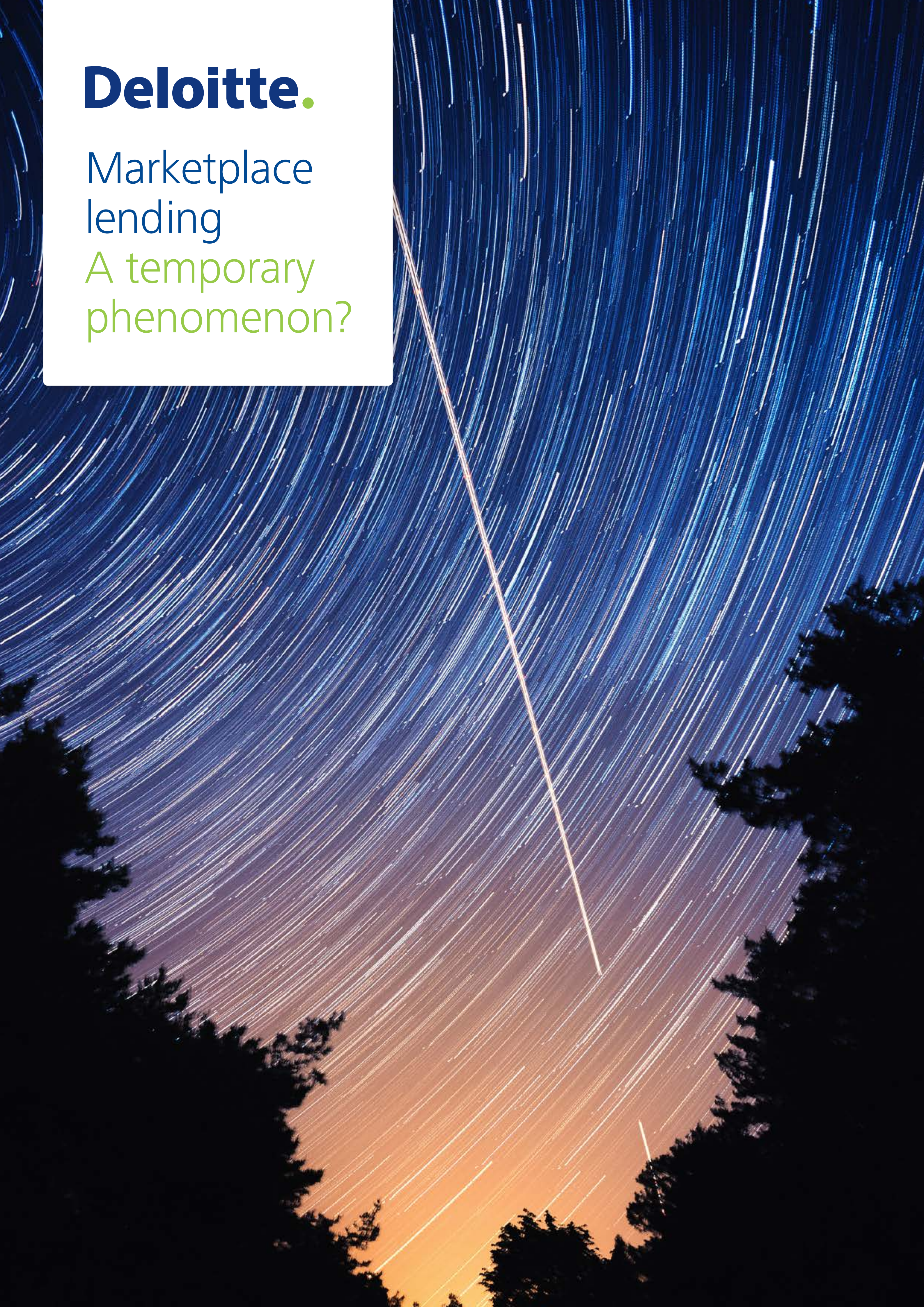
Marketplace lending
A temporary phenomenon?



Foreword

As explored in Deloitte's *Banking disrupted* and *Payments disrupted* reports, and Deloitte's *The Future of Financial Services* report, produced in collaboration with the World Economic Forum, a combination of new technology and regulation is eroding many of the core competitive advantages that banks have over new market entrants. These structural threats have arrived at a time when interest rates are at historic lows, and seem likely to remain 'lower for longer'. Combined with an increase in regulatory capital requirements, these changes are making the goal of generating returns above the cost of (more) capital a continuing challenge.

At the same time, customer expectations are changing. Consumers' experience of digital in industries such as retail, accommodation and transport is heightening expectations for convenience and immediacy. And consumers are increasingly willing to experiment with new providers, even for services where trust is required. This is creating ideal conditions for technology-enabled entrants to challenge the integrated banking model.

Marketplace lenders (MPLs) are leveraging all of these trends to attack one of the core profit-generating activities of commercial banks: lending. The MPL model is built around modern technology that enables highly-efficient customer acquisition, approval and servicing activities within a relatively light-touch regulatory environment. Most banks' operating models, by contrast, include legacy IT expenses, significant regulatory overheads and the mature collections and recoveries function that is needed to service an aged book. All these are factors that add to the average cost of a loan. Many commentators recognise the significant cost advantage that this will give MPLs and are highlighting the resultant disruptive threat that MPLs represent to the traditional banking business model.

Marketplace lenders (MPLs) are leveraging all of these trends to attack one of the core profit-generating activities of commercial banks: lending.

This report is our contribution to this debate. It is based on extensive research and analysis, including expert interviews and a survey of consumers and small businesses, which aim to answer the following questions:

- is marketplace lending a temporary phenomenon? Does it constitute a disruptive threat to banks' core lending and deposit-gathering business? Or is it, instead, a sustaining innovation, that does not fundamentally change the financial services landscape but may instead drive improved performance and pioneer the provision of credit into previously under-served segments?
- what should (and can) banks do to react to the emergence of the MPL model?

Our findings suggest that MPLs are unlikely to pose a threat to banks in the mass market. In the medium term, however, MPLs are likely to find a series of profitable niches to exploit, such as borrowing which falls outside banks' risk appetite and segments that value speed and convenience enough to pay a premium (for example SMEs, particularly in invoice financing, or high-risk retail borrowers). So while banks cannot afford to be complacent, they probably have more to gain than to lose from implementing a strategy of effective collaboration and partnering with MPLs.

Neil Tomlinson
Head of UK Banking

Executive summary

MPLs do not have a sufficiently material source of competitive advantage to threaten banks' mainstream retail and commercial lending and deposit-gathering businesses.

Marketplace lenders (MPLs) have recently gained prominence following rapid growth in markets like the UK, the US and China. This growth, along with an apparent investor appetite to provide them with equity funding and use them to channel funds directly into consumer and SME lending, has led some to predict profound disruption of the traditional banking model.

Unlike banks, which take in deposits and lend to consumers and businesses, MPLs do not take deposits or lend themselves. They take no risk onto their own balance sheets, and they receive no interest income directly from borrowers. Rather, they generate income from fees and commissions generated by matching borrowers with lenders.

This paper looks at the potential for MPLs to take material share from banks' core lending and deposit-taking businesses. It tests the hypothesis that, to be truly disruptive, MPLs would need to possess competitive advantages that create real customer value for both borrowers and lenders that incumbent banks cannot counter. As part of this research, Deloitte commissioned YouGov to conduct consumer and small-business research, and also spoke to several UK marketplace lenders, banks and investment managers. Deloitte also developed a UK 'MPL opportunity-assessment model', comparing the lending costs of banks and MPLs, and forecasting the future size of the MPL market.

Based on this research, Deloitte draws the conclusion that MPLs do not have a sufficiently material source of competitive advantage to threaten banks' mainstream retail and commercial lending and deposit-gathering businesses. Critically, banks should be able to deploy a structural cost of funds advantage to sustainably under-price MPLs if it becomes clear that the threat of lost volumes makes this the value maximising strategy. Three key observations underpin this conclusion:

- any operating cost advantage that MPLs may have is insufficient to offset the banking model's material cost-of-funds advantage. It is our view that in today's credit environment, the cost profiles of banks and MPLs are roughly equal, meaning neither has a material pricing advantage. However, Deloitte also believes that banks will have a structural cost advantage over MPLs if and when the credit environment normalises

- although borrowers currently value the benefits of speed and convenience offered by MPLs, these are likely to prove temporary as banks replicate successful innovation in this area. In addition, Deloitte believes that borrowers who are willing to pay a material premium to access loans quickly are in the minority

- our research suggests that most people understand that lending money via an MPL is not comparable to depositing money with a bank. This is largely due to the fact that MPL investments are not covered by the government's Financial Services Compensation Scheme (FSCS) which protects the first £75,000 of deposits. There may be times in the cycle where supply constraints in the banking sector make certain areas of marketplace lending a more attractive asset class. This is unlikely to be an enduring advantage, however, and the capital provided here is more likely to be deflected from fixed-income or equity investments rather than from bank deposits.

In this publication, 'we' and 'our' refer to Deloitte LLP, the UK member firm of Deloitte Touche Tohmatsu Limited.

We do not believe that the banking model will be fully disrupted by MPLs. Based on our market sizing analysis, MPLs will not be significant players in terms of overall volume or market share. However, we also do not believe that MPLs are a temporary phenomenon. They seem likely to become a permanent part of the landscape by performing at least two valuable functions:

- they may provide supply into areas of the lending market where banks do not have the risk appetite to participate, such as high-risk retail borrowers
- while the likelihood of a significant outflow of deposits from the banking system does not seem strong, MPLs may offer a low-cost option for certain investors to gain direct exposure to new asset classes.

So what, if anything, should banks do? Our fundamental view is that MPLs do not present an existential threat to banks and, therefore, that banks should view MPLs as complementary to the core banking model, not as mainstream competitors. We therefore believe that banks can, and should, evaluate a wide range of options for enhancing their overall customer proposition by partnering with MPLs. Options might include:

- providing easy access to such platforms for borrowing that is outside a bank's risk appetite
- keeping an eye on evolving credit models
- leveraging MPL technology to enhance the customer experience
- utilising elements of the MPL model to expand geographically without bearing the distribution and regulatory costs of the traditional bank model.

We do not believe that the banking model will be fully disrupted by MPLs. However, we also do not believe that MPLs are a temporary phenomenon.

1. What is marketplace lending?

This section is designed as an introduction to what marketplace lending (MPL) is and how the MPL model differs from the banks' traditional lending model. It also provides a snapshot of the state of the MPL market in the US and continental Europe for comparison with the UK.

The world's first MPL, Zopa, was founded in the UK in 2005. The first MPL in the US, Prosper, was founded in 2006, and the first in China, Paipaidai, was launched in 2007. Initially, such platforms enabled retail borrowers and investors to contact each other directly, or 'peer-to-peer' (P2P). More recently, institutions have begun investing in bundles of loans, prompting the sector to be named more accurately as 'marketplace lending.'

Unlike banks, which take in deposits and lend to consumers and businesses, MPLs do not take deposits or lend themselves. They therefore take no risk onto their balance sheets (see Figure 1). Nor do they have an interest income, but rather generate income from fees and commissions received from borrowers and lenders/investors.

Investors can select the return they require on their investment by specifying maturity or risk profile (based on an assessment of the credit risk represented by the platform) or through a combination of the two.

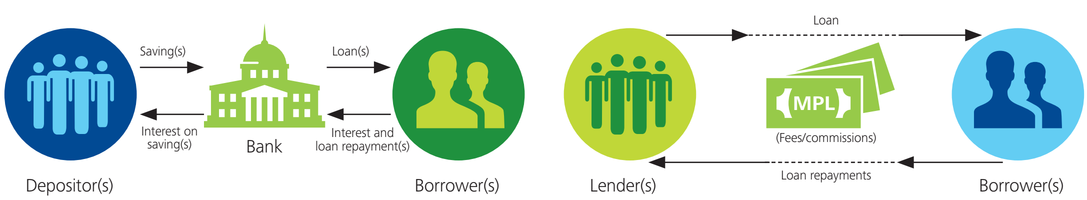
Most platforms split the money invested by lenders into smaller 'tranches' and lend it on to several borrowers. This 'embedded securitisation' aims to minimise the risk of default by spreading lenders' investments across a large number of borrowers.

MPLs generally update the risk-model algorithms that underpin their credit-scoring approach more frequently than banks do.[1]

In 2014, US$23.7 billion of loans were issued through marketplace lending platforms globally, concentrated primarily in the US (51 per cent), China (38 per cent) and the UK (10 per cent). The total grew at a CAGR of around 120 per cent between 2010 and 2014.[2] (Please see the US and European boxes below for more information on the respective markets).

Figure 1. Lending business models, banks vs MPLs

Traditional bank lending model	Marketplace lending (MPL)



Traditional bank lending model

- Banks act as an intermediary between savers and borrowers. They pay interest on deposits and lend money to consumers and businesses
- They generate income by taking risk onto their balance sheets and managing spreads between the interest banks charge on loans and that paid on savings
- This risk-taking requires them to hold capital to absorb potential losses
- Depositors have limited control or visibility over how their money is used
- Banks engage in maturity transformation as the deposits are typically shorter term than the loans, creating a need for a liquidity buffer.

Marketplace lending (MPL)

- Marketplace lenders directly match lenders with borrowers via online platforms
- They do not lend themselves, so they do not earn interest and do not need to hold capital to absorb any losses
- They make money from fees and commissions from borrowers and lenders
- MPLs use traditional, bank-like, credit-scoring approaches, and publicise these credit risk scores
- MPLs offer transparency and control to lenders, such as through disclosure on recipients of funds lent out
- Generally, by design, there is no maturity transformation involved.

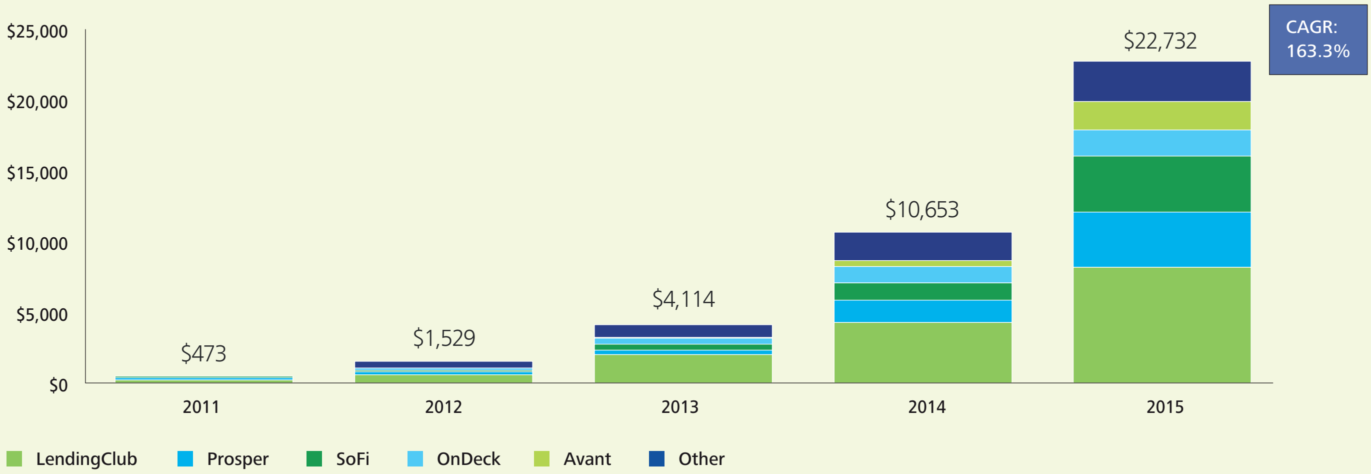
Source: Deloitte analysis

An overview of marketplace lending in the US

Current size of the market

It is estimated that marketplace lenders (MPLs) in the US accounted for loan originations worth approximately US$23 billion in 2015 (see Figure 2). LendingClub, an unsecured consumer lending platform, is the largest MPL in the US and originated US$8.4 billion-worth of loans in 2015.[3] While LendingClub accounts for a significant share of the market, many other players in the US lending marketplace are focused on a wide range of individual segments, such as student loans.

Figure 2. US MPL annual loan volumes, US$ million, 2011 – 2015*



Source: Direct Lending: Finding value/minimising risk, Liberum, 20 October 2015, p.6.
See also: http://www.liberum.com/media/69233/Liberum-LendIt-Presentation.pdf; Deloitte analysis
* Figures are rounded to the nearest million

Notary model

The widely adopted model for US marketplace lenders is the so-called 'notary' model,[4] in which:

- borrowers apply for a loan on a marketplace platform
- accepted loan applications are then originated by a partner bank (LendingClub and Prosper use Utah-based WebBank); the MPL performs the underwriting of the loans, using criteria agreed with the partner bank[5]
- platforms purchase the loan from the partner bank[6]
- the platform issues a note to lenders, instead of a contract.[7]

(Since February 2016, WebBank has held an interest in newly-issued loans sold via the LendingClub platform; in return, LendingClub pays a 'trailing fee' to the bank.)[8]

Institutional investors

Institutions, including hedge funds, private equity firms and banks, provide the bulk of lending through marketplace platforms in the US.[9] Such investors, which are able to use due-diligence services offered by intermediaries such as Orchard,[10] can also use their own risk models to 'cherry-pick' under-priced loans on the platforms. (The Peer-to-Peer Finance Association (P2PFA) has prohibited this practice to its members in the UK.)[11]

Partnerships between banks and MPLs are becoming increasingly common in the US. BBVA Compass bank, for example, partners with OnDeck to originate small business loans through the platform by referring customers for smaller loan amounts.[12]

Other bank partnerships focus on funding, i.e. rather than simply referring the loan on to an MPL, the bank provides the funding themselves. For example, LendingClub and Citigroup announced a partnership in April 2015 in which Citigroup provides borrowers on the platform with funding through the Varadero Capital hedge fund, which takes on the first loss risk. Such arrangements allow banks to provide funding to higher-risk individuals or SMEs, while passing much of the credit risk on to investors searching for yield.[13]

Retail investors

The Securities and Exchange Commission (SEC) views promissory notes[14] issued by platforms as debt-backed securities. Securities regulations prevent retail investors from investing in unregistered securities, meaning that retail investors may lend only via platforms that have registered their promissory notes as securities with the SEC. Both LendingClub and Prosper have gone through the SEC-registration process, allowing retail investment through these platforms. Securities regulations also prevent retail investors from investing in business loans in the US.[15]

Furthermore, some state regulations prevent retail investors who do not meet certain eligibility requirements from lending through the platforms. Some states currently prevent retail investment altogether.[16]

Securitisation

The development of marketplace lending in the US has been so strong and rapid that there is now demand for securities backed by marketplace loans, as they have become an investment-worthy asset class in their own right. This has added liquidity to the market, and may help to lower the cost of funding. There were approximately 40 MPL securitisations up until Q4 2015,[17] and the market has also seen its first rated securitisations.

One MPL, SoFi, which offers loans to creditworthy students at lower rates than the government or traditional lenders, was the first to receive a triple-A rating for a marketplace loan-backed securitisation.[18] Prosper, too, has securitised US$327 million of its loans with the participation of the BlackRock investment management firm.[19]

What lies ahead?

The US market has already witnessed increased collaboration between banks and marketplace lenders, and Deloitte expects stronger integration of this sort to take place in the future. Such partnerships will help marketplace lenders to increase awareness among borrowers and investors, gain scale and possibly lower their customer acquisition costs.

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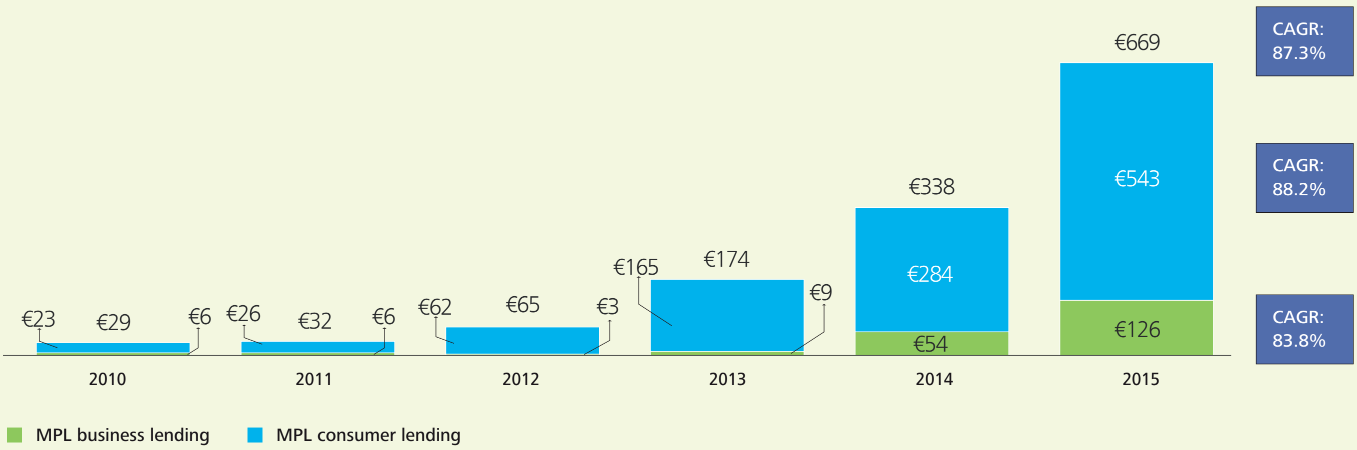
An overview of marketplace lending in continental Europe

MPLs in continental European markets have not benefitted from the same government support or regulatory approach as their counterparts in the UK. A deeper-rooted cultural aversion to risk than in the UK may also have constrained growth.[20] This may explain why MPLs in continental Europe originated just €669 million in loans in 2015 (see Figure 3), while UK marketplace lenders originated £2,739 million (€3,513 million[21]) (see Figure 4).

Germany and France are the largest MPL markets in Europe after the UK.[22] In continental Europe, the consumer lending market accounts for the bulk of marketplace loans (see Figure 3). The situation is different in the UK, where both the consumer and business lending markets are well developed (see Figure 4).

Figure 3. European MPL annual loan volumes (excluding the UK), € million, 2010 – 2015*



See also: http://www.altfi.com/charts/charts/eur-volume_chart.php; Deloitte analysis
*MPL business lending includes invoice trading, figures are rounded to the nearest million

Recent developments in the market

Currently, there is no pan-European regulation that specifically covers marketplace lending. MPLs are subject to regulation at a national level. While many countries do not have MPL-specific regulation in place, some member states, including France, have introduced specific regulation covering aspects such as disclosure, due diligence and the assessment of creditworthiness.[23] Furthermore, the European Commission's Capital Markets Union initiative emphasises the role that MPLs could play in helping SMEs diversify their sources of funding.

Despite such differences between national regulatory frameworks in Europe, a number of MPLs have sought to expand or consolidate across borders in an attempt to achieve the volume required to scale their businesses. For example, French consumer MPL Prêt D'Union, the largest player in the French market, has raised €31 million primarily to expand into Italy.[24] UK MPLs are also expanding into continental Europe: Funding Circle, for example, has acquired German MPL Zencap and launched operations in Spain and the Netherlands.[25]

The continental European market is also following the lead of better-established markets with the growing involvement of mainstream financial institutions. There is an emerging trend for MPLs to partner with banks. This includes the recent joint partnership between Sparda-Bank Berlin and Zencap (now Funding Circle Germany)[26] in which the bank provides its clients with the MPL platform's business loans as an investment option.

Aegon, the Dutch insurer, also announced plans in October 2015 to lend €150 million to borrowers through the German consumer MPL, Auxmoney.[27]

As the market gains traction, we believe that the unclear implications associated with the currently limited regulation may lead to concerns about MPLs potentially looking to gain scale through imprudent business practices and the improper use of client monies. In October 2015, for example, the Swedish marketplace lender TrustBuddy declared bankruptcy[28] after the platform uncovered alleged misconduct within the organisation, including misuse of lender capital.[29] Such developments have fed existing fears that the failure or impropriety of one platform may tarnish the entire industry at this early stage of development.

2. Marketplace lending: a disruptive threat or a sustaining innovation?

On the surface, marketplace lending looks like a quintessential disruptive force, as it embraces such structural effects of the digital economy as:

- the trend towards growing trust in online transactions
- increasing consumer expectations of immediacy
- the proliferation of public data (for risk scoring).

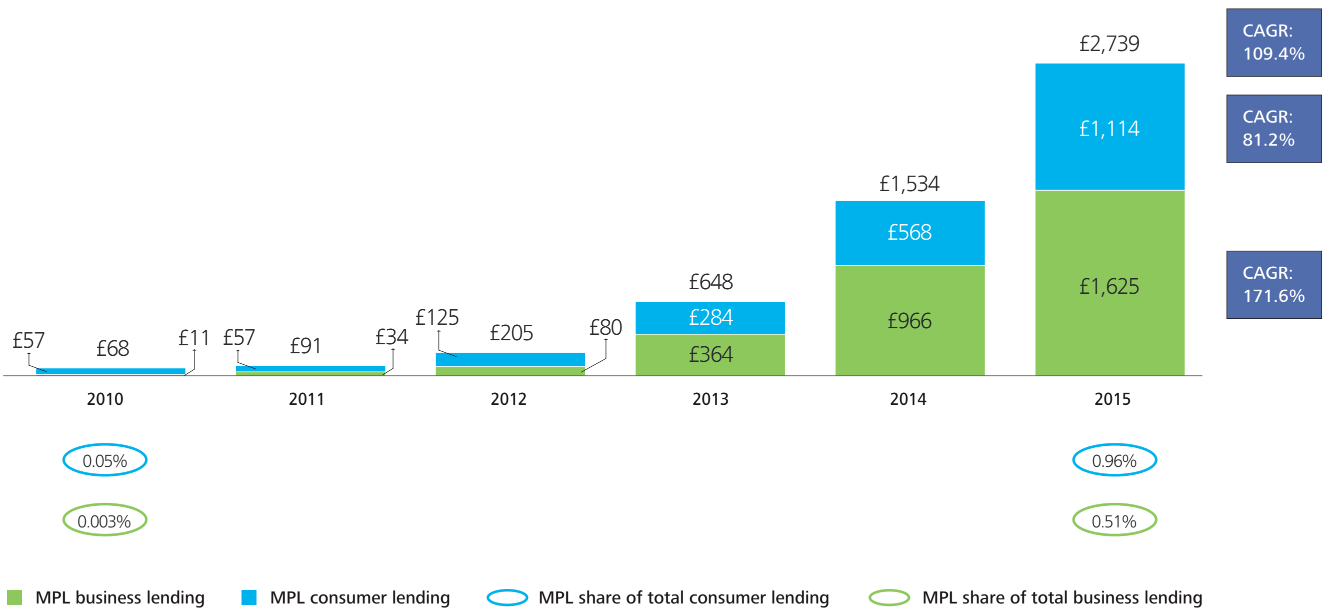
MPLs appear set to overcome structural barriers to entry such as banks' extensive branch networks and privileged access to customers and their data. The use of digital channels, streamlined processing and innovative risk scoring, combined with a model without the compliance costs of highly-regulated bank intermediation, is certainly advantageous. It would appear to position MPLs well to provide a wider base of borrowers with faster, more convenient access to credit at a lower price point than is achievable by banks, which remain hamstrung by legacy IT infrastructure and an outdated and expensive physical distribution network.

At the same time, by offering investors access to profitable asset classes that had hitherto been the exclusive preserve of the banks, MPLs appear capable of threatening the core deposit-funding base of the banks if deposit customers can be attracted to the higher yields and easy, transparent access they offer.

In many ways the situation appears analogous to the rapid growth of the securities markets in the US. This witnessed a dramatic reshaping of financial services as loans and deposits left the core banking system, attracted to the solutions offered by the new 'technology' of the capital markets. According to Deutsche Bank, capital markets accounted for more than 80 per cent of debt financing for businesses in the US in Q4 2013, compared to just 20 per cent in Europe.[30]

That is the core of the argument stating that the traditional bank lending model faces profound disruption, and there is some evidence to support it. MPL-based consumer lending in the UK grew at a CAGR of 81.2 per cent between 2010 and 2015. SME lending (including invoice trading) via MPLs experienced even faster growth, growing at a CAGR of 171.6 per cent during the same period (see Figure 4). Furthermore, the total number of active borrowers using UK MPL platforms almost doubled in 2015 alone, rising year-on-year from approximately 140,000 to approximately 275,000, as of Q4 2015.[31]

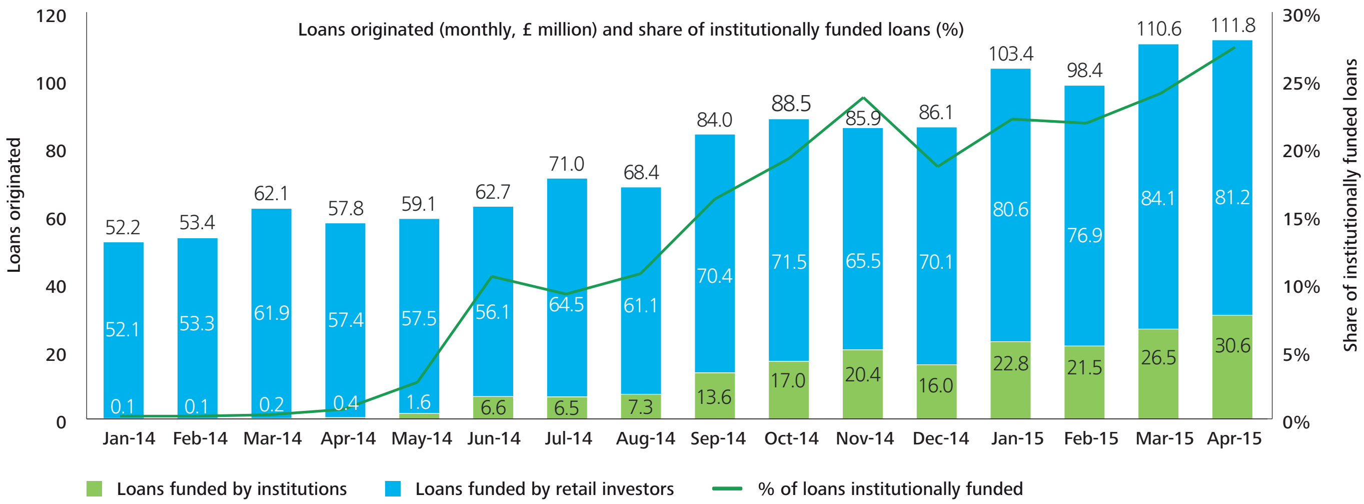
Figure 4. UK MPL annual loan volumes, £ million, 2010 – 2015*



Source: Liberum AltFi Volume Index, AltFi Data, data as of 26 February 2016.
See also: http://www.altfi.com/charts/charts/uk-volume_chart.php; Bank of England; Deloitte analysis
*MPL business lending includes real estate loans and invoice trading, figures are rounded to the nearest million

In addition, the amount of direct equity investment in MPL platforms (UK MPLs raised more than US$220 million in equity capital in 2015[32]), and the amount of institutional money being channelled through MPLs into consumer and SME lending, suggest that sophisticated players are backing this sector to grow significantly.

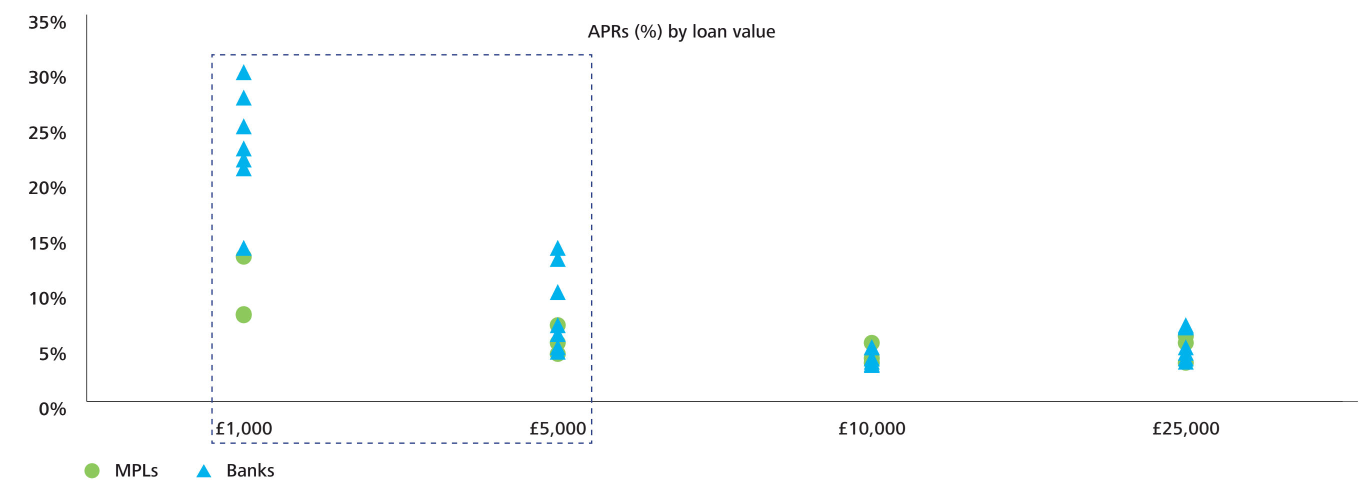
Figure 5. Estimated aggregate institutional participation in loans originated by Funding Circle, Zopa and RateSetter



Source: Is 'P2P' Lending a thing of the past?, AltFi Data, 19 May 2015.
See also: http://www.altfi.com/article/1055_is_p2p_lending_a_thing_of_the_past, Deloitte analysis

Finally, any search for a personal loan on key aggregator sites shows the increasing pervasiveness of MPLs. Overall, MPLs look highly price-competitive, particularly for lower-value loans (see Figure 6).

Figure 6. UK personal loan annual percentage rates (APRs) for three-year duration loans, MPLs and banks



Source: MPL and bank websites, Uswitch.com, Deloitte analysis. Data as of 23 February 2016

The key question is whether the momentum we are currently witnessing could progress to cause a profound disruption of banking (and possibly some elements of asset management), or whether MPLs will turn out instead to be a 'sustaining innovation': one that forces incumbents to up their game in core markets and that may pioneer the provision of credit into previously under-served segments, but that does not fundamentally change the financial services landscape.

Given that the market-penetration achieved by MPLs is to date still well below one per cent, and that the ability to lead the market for pricing on loans does not necessarily indicate superior or sustainable risk management or cost control, it is worth investigating such broad assertions in detail. Essentially, the case for MPL disruption is built on four potential sources of sustainable competitive advantage:

- a fundamentally lower-cost operating **model**
- an ability to use public data to (safely) overcome incumbents' data advantage in scoring risk, potentially going on to achieve better risk-pricing by taking a more agile 'Big Data'-based approach
- a superior customer (borrower) experience, driven by speed and convenience
- an ability to better absorb and diversify risk by matching the appetite of borrowers and investors for both risk and duration.

The next three sections review these factors to understand whether MPLs constitute a truly disruptive threat to banks. We then use our findings to determine our view on the potential market size of marketplace lending in the UK.

3. The relative economics of marketplace lenders vs banks

Banking has a reputation as an expensive form of financial intermediation. After all, if banks provide the most efficient way to borrow, why would so many of the world's largest borrowers rely instead on the capital markets?

However, there have historically been limits to the scope and reach of the capital markets. Borrowers need to be of sufficient scale to justify the investment required to gain a credit rating, and must also be prepared to disclose the information necessary for securities to be issued. Mid-market/SME banking in general has proven to be an asset class where the cost of securitisation outweighs its value, leaving banks as the main source of funding.

So, have MPLs found ways to overcome these cost barriers and provide a lower potential price-point than the banks at these lower loan values? Below we look at the relative costs of various loan types offered by the traditional bank lending model and the MPL model.[33] We have examined the costs incurred in originating and servicing a loan through the traditional bank model with an equivalent loan originated and serviced through an MPL. This analysis does not compare the total costs of operating a bank to the total costs of operating an MPL.

Figure 7. Cost economics of illustrative bank and MPL loans

Source: Deloitte analysis

MPLs’ costs will rise by more than banks’ as the credit environment normalises and interest rates increase.

Whether or not MPLs have a pricing advantage over banks depends primarily on three factors: the cost of funds; operating expenses; and how they price risk. While operating expenses of MPLs are most commonly compared with those of banks, we believe that a holistic comparison including funding costs is necessary to reach an accurate assessment of the two models’ relative economics.

Cost of funds

For banks and MPLs alike, funding costs are a major component of a loan’s total cost profile. To make a true comparison between the expenses incurred by each type of institution, we have examined the respective costs of attracting the funds they require to participate in the loan-making process.

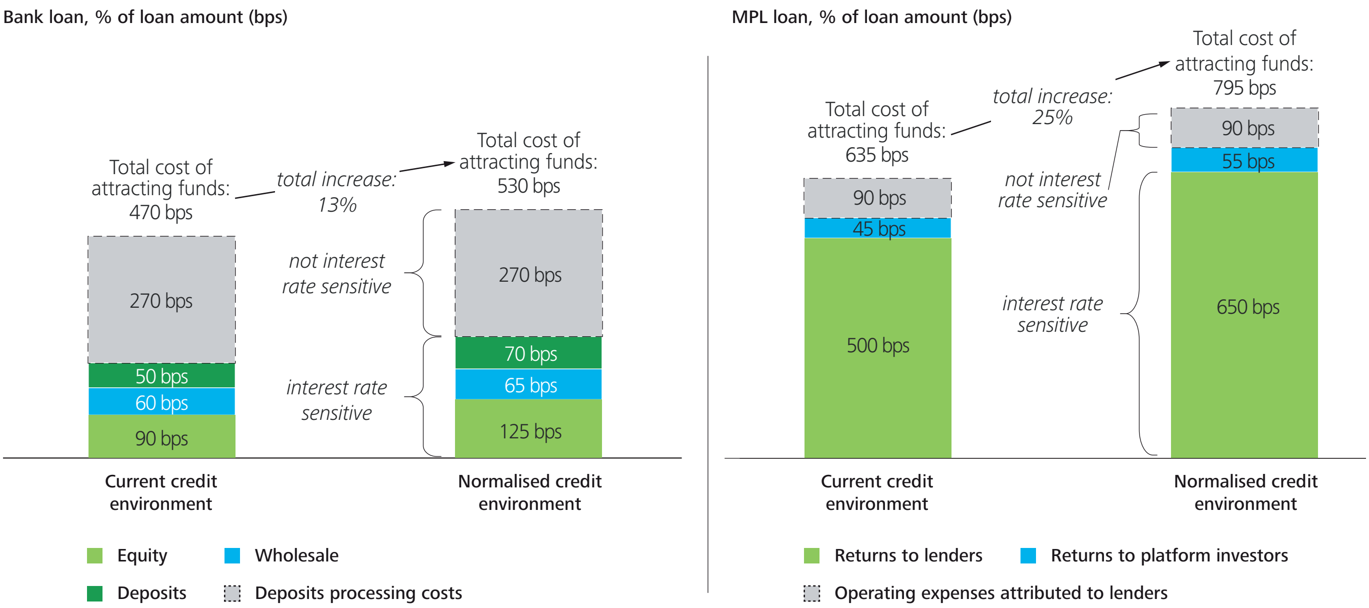
For a bank to make a loan, it must first attract deposits, wholesale funding and equity onto its balance sheet and must maintain liquidity reserves to meet the needs of its customers. The costs of loan-making include the direct costs of funding and liquidity (such as the interest rates, yields and returns payable on these funding sources). Furthermore, attracting and retaining deposits involves more than just paying interest: banks must also provide payment and processing services; most must also run a branch network; and they will incur significant regulatory and marketing costs and other non-interest expenses. The true cost of attracting the funds to the bank must take account of these non interest-based costs of gathering deposits.[34]

However, borrowing via a bank may give the borrower access to a wider range of services, such as international payment systems, which are not part of the MPL service offering. Banks may be able to generate income from these services and the borrower may see value in “one-stop-shopping”.

For an MPL to make a loan, it must attract lenders. Clearly this involves offering returns that outweigh the risks that lenders are prepared to take on. It will also incur marketing costs, lender-processing and servicing costs and other non-interest expenses. In addition, the platform itself must be funded, and the MPL must be able to pay a return to its own investors. Unlike a bank, however, an MPL does not need to incur the costs associated with offering current accounts, such as providing payment services and running a branch network.

In Figure 8, we examine these ‘fully-loaded’ costs, comparing the total costs of attracting funds into banks versus the costs faced by MPLs. Two observations are key. First, the total funding costs for banks are lower than for MPLs. Second, the non-interest component of an MPL’s funding profile is proportionately lower than it is for a bank. We therefore believe that MPLs’ costs will rise by more than banks’ as the credit environment normalises and interest rates increase. Figure 8 illustrates this point, using a scenario where base rates have returned to 200 bps, and credit spreads are at pre-crisis levels, to show the estimated increase in these ‘fully-loaded’ funding costs.

Figure 8. Costs of funding an unsecured personal loan: banks and MPLs, current and normalised credit environments

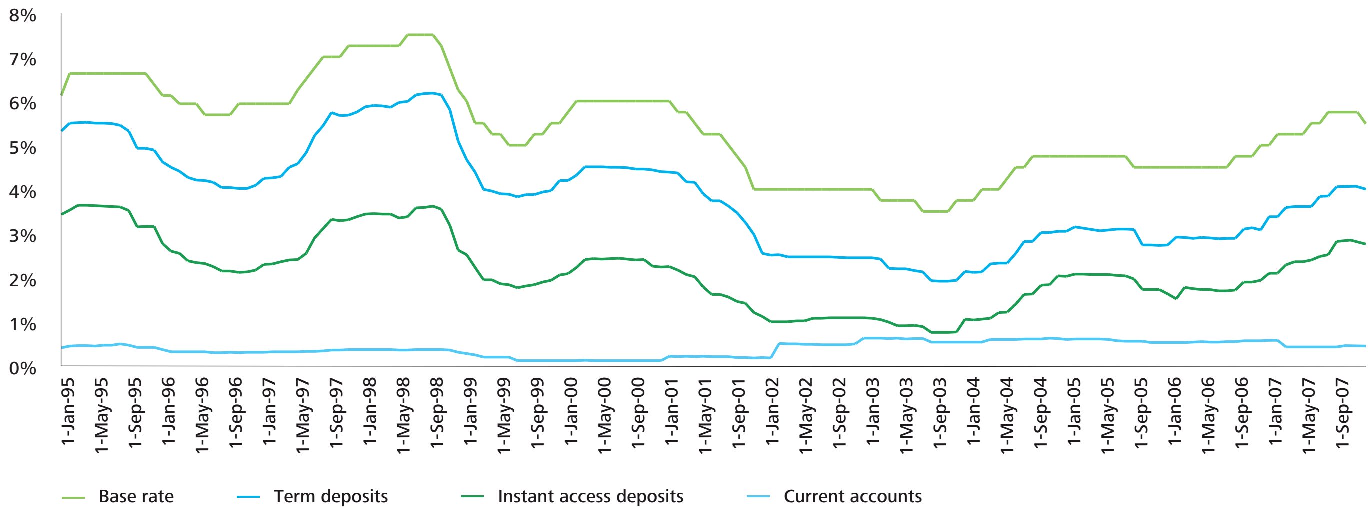


Source: Deloitte analysis

To look at this another way, consider that banks are able to borrow very cheaply – taking deposits gives them inexpensive access to funding. This is a structural benefit enabled both by their unique regulatory position (with deposits underwritten by the protection scheme/government) and by their ownership of the payments infrastructure. Banks fund a significant proportion of their balance sheets by taking current-account deposits that are inherently less sensitive to changes in base rates than other sources of funding, such as term deposits (see Figure 9). For these reasons, we believe that banks will have a structural cost advantage over MPLs if and when the credit environment normalises.

For these reasons, we believe that banks will have a structural cost advantage over MPLs if and when the credit environment normalises.

Figure 9. Bank deposit interest rates in a normal credit environment, percentages

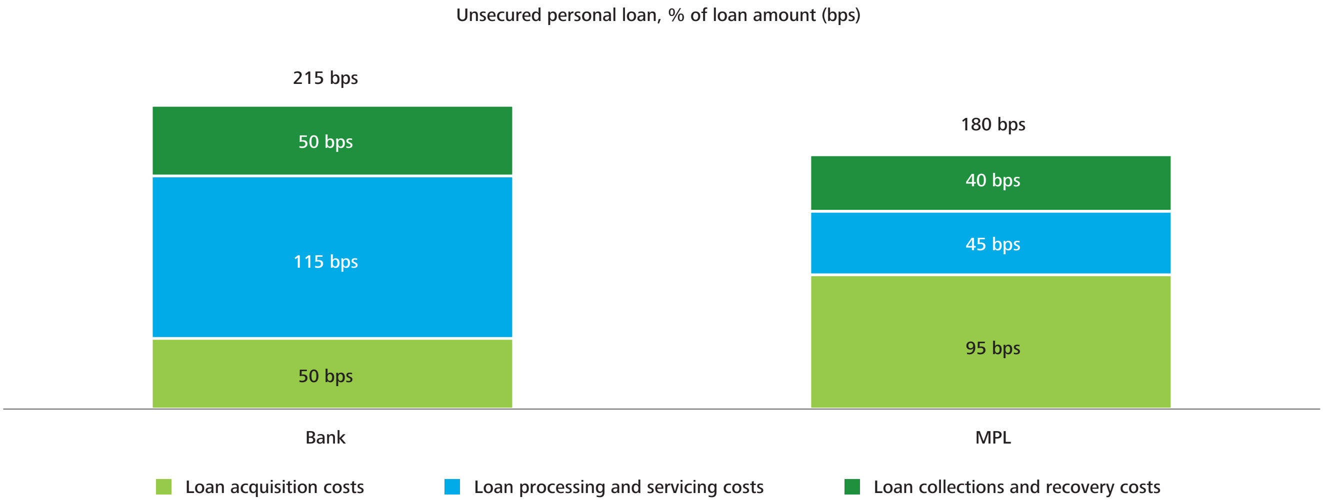


Source: Bank of England, Deloitte analysis

Operating expenses

In this section, we compare the operating costs incurred by banks and MPLs by examining the structural advantages for each model in making and servicing loans (considering the operating costs associated with lending activities alone).[35]

Figure 10. Operating expenses of an unsecured personal loan, banks and MPLs



Source: Deloitte analysis

Customer awareness of marketplace lenders in the UK

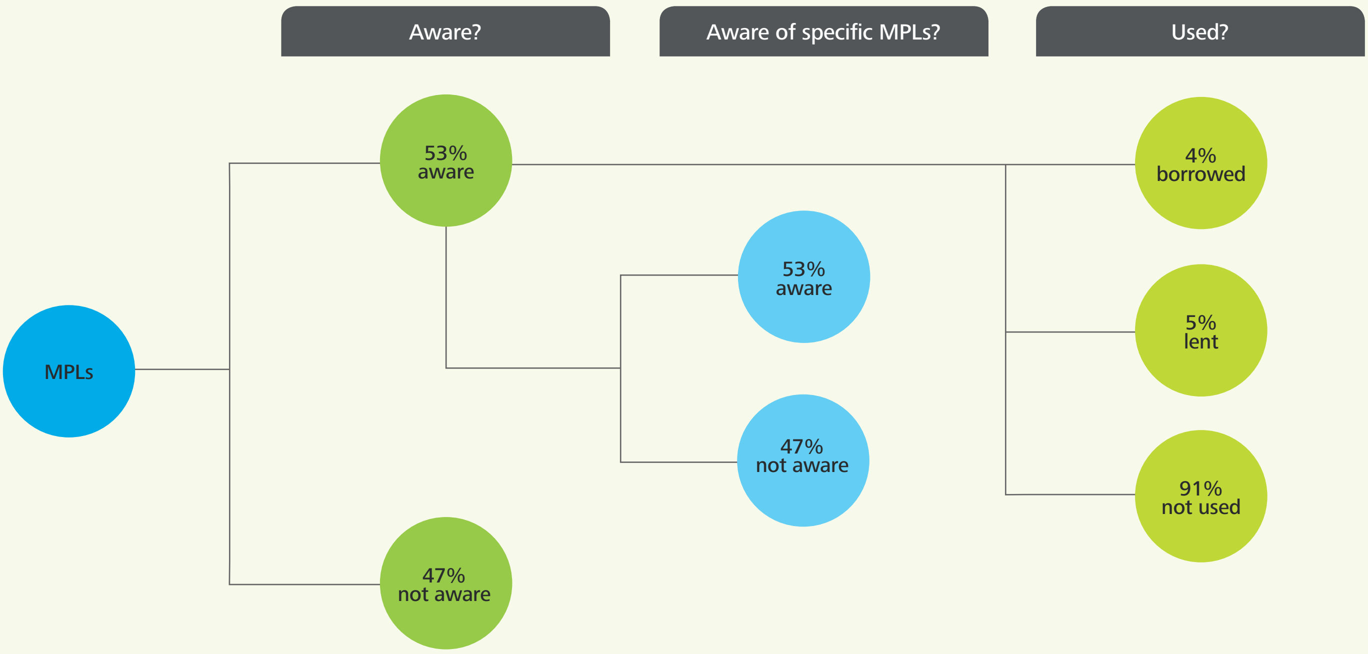
According to the survey we commissioned as part of this research, there is a reasonable awareness of MPLs among retail consumers and SMEs in Britain. Just over half of consumers and three-quarters of SMEs are aware of MPLs.

One in 25 retail consumers who are aware of MPLs, meanwhile, has borrowed from one. Similarly, one in 20 retail consumers who are aware of MPLs has lent through one (see Figure 11).

Among SMEs, one in 25 that are aware of MPLs has borrowed from an MPL and around one in 30 that have heard of MPLs has lent through such a platform (see Figure 12).

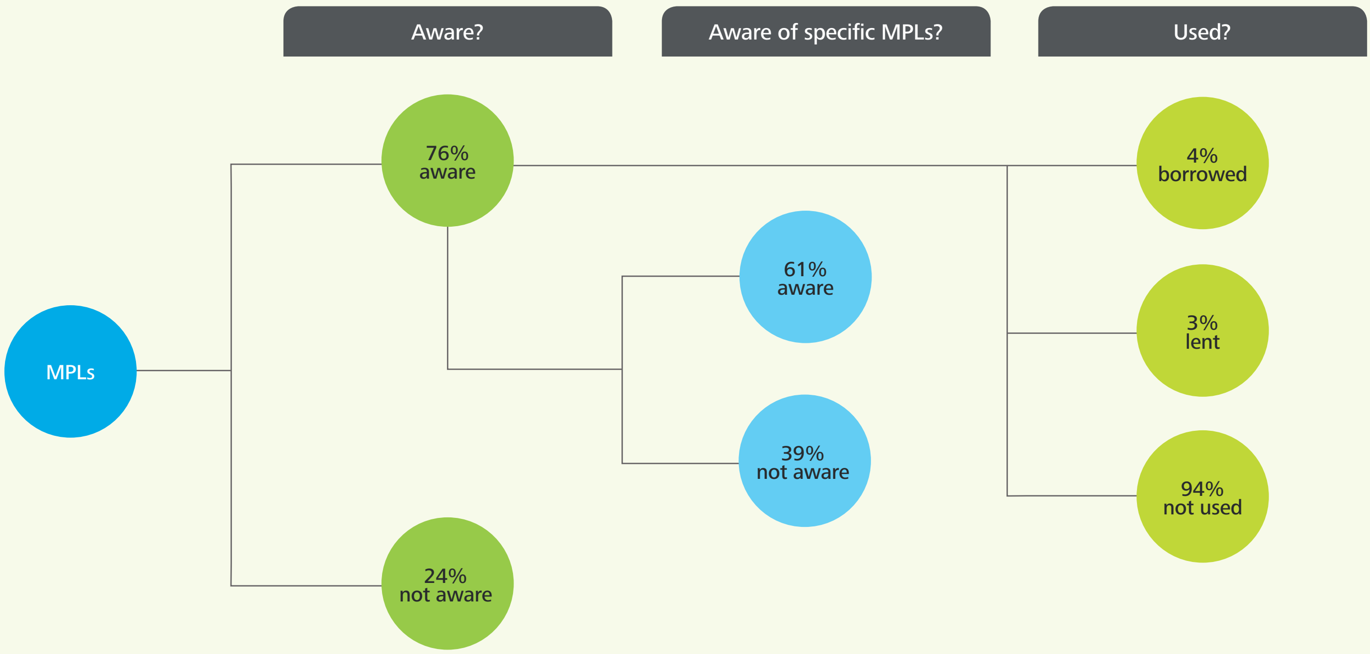
MPLs are now aiming to leverage these high awareness figures to improve their conversion rates. One way of achieving this is to form industry bodies to educate consumers. UK MPLs have formed the P2PFA, representing the majority of the UK MPL market across all segments,[37] to promote their nascent industry.

Figure 11. Awareness and usage of MPLs, retail consumers



Source: YouGov plc 2016 © All rights reserved, Deloitte analysis
Base: All GB adults (nationally representative), 2,090
See appendix for survey questions

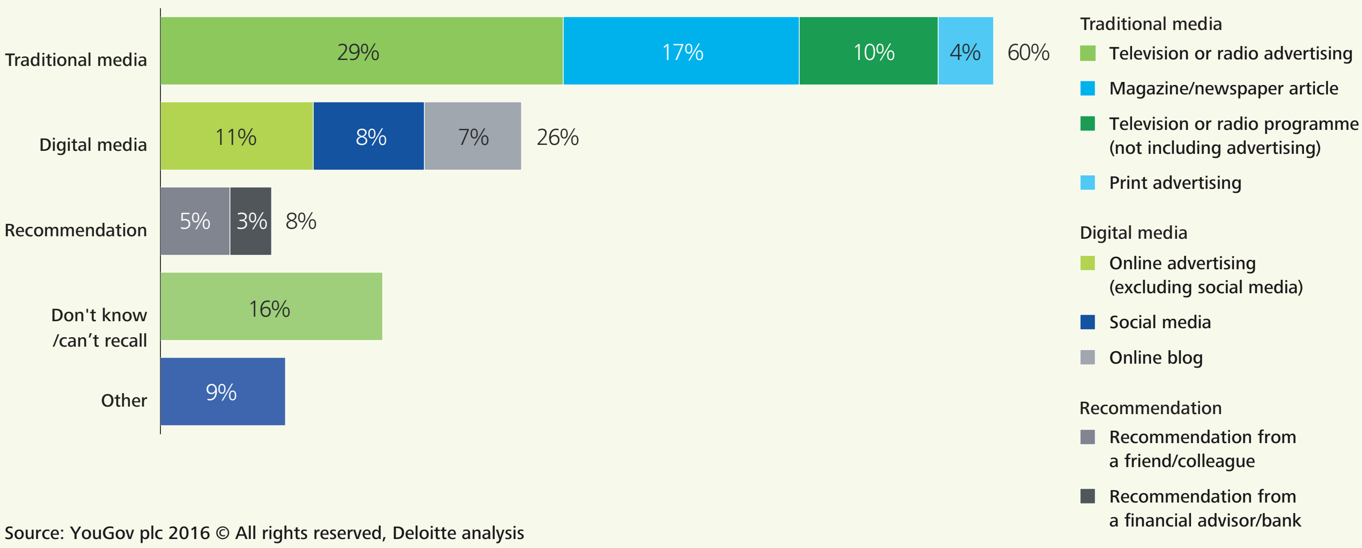
Figure 12. Awareness and usage of MPLs, SMEs



Source: YouGov plc 2016 © All rights reserved, Deloitte analysis
Base: All SME senior decision makers (nationally representative), 1,609
See appendix for survey questions

MPLs have used a wide variety of marketing methods to drive awareness. As MPLs are innovative, digital platforms, it is interesting to note that traditional media (TV and radio advertising in particular) represent by far the greatest source of awareness. And while early growth in the industry is often attributed to word-of-mouth, such recommendations are not a key source of awareness at this stage (see Figure 13).

Figure 13. Sources of awareness of MPLs, retail consumers



Source: YouGov plc 2016 © All rights reserved, Deloitte analysis
Base: All GB adults aware of one or more of the above peer-to-peer lenders (nationally representative), 588
See appendix for survey questions

Acquisition
Unlike MPLs, banks tend to have large existing customer bases and the ability to drive awareness via above-the-line advertising across a wide product portfolio. While it seems likely that these attributes give them a material advantage in acquiring new personal and SME loans, our research in this area suggests that MPLs already have a surprisingly good level of awareness: one in two retail consumers (53 per cent) and three in four SMEs (76 per cent) are aware that they exist[36] (see the 'customer awareness' box). Conversion is currently relatively low: only one in 25 retail consumers who are aware of MPLs has actually borrowed from one. However, the ability of MPLs to spread their message via new digital channels, to use their speedy processes to encourage purchase, and to leverage their structurally-advantaged risk appetite (see 'credit risk' below) points to the potential they have to negate the banks' advantages. Two analogies, however, provide a counterpoint to this optimistic view of MPL's acquisition costs.

The first is the escalation of acquisition costs among online price-comparison sites in the UK. Here, a marketing 'arms race' has pushed above-the-line advertising spend to a remarkable level, with the largest four UK price comparison sites spending more than £100 million a year.[38] Similarly, the competition among these sites has pushed the price of financial services-related keywords to levels where loans sourced through these channels are believed to be breakeven at best. Such search terms, in fact, make up 11 of the top 20 most expensive Google AdWords in the UK.[39] As MPLs seek to compete both with the banks and with one another in mainstream lending, it therefore appears likely that search engines or price-comparison sites will end up with much of the value.

The other analogy is with the credit card market, where over the last 25 years or so banks have faced intense competition from non-bank monolines seeking to break the relationship between the primary current account and credit products. While these credit specialists have had some success, even after this period of sustained competition around a third of active credit card holders in the UK still have a current account with the same bank that issued their card.[40] The task facing MPLs is therefore significant, particularly given that the relationship between the primary current account and loans is even tighter. (For example, almost 90 per cent of SME loans are extended to existing holders of business current accounts.) [41]

Processing/servicing
Unlike in the customer-acquisition area, MPLs have a potential advantage in processing/servicing thanks to their ability to design from scratch purely online channels to handle the loans on-boarding and servicing processes.

A fully automated process for processing and underwriting loans allows MPLs to avoid the material costs that banks have to deal with as a result of their legacy systems and multiple channels. This also holds true for servicing where a surprising number of banks have, for example, no automated scoring systems for SME overdrafts – this results in a significant proportion of relationship managers' time being taken up in renewing overdrafts.

As highly regulated entities, banks also incur significant costs, both in ensuring compliance and in redressing any breaches. For the time being at least, MPLs can avoid much of this burden (see the 'Regulation – friend or foe?' box on page 18).

Regulation – friend or foe?

Before 2013, MPLs were subject to little or no regulation, with none at all being tailored to the MPL model. The UK Financial Conduct Authority (FCA) had the stated aim of providing "adequate consumer protections that do not create too many barriers to entry or significant regulatory burdens for firms".[42] The FCA operates a disclosure-based regime, designed to advance its objectives of supporting effective competition and an appropriate degree of protection for consumers.

The current FCA MPL regulation consists of:

- capital requirements – before 1 April 2017, marketplace lenders with FCA authorisation must hold the following in regulatory capital:
  - a minimum of £20,000
  - 0.2 per cent of the first £50 million of total loans outstanding, 0.15 per cent of the next £200 million, 0.1 per cent of the next £250 million, 0.05 per cent of the remaining balance.

  This will increase from 1 April 2017 to whichever is the higher of:
  - a minimum of £50,000
  - 0.3 per cent of the first £50 million, 0.2 per cent of the next £450 million, and 0.1 per cent of all money lent above £500 million.[43]
- client money protection rules – MPLs holding client money are subject to Client Assets Sourcebook (CASS) rules requiring firms "to ensure adequate protection of client money when the firm is responsible for it"[44]
- dispute resolution rules – investors have the right to complain, firstly to the MPL and, if the dispute remains unresolved, to the Financial Ombudsman Service. "The rules for dispute resolution do not mandate specific processes, so long as complaints are dealt with fairly and promptly"[45]
- if an MPL goes out of business, it must take "reasonable steps … to ensure loan agreements facilitated on the platform will continue to be managed and administered with the contract terms, if the firm ceases to carry on the regulated activity in relation to lending"[46]
- conduct – MPLs must "ensure that investors have the information they need to be able to make informed investment decisions and that all communications are fair, clear and not misleading."[47] (For further information, see conduct risk section below.)

Conduct risk

The FCA has defined conduct risk as "the risk that firm behaviour will result in poor outcomes for customers."[48]

The FCA expects MPLs to manage conduct risk by looking at their business models and strategic plans to ensure that they are identifying, mitigating and monitoring all the risks to consumers arising from them. The FCA is clear that all firms, including MPLs, need to accord equal significance to customer outcomes as to commercial objectives.

Deloitte believes that five key conduct risk considerations relate equally to lenders/investors and borrowers:

1. Investor funds are not guaranteed

MPL investors do not have access to the Financial Services Compensation Scheme (FSCS), which protects the first £75,000 of deposits; this is because the money lent is not classified as a 'deposit'.

Second, some MPL platforms have established their own 'provision funds' to help investors recover lost monies in the event of borrower default. However, no MPL platform guarantees that a provision fund will make investors 'whole' (enable them to receive all their money) after borrowers have defaulted. There is a risk that investors will misunderstand such funds as a guarantee that their investment is safe, when their role is simply to mitigate possible losses.

2. Liquidity risk

Investors on MPL platforms may not realise that they are usually 'locked in' to their investments until they mature. (While some MPLs have a secondary market in which investors can cash in their investments before maturity, such markets are currently underdeveloped.)

3. Investor understanding

Deloitte's consumer survey shows that the general population has a good understanding of the risks involved in lending through MPLs. However, a significant minority (see Figure 14) believes that savings accounts and government bonds are riskier than investing through MPLs.

This suggests that the industry has not yet attained the levels of customer understanding that the FCA is looking for.

Firms that fail to comply with the FCA's disclosure regime are at risk of enforcement action by the FCA, but this is a punitive tool after the event, rather than a preventative one.

4. Credit risk and the potential for financial loss

Most MPLs assign a credit risk score or particular pricing to a loan. Investors face the risk that such scoring is inaccurate or that such pricing does not truly reflect the credit risk exposure.

5. Treatment of borrowers

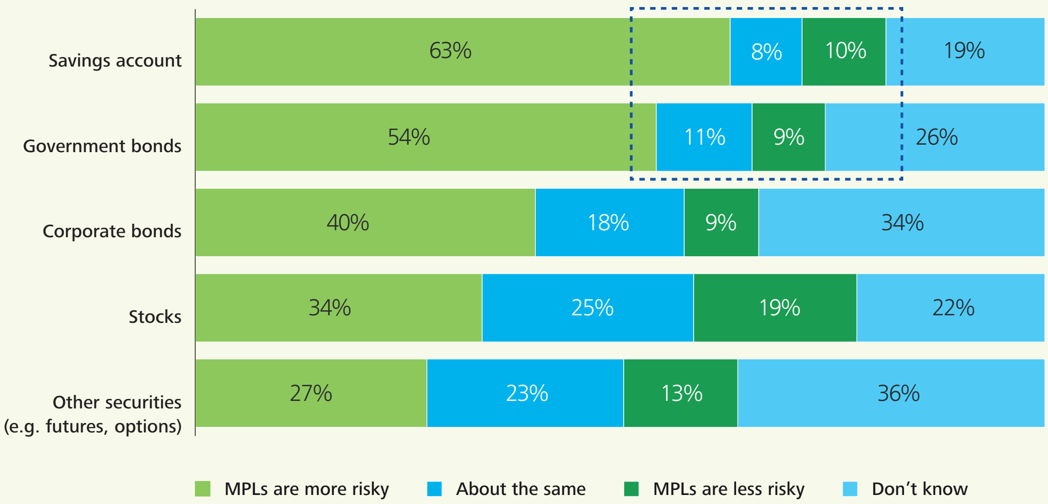
Borrowers participating in marketplace lending are also exposed to conduct risks, which principally include loan affordability, treatment of customers in financial difficulty and clarity of information before, during and after the point of sale.

UK regulation – outlook

MPLs have a favourable view of the current size and scope of regulation. They believe the regulation is not overly onerous, particularly in terms of capital requirements, allowing them to maintain one of their key competitive advantages over banks. This light-touch regime also allows MPLs to concentrate on growth and innovation rather than regulatory compliance.

However, as MPLs grow and become more important to the financial system, they are likely to become more tightly regulated, with higher capital-adequacy ratios, limitations to business models and more prescriptive disclosure requirements. This could erode the favourable regulatory arbitrage MPLs currently have over banks, and cause them to refocus their efforts less single-mindedly on growth and innovation.

Figure 14. Risk of lending through an MPL platform compared to other savings/investment options, retail consumers



Source: YouGov plc 2016 © All rights reserved, Deloitte analysis
Base: All GB adults aware of peer-to-peer lenders (nationally representative), 1,168
See appendix for survey questions

Approximately one in five retail consumers believes lending through MPLs is as risky or less risky than savings account or government bonds

Overall, our research gives us limited grounds to believe that MPLs will systematically price risk better in areas where banks have an appetite to play.

There are questions over the sustainability of MPLs' advantage in the area of operating costs. Banks do appear to be disadvantaged for the time being, however, and their ability to address this in the near future is hamstrung by a series of factors, which also constrain their ability to improve customer experience. Factors include:

- their ability to attract the right talent
- their ability to prioritise investment in an environment that is still dominated by post-crisis regulatory change
- an understandably cautious culture.

Collections and recoveries

Our research suggests that at maturity, when MPLs' loan portfolios are likely to more closely resemble those of the market as a whole, MPLs will have no material source of cost advantage over banks relating to collections and recoveries. And while MPLs may pass the costs of collections and recoveries on to lenders, this will over time simply increase the required return and the cost of funds.

Credit risk

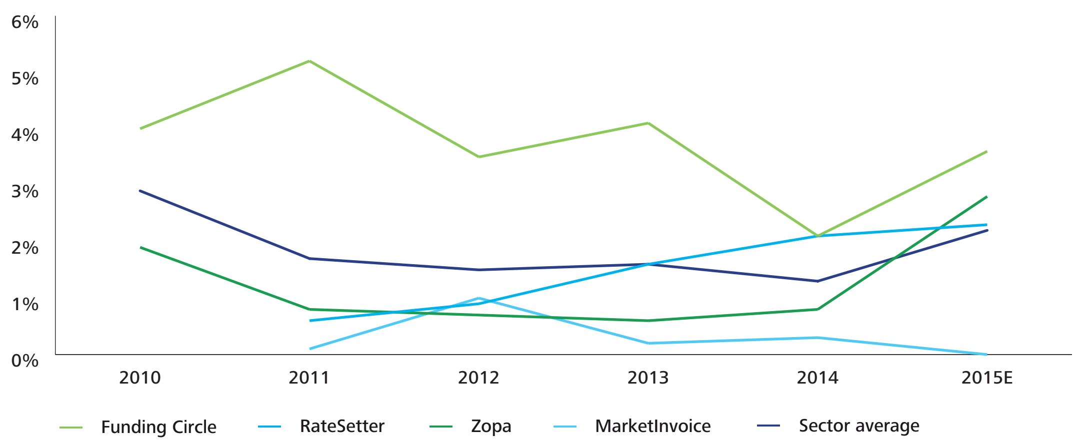
Overall, our research gives us limited grounds to believe that MPLs will systematically price risk better in areas where banks have an appetite to play.

Supporters of MPLs point to a number of potential areas of advantage over the traditional bank model, including:

- a willingness (in part born of necessity) to experiment with a wider set of data sources for risk scoring
- a more agile approach to developing and evolving a more agile core risk-scoring algorithm.

As further evidence that innovative approaches are working and will improve over time, these supporters also point to the current quoted loss rates of MPLs, which look no worse than typical bank loss rates (see Figure 15). However, the majority of UK MPLs are yet to go through a credit cycle, and it therefore remains to be seen if there will be an increase in default rates in the event of an economic downturn.

Figure 15. MPL default rates, 2010-2015*



Source: MPL websites, Deloitte analysis
*2015 figures are estimated default rates from MPL websites

However, while some of the risk professionals and other market participants we interviewed acknowledged that a better risk-scoring algorithm might be developed outside the banking system, all cautioned that it is too early to tell whether or not this has happened. And, if it is does happen, the consensus was that this was unlikely to be the result of a systematic advantage of the MPL model; rather, it would be a specific, model-agnostic, innovation. In other words, banks could exploit the same algorithmic innovations. All also commented on the fact that, in the short-term at least, MPLs cannot replicate banks' core advantage of having access to customers' historical transactional data.

That said, provided that loans behave broadly as predicted over time, the ability to use the brokerage model to match borrowers and lenders by risk appetite, coupled with the diversification achieved by pooling invested money and lending it out to several borrowers, does seem likely to support an inherently wider risk appetite. In turn, the resulting wider coverage of businesses or individuals eligible for loans may potentially deliver higher acceptance rates and so reduce the effective cost of customer acquisition.

Relative economics of MPLs vs banks: our conclusion
Our analysis shows that banks have a structural cost advantage over MPLs. While MPLs may enjoy slightly lower operating costs, a bank's broad cost profile is less sensitive to changing interest rates than that of an equivalent MPL. This advantage is not particularly evident in the current credit environment, with rates at historically low levels. However, if and when the credit environment normalises and rates and spreads return to pre-crisis levels, we expect that the costs incurred in MPL credit transmission will increase by more than those of bank lending.

For these reasons, we do not believe that MPLs pose a disruptive threat to banks in terms of relative economics. Banks currently have a pricing parity with MPLs; this will become a pricing advantage in a normalised interest rate environment. Our market-sizing assessment, therefore, does not foresee a shift in lending from banks to MPLs owing to a structural pricing advantage.

For MPLs to be a disruptive threat, they would need to achieve at least one of the following:

- offer a superior customer experience, potentially by expanding their offering to include ancillary services such as cashflow tools and business advice, for which customers would be willing to pay a premium
- undermine banks' funding advantage by drawing funds away from deposits into marketplace lending.

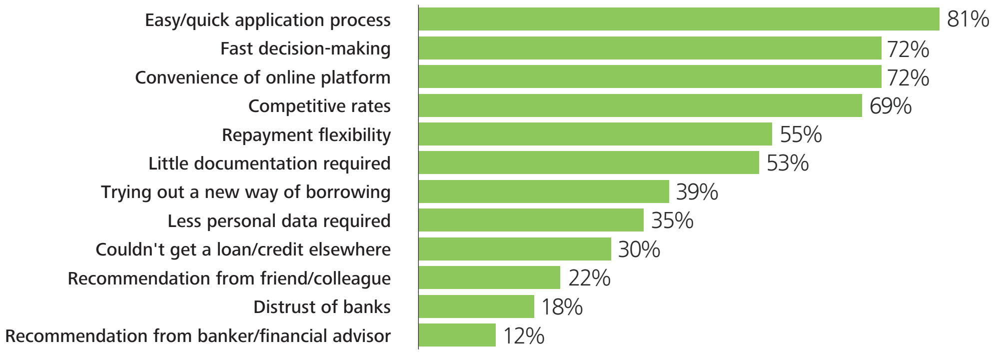
Our analysis shows that banks have a structural cost advantage over MPLs.

MPLs have been able to differentiate themselves by offering an attractive customer experience.

4. The user experience of marketplace lenders vs banks

As part of our research, Deloitte conducted a YouGov survey of retail consumers and SMEs. The results provide strong evidence that MPLs have been able to differentiate themselves by offering an attractive customer experience at acceptable lending rates (see Figure 16 below).[49]

Figure 16. Drivers behind usage of MPLs to borrow money, retail consumers



Source: YouGov plc 2016 © All rights reserved, Deloitte analysis
Base: All GB adults who have borrowed via a peer-to-peer lending platform (non-nationally representative), 89
See appendix for survey questions

This is backed up by the views expressed by the UK MPLs, banks and investment managers we interviewed as part of the research. According to our interviewees, borrowers are primarily drawn to MPLs due to:

- the certainty of outcome for a loan application enabled by a fast decision-making process
- the small amount of documentation that borrowers need to provide as part of a loan application.

These advantages largely arise from MPLs' customer-driven focus on user experience (UX) as a source of differentiation. Two questions arise:

1. how sustainable is this UX advantage? (Surely banks can easily copy user journeys that are seen to work and then leverage their broader customer relationships and data to deliver a distinctive experience that trumps what MPLs have to offer?)
2. if banks choose to flex the pricing advantage we believe they have, how many customers will be willing to trade UX against price?

It is clear that replicating this experience, or even substantially closing the gap, requires more than just overlaying a slick digital interface onto existing processes. It ultimately requires taking a far more customer-centric approach to product and proposition innovation, accordingly re-engineering and automating processes deep in the bank's operating model. Deloitte's work with major institutions trying to do this has given us a healthy respect for just how hard it is for most banks to achieve this level of change. In our experience, a number of factors may prevent banks from quickly doing so, including:

- cultural and capability limitations
- the current regulatory environment
- a relatively risk-averse approach to innovation
- a limited appetite for investment, particularly given the competing claims on such funds.

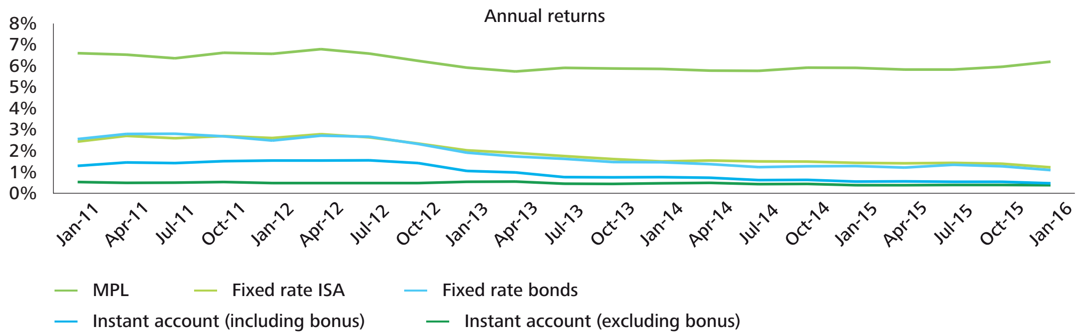
As a result, Deloitte believes that this non-cost advantage is likely to endure for some time.

Turning to the second question, our work in the sector suggests that while there are cases where time is critical, a customer's willingness to trade off UX against rate ultimately (and unsurprisingly) tends to correlate with the absolute difference in interest cost between the two alternatives. We have reflected this in arriving at our assessment of where and to what extent MPLs will win in the market.

5. Marketplace lending as an asset class

Turning to the other side of the market (where investors participate to lend funds), there is a potential risk to banks. This is that MPLs might provide easy access to a new, higher-yielding asset class (see Figure 17) for those deposit-holders whose low returns currently provide banks with their advantaged funding base. (As noted above, this advantage is the key to banks being able to sustain their position on the borrowing side of the market.)

Figure 17. UK returns, MPLs vs savings accounts, 2011-2015



Source: Liberum AltFi Returns Index, AltFi Data
See also: http://www.altfi.com/data/indices/returns, Interest and Exchange Rates Data, Bank of England.
See also: http://www.bankofengland.co.uk/boeapps/iadb/index.asp?first=yes&SectionRequired=I&HideNums=-1&ExtraInfo=true&Travel=NIxIRx; Deloitte analysis

Lenders are also increasingly attracted to several intrinsic qualities of the MPL model, such as:

Asset managers in marketplace lending

The case for alternative lending

Many of the investment managers we spoke with as part of our research believe that alternative lending offers two key benefits:

- it can provide higher yields than many other fixed-income assets (adjusted for duration and risk)
- it can be less correlated to other assets.

Such investments can come in the shape of private placements of company debt, securitised loan funds and direct lending through channels such as MPL platforms. Chasing this opportunity, European fund managers have raised around US$170 billion[50] over the past five years to invest specifically in private debt, with a marked acceleration since 2012.

Historically, exposure to this asset class has largely been provided by players such as hedge funds, limiting its availability to select investors. However, increasing longevity means the requirements of all savers are growing more demanding, as they need their savings to last longer while also using them for income.

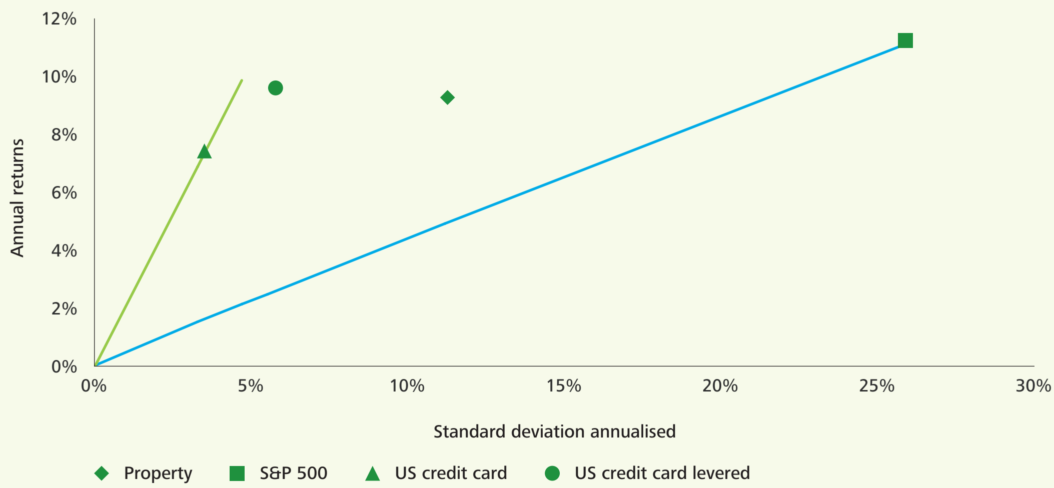
Traditional asset managers are responding to these more complex demands by building exposure to investments beyond equities and bonds. Both models are converging, with hedge funds seeking to expand their investor base through more retail offerings, and traditional asset managers increasingly offering specialised funds to compete for market share. The resulting ‘democratisation’ of alternative asset classes, including lending, appears set to drive a major boost in demand.

Where MPLs fit within alternative lending

Marketplace lending is a small sub-set of the alternative lending asset class. But it offers competitive annualised yields (non-risk-adjusted) of 5-7 per cent (see Figure 17) compared to other debt instruments such as US investment-grade corporate bonds (3.3 per cent).[51]

The charts below compare the risk-adjusted returns offered by MPLs to those from equities (using credit card lending as a proxy for MPLs). This data suggests that MPLs’ annual risk-adjusted returns are competitive with equities. Specifically, while direct lending has underperformed the S&P 500 index over the past 20 years, it has not had any negative return years and has been much less volatile.

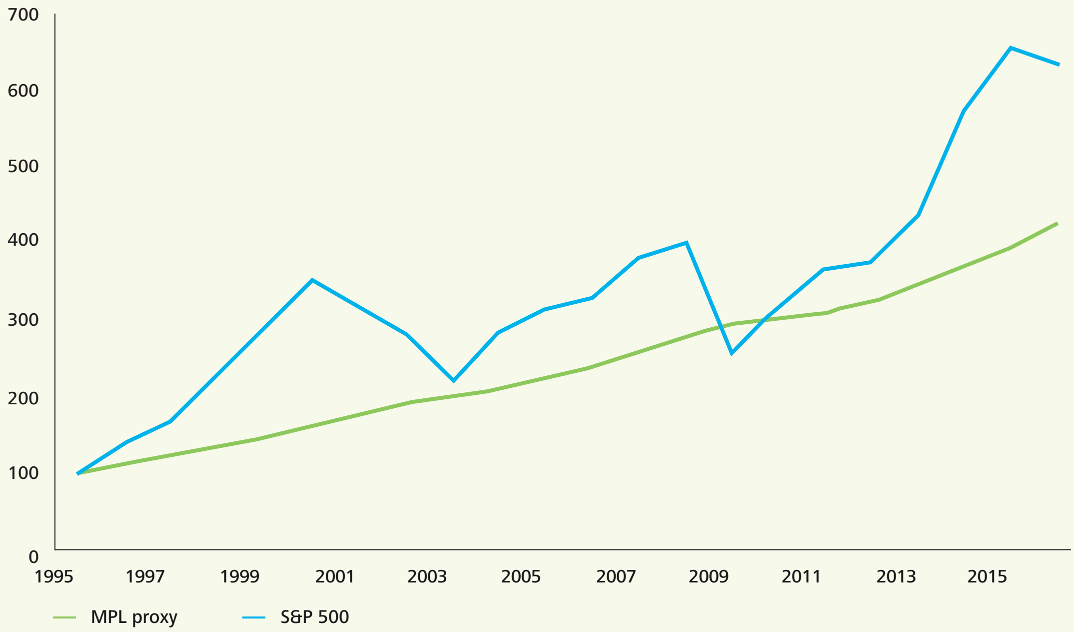
Figure 18. Annual returns vs standard deviation



Source: Direct Lending: Finding value/minimising risk, Liberum, 20 October 2015, p.18.
See also: http://www.liberum.com/media/69233/Liberum-LendIt-Presentation.pdf; Deloitte analysis

The resulting ‘democratisation’ of alternative asset classes, including lending, appears set to drive a major boost in demand.

Figure 19. MPL proxy vs S&P 500 total return index

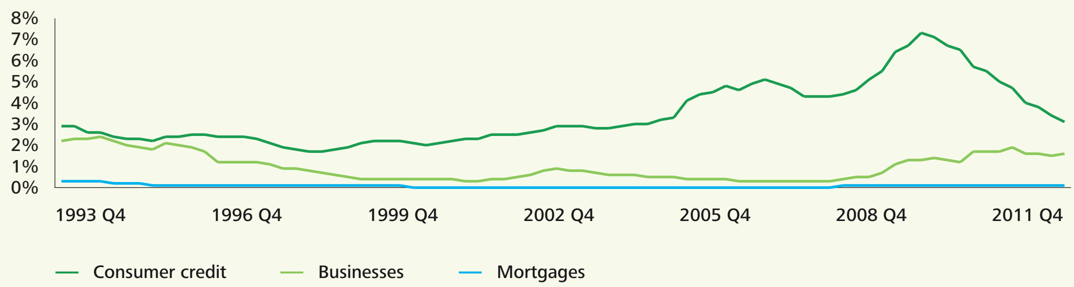


Source: Direct Lending: Finding value/minimising risk, Liberum, October 2015, p.18
See also: http://www.liberum.com/media/69233/Liberum-LendIt-Presentation.pdf

A key advantage claimed by advocates of marketplace lending as an asset class is that it is less correlated to other asset classes. This means that exposure to MPLs can help asset managers boost returns while diluting risk through diversification. MPLs offer access to a distinct borrower profile (SMEs and retail consumers), meaning that products can be packaged to reduce specific borrower risk. However, stresses in the economic cycle are likely to affect these borrowers as well.

The chart below examines how write-offs in UK business/consumer lending have varied over time, highlighting that these are indeed linked to the economic cycle. While the current default experience of MPLs is low, this is probably flattered by the prevailing benign credit environment and defaults may increase in time. Default rates are also likely to rise as the growth of the marketplace lending model forces it to chase more risk-laden opportunities.

Figure 20. UK write-off rates on lending to businesses and individuals, 1993-2013



Source: Trends in Lending, Bank of England, July 2013, p.5.
See also: http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjuly13.pdf; Deloitte analysis

It is worth noting that marketplace loan products will be eligible for investment in Individual Savings Accounts (ISAs)[52] from the 2016-17 financial year. These will be among the few fixed-income instruments readily available to retail investors.

Not surprisingly, given the high absolute returns as well as claims of low correlations to other assets, institutions are increasingly being attracted to marketplace lending. As a result, they are:

- lending directly through MPL platforms
- investing in investment trusts that lend through these platforms
- investing in outstanding marketplace loans
- purchasing equity in MPLs
- investing in rated marketplace loan-backed securities (in the US).[53]

Not surprisingly, given the high absolute returns as well as claims of low correlations to other assets, institutions are increasingly being attracted to marketplace lending.

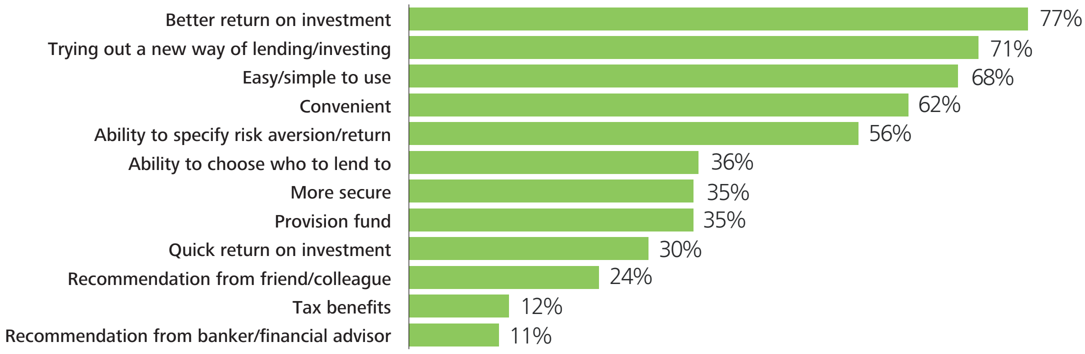
The implications for MPLs

We believe that greater asset-manager involvement will have the following impacts on marketplace lending:

- the majority of growth will come from credit funds investing in securitised assets or secondary loans, rather than from investors lending directly to specific individuals; the creation of this secondary market for loans will improve liquidity
- institutional investors such as pension funds, given their longer investment horizons, can provide stable funding to the sector; marketplace lenders will benefit from this stability
- catering to the needs of these investors could boost innovation in funding vehicles; for example, closed-end funds have the advantage of a dedicated pool of 'locked-in' investors, which can help marketplace lenders better match them with the risk/maturities
- the increase in mainstream institutional money will 'professionalise' marketplace lending
- as asset managers increase their exposure, marketplace lenders will need to ensure that they can deploy incoming proceeds efficiently without ratcheting up risk
- initial asset manager interest will be in relatively larger loans (by size). However, as more asset managers enter the space, they will have to invest in smaller loan sizes due to both limited supply and the need to diversify their exposure
- at that stage, large asset managers may need to compete directly with (or indeed swallow) marketplace lenders to access the asset class
- however, as more asset managers invest into these products, and given the increasing risk to client assets, pressure will gather for marketplace lenders to face increased regulation and higher capital requirements.

Our consumer survey illustrates both these points well. While still primarily driven by a search for yield, lenders also rate customer experience and the ability to specify levels of risk aversion/return as key drivers (see Figure 21).

Figure 21. Drivers behind using MPLs to lend money, retail consumers



Source: YouGov plc 2016 © All rights reserved, Deloitte analysis
Base: All GB adults who have lent via a peer-to-peer lending platform (non-nationally representative), 161
See appendix for survey questions
*A provision fund is a stock of money, kept in a separate account, maintained to account for investor losses. It is not insurance against default.

Proponents of disruption could point to the very material shift in the make-up of household financial assets in the US that was driven by the growth of capital markets. They could make the case for a similar decline in deposits, with MPLs playing the role of a more democratised capital market. However, such a perspective is predicated on the belief that the asset classes MPLs are opening up to retail investors provide a compelling alternative to deposits. Our research suggests that most people understand that lending money through an MPL is much riskier than depositing money with a bank (see Figure 14), and therefore is not a comparable investment. And, while the creation of an ISA-wrapped product may cause some existing ISA funds to switch to this new asset class, the underlying risk profile of MPLs would make it more likely for them to cannibalise existing stocks & shares ISAs than cash ISAs.

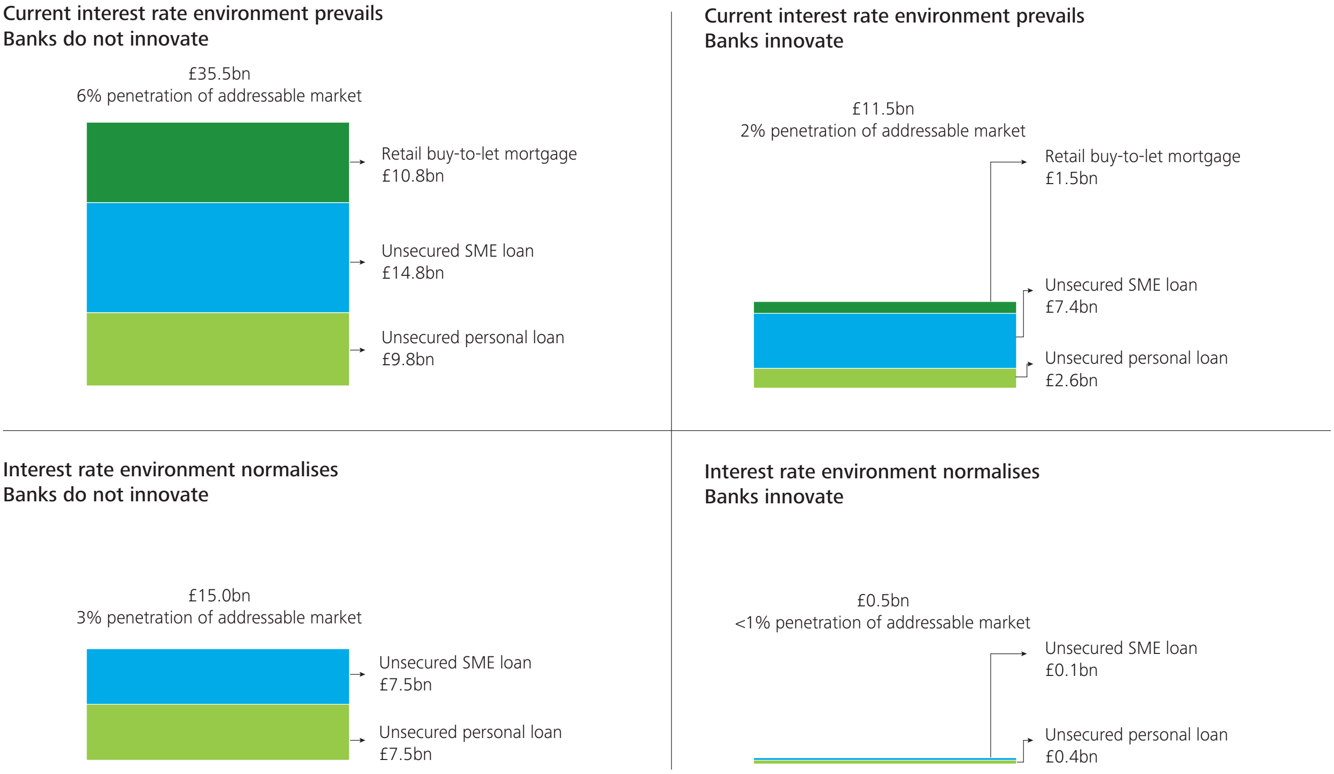
Our research also suggests that, while the non-price benefits that MPLs provide to lenders (namely the transparency and control over the businesses or individuals to which funds are lent) may provide a material motivation for some participants, this is certainly not universally the case.

Overall, therefore, the case for predicting a significant outflow of deposits from the banking system does not seem strong.

Rather, we see MPLs as a low-cost approach for certain investors to gain direct exposure to new asset classes. This is particularly attractive when coupled with emerging technologies to dynamically manage an overall portfolio of such investments, with potential implications for the fees that traditional asset managers charge.

6. The future of marketplace lending

Figure 22. UK MPL total market penetration scenarios, 2025*



Source: Deloitte analysis[55, 56]
*** We calculated our market penetration forecasts for retail mortgages in the chart above using buy-to-let mortgages as the total addressable market as these are currently the only retail mortgages that MPLs offer in the UK. More generally, we think that price is a sufficiently important purchase criterion in the prime residential mortgage market to prevent MPLs from addressing it.**

The extent to which MPLs take share across various asset classes will depend on a number of complex and interrelated factors. However, to arrive at an initial view, we have considered just two primary variables in a total of four scenarios:

- how MPLs may grow in the current credit market environment, compared with how they may fare once rates increase and banks' cost-of-funds advantage becomes more material
- how MPLs' growth may be affected if incumbent banks invest to improve their customer experience, compared with a scenario where banks rely purely on their pricing advantage.

Having done this, we then assigned a probability to each of these four scenarios and computed a weighted estimate of market share. This analysis makes use of our assessment of both the cost and non-cost drivers of the MPL model's potential advantages detailed above to forecast the future size of the MPL market and the penetration of marketplace lending.[54]

Based on this analysis, we believe that MPLs will not be significant players in terms of overall volume or share. We do not believe that marketplace lending will fundamentally disrupt or displace banks' core function as lenders in the mass market. That is not to belittle MPLs' undoubted achievements or the innovation they have brought to the market. But we see them as a sustaining innovation, likely to be limited to serving profitable, underserved segments that are currently overlooked by incumbent banks.

We do not believe that marketplace lending will fundamentally disrupt or displace banks' core function as lenders in the mass market.

More specifically, we see MPL penetration varying across asset classes. This is primarily due to the differential in risk appetite between incumbents and MPLs, as well as differing customer preferences. MPLs seem more likely to corner parts of the market where a significant proportion of borrowers fall outside the banks' risk appetite. And while we believe that such customers are in the minority, MPLs are also likely to continue succeeding in segments that value speed and convenience enough to pay a premium (such as SMEs, particularly in invoice financing, or high-risk retail borrowers). We believe MPLs will struggle to compete in asset classes where the cost of funds makes up a greater proportion of the total cost of a loan, and where price is a far more important consideration than speed and convenience (such as buy-to-let mortgages).

However, even while MPLs look unlikely to grow sufficiently to displace banks, banks can benefit from adopting some of their best practices, particularly those around customer experience. We explore this in the following section.

However, even while MPLs look unlikely to grow sufficiently to displace banks, banks can benefit from adopting some of their best practices, particularly those around customer experience.

7. How should incumbents respond?

So, given this overall conclusion about the relative competitiveness and advantages between MPLs and banks, how should banks respond? Clearly the answer will depend significantly on an individual bank's current and future participation and competitive strategy, including geographical expansion; however, focusing on MPLs' relative advantages in terms of better UX and a wider potential risk appetite leads us to two broad strategic recommendations regarding banks' lending business.

First, we think it is clear that banks should seek to replicate elements of the UX being delivered by leading MPLs, particularly on the borrowers' side of the marketplaces. They should prioritise those asset classes and use cases where UX has the most weight in influencing customers' purchasing decisions.

Second, we think that providing customers with transparent access to MPL-originated funds (when a customers' requirements are outside the bank's risk appetite) would be a sensible step. It would enhance a bank's overall customer proposition and, structured properly, provide an opportunity to capture more of the latent value inherent in its brand, physical distribution network and existing customer relationships.

However, some important and complex choices underlie these two broad recommendations:

- in seeking to improve their UX, should banks: pursue an organic, in-house development approach; buy an existing MPL that might have great technology but has failed to gain market traction; or in-source those parts of the overall customer journey that are most in need of improvement from an established player (such as JP Morgan Chase's deal with OnDeck detailed in Figure 23)?
- in seeking to offer MPL-originated funding to its customers, a bank faces a series of choices that are not dissimilar to those involved in providing general insurance (GI) products to their customers. This is true both in terms of the overall model to adopt and the choices, deep inside their operating model, that will determine the degree of control they will continue to exercise over their customers' overall experience. So, should a bank create its own MPL, develop a close partnership with a single MPL, or set up a panel of such providers? And, in relation to the last two options, who would manage collections and recoveries?

Answering these questions is beyond the scope of this paper. As noted above, answers will depend on a bank's overall strategy and capabilities. But we have attempted to start making some general observations on the main high-level options we see for collaboration, summarised in Figure 23.

Figure 23. Banks' short-term collaboration options

Banks co-opting elements of the MPL model

Options	Description	Example	Benefits	Challenges	Suitable for
White label	• A bank-branded MPL, for which the bank provides only the brand name • End-to-end MPL model operated by third-party MPL	• No known examples	• Relatively quick, low-risk and non-capital-intensive way to enter or expand bank's participation in existing or new segments • Leverages existing brand equity and maintains/creates brand recognition in target market • Provides potential access to data to improve bank's risk scoring	• Potential risk to brand for limited financial upside • Delivering joined up customer service to multi-product customers • Managing customers' core UX expectations • Financial viability of partner MPL	• Banks with a strong customer franchise but constrained organic growth capacity due to challenges relating to, e.g.: – access to competitive funding – risk appetite/capital capacity – investment capacity
Capability insource	• A bank-branded, on balance sheet lending service (i.e. consistent with current banking model) • Involves sourcing elements of the lending value-chain, such as: – acquisition – origination – underwriting – servicing	• JP Morgan Chase provides loans to its SME customers using OnDeck's platform[57] • OnDeck provides origination, underwriting and servicing • Platform is externally branded Chase • Funds come from JP Morgan Chase's balance sheet	• Delivers benefits of superior MPL UX capability and opex efficiency quickly and with limited investment • Maintains customer relationship and grows balance sheet • Provides deeper learning opportunity than less integrated options	• Maintaining appropriate level of control and oversight without undermining competitiveness of insourced capability • Adjusting internal processes and policies to enable full benefits of new capabilities to be realised • Financial strength/ viability of supplier MPL	• Banks already in the market, with strong demand and available funds but which are hampered by legacy tech/processes and want to improve efficiency and cost effectiveness • An enabler for smaller banks with limited customer acquisition and/or limited capability to underwrite[61]
Deploy funds	• Investing customer deposits through an MPL platform	• Metro Bank deploys customer deposits through Zopa[58]	• Flexible, low-cost channel (limited lending opex) to deploy excess customer deposits with relatively high expected net yield • Provides potential access to data to improve bank's risk scoring • Potential brand halo effect (supporting the challengers)	• Does not directly build the customer (lending) franchise • Need to perform proper due diligence on the underlying model, as many MPLs have a limited track record	• Banks with a low loan-to-deposit ratio seeking alternative use of "excess" funds • Banks seeking to create positive public relations
Refer borrowers	• Referring less profitable customers or customers outside of the bank's risk appetite to an MPL platform	• RBS and Santander UK[59] refer SME customers rejected for a loan to Funding Circle	• Improves risk-weighted assets while maintaining customer relationship • Involves possibility of bank receiving referral fees from MPL • Allows banks to provide an option to under-served segments • Enables any regulatory requirements to be met, such as referral legislation[60]	• No immediate income, if referral fees are opted out • Responsible-lending issues may arise from economic interests	• Banks with a large number of loan applications which they are unable to serve

Source: Deloitte analysis

Beyond such important choices relating to banks' lending business, our research suggests that there is only a limited need for banks to respond to the potential threat MPLs pose to their deposit-gathering activities. Deloitte believes that they can be relatively relaxed about their choices regarding access to such investment opportunities alongside their traditional savings products, and about how far they seek to create greater transparency around the uses to which they put depositors' funds. That said, banks aiming to create a specific brand positioning might find an interesting opportunity in the transparency of the MPL model to bring such brand promises to life.

Our analysis highlights that banks' low cost funding model means they retain a powerful competitive advantage. This is likely to prove even more powerful when and if base rates rise.

Conclusion

Marketplace lending is demonstrating the potential for new business models to disrupt traditional banking by:

- taking advantage of the wider trends that are reducing barriers to entry
- enabling the rapid deployment of capital into hitherto restricted asset classes.

However, our analysis highlights that banks' low-cost funding model means they retain a powerful competitive advantage. This is likely to prove even more powerful when and if base rates rise. As a consequence, we do not foresee banks being systematically displaced from their core roles of lending to retail consumers and small businesses, and collecting deposits from those segments.

However, we believe marketplace lenders are likely to secure a strong foothold in areas of the market where banks do not have the risk appetite to compete.

This will form a bridgehead from which they can expand at those times in the cycle when banks are pulling back from lending or relying on super-normal profits in order to cross-subsidise other parts of their business. (This is a particular problem in the UK at this point in the cycle.)

We therefore believe that there is a significant consumer benefit to be had by establishing a vibrant, innovative MPL sector, provided that consumer interests are fully considered and that players do not over-reach and over-promise in trying to compete with banks in mainstream markets.

Appendix

Figure 11: (Aware of marketplace lending?) – For the following question, by 'peer-to-peer lenders', we mean lenders other than banks or building societies that facilitate direct contact between borrowers and lenders via an online platform. This excludes payday lenders such as Wonga. Before taking this survey, were you aware of the existence of peer-to-peer lenders? Base: All GB adults (nationally representative), 2,090

(Aware of specific MPLs?) – Before taking this survey, which, if any, of the following peer-to-peer lenders (Assetz Capital, Folk2Folk, Funding Circle, Landbay, LendInvest, Lending Works, Madiston LendLoanInvest, RateSetter, Wellesley and Co, Zopa) had you heard of? Base: All GB adults aware of peer-to-peer lenders (nationally representative), 1,168

(Used?) – Which of the following statements (I have borrowed via a peer-to-peer lending platform; I have lent via a peer-to-peer lending platform; I have both borrowed and lent via a peer-to-peer lending platform; I have neither borrowed nor lent via a peer-to-peer lending platform) apply to you? Base: All GB adults aware of peer-to-peer lenders (nationally representative), 1,168

Figure 12: (Aware of marketplace lending?) – The following questions are about SME 'peer-to-peer lenders'. By this we mean lenders other than banks or building societies that facilitate direct contact between SME borrowers and lenders via an online platform. This excludes payday lenders such as Wonga. Before taking this survey, were you aware of the existence of peer-to-peer lenders for SMEs? Base: All SME senior decision makers (nationally representative), 1,609

(Aware of specific MPLs?) – Before taking this survey, which, if any, of the following SME peer-to-peer lenders (Assetz Capital, Folk2Folk, Funding Circle, LendInvest, MarketInvoice, Platform Black, ThinCats, Wellesley and Co) had you heard of? Base: All SME senior decision makers aware of peer-to-peer lenders for SMEs (nationally representative), 1,223

(Used?) – Which of the following sentences (My business has borrowed via a peer-to-peer lending platform; My business has lent via a peer-to-peer lending platform; My business has both borrowed and lent via a peer-to-peer lending platform; My business has neither borrowed nor lent via a peer-to-peer lending platform) apply to your business? Base: All SME senior decision makers aware of peer-to-peer lenders for SMEs (nationally representative), 1,223

Figure 13: How did you first become aware of each of the following peer-to-peer lending platforms (Assetz Capital, Folk2Folk, Funding Circle, Landbay, LendInvest, Lending Works, Madiston LendLoanInvest, RateSetter, Wellesley and Co, Zopa)? (Percentages add up to more than 100 per cent as data is aggregated for all of the above lenders) Base: All GB adults aware of one or more of the above peer-to-peer lenders (nationally representative), 588

Figure 14: From a financial point of view, to what extent would you say that lending through a peer-to-peer lending platform is more or less risky than each of the following, or is it about the same? Base: All GB adults aware of peer-to-peer lenders (nationally representative), 1,168

Figure 16: Thinking about any occasions when you have borrowed money via a peer-to-peer lending platform... On a scale of 1 to 5, where 1 is 'Not at all applicable' and 5 is 'Very applicable', how applicable were each of the following factors in your decision to use a peer-to-peer lender rather than another source? (Chart shows percentage of respondents choosing 4 or 5 for each factor) Base: All GB adults who have borrowed via a peer-to-peer lending platform (non-nationally representative), 89

Figure 21: Thinking about any occasions when you have lent money via a peer-to-peer lending platform... On a scale of 1 to 5, where 1 is 'Not at all applicable' and 5 is 'Very applicable', how applicable were each of the following factors in your decision to use a peer-to-peer lender rather than another source? (Chart shows percentage of respondents choosing 4 or 5 for each factor) Base: All GB adults who have lent via a peer-to-peer lending platform (non-nationally representative), 161

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34. We estimate the non-interest costs of running a deposit book at approximately 310 bps of the total deposits held. Approximately 60% of this is attributable to the costs of the branch network, with the remainder relating to acquisition, processing and servicing expenses. Furthermore, we assume that in a normally capitalised banking book with sufficient liquidity reserves, total deposits will equal approximately 87% of total loans. As such, we compute the non-interest costs incurred in attracting and retaining deposits at approximately 270 bps of the total loans funded by the deposits.

35. Banks and MPLs clearly do incur other operating costs: banks must service their deposits and branch networks, while MPLs must service their investors. However, we have factored these into the 'fully-loaded' costs of attracting funds set out in the previous section.

36. As part of this research, Deloitte constructed two questionnaires around the awareness, usage and potential future usage of marketplace lenders – one for consumers and one for SMEs, using YouGov as the source research agency. In collecting the data, a hybrid model was used. Questions around awareness and potential future usage were asked to a nationally representative sample of 2,090 consumers and 1,609 senior SME decision-makers. Questions about previous usage were asked to a non-representative sample group of 4,296 consumers and 1,671 senior SME decision-makers, in order to obtain a statistically relevant sample size. The objective was to understand the factors driving and inhibiting usage, and the potential for future growth, of MPLs.

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54. See endnote 33

55. Deloitte defines the addressable market as the UK consumer unsecured personal lending market, the UK small and medium-sized business lending market, and the UK retail buy-to-let market. To estimate the size of the addressable market, Deloitte has taken data relating to consumer and SME lending published by the Bank of England and applied prudent growth rates to estimate market size in 2025. In addition, Deloitte has taken data relating to UK retail mortgage lending from the Bank of England and carved out an amount commensurate with current buy-to-let mortgage lending. Deloitte has then applied prudent growth rates to arrive at an estimated market size in 2025. In combination, these amounts represent our estimated addressable market.

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