VIEWPOINTS

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The U.S. Online, Non-Bank Finance Landscape

Jackson Mueller

Executive Summary

Advances in computing power and the shift toward a digital economy within the last two decades have changed how consumers and businesses transact, interact, and access financial services. More recently, as traditional financial institutions became hesitant to lend to small business and some consumer categories, online, non-bank finance platforms are picking up the slack in those markets. The once-typical face-to-face meetings with bank representatives, complete with stacks of paperwork, is being replaced with automated processes that dramatically reduce the friction long associated with obtaining capital.

This evolution has brought with it dramatically reduced costs, greater efficiencies, and an abundance of data about the borrower, creating a fertile environment for the development of online finance. Internet platforms have capitalized on the shift and harnessed the data (both public and private) to build underwriting models capable of providing a credit score based on thousands, perhaps tens of thousands, of data points on a borrower in real time. The click of a button is replacing the handshake.

But who are these non-bank lenders? How do these firms operate? What sort of products do they offer? And, most importantly, how did they grow to become such a recognizable resource for credit? In the supplemental landscape to this paper, I have profiled more than 70 predominantly U.S.-based online, non-bank financing platforms seeking to answer such questions. Given the variety of business models, products, and practices associated with the non-bank financing space, it is incumbent upon regulators and policymakers to understand these distinctions in developing oversight frameworks that support innovation while ensuring sufficient protections for borrowers and investors.

Introduction

In the wake of the 2007-09 financial crisis, and arguably even before then, traditional financial institutions pulled back from providing capital to small businesses and some categories of consumers as tightened regulatory restrictions, an uncertain economy, and the need to shed assets made it more costly to fill these credit needs. This retrenchment opened a sizable gap in the capital access pipeline.

For instance, small business loans' share of total bank loans fell from roughly half in the mid-1990s to less than 30 percent by 2012, and the costs associated with underwriting a $100,000 small business loan are now comparable to a $1 million loan.[1] In 2011, an average of 8,000 small and micro businesses were denied funding each day, according to U.S. Treasury Secretary Jack Lew.[2] As the Association for Enterprise Opportunity has stated, the credit gap, estimated between $44 billion and $52 billion, "represents a massive market failure that cannot be solved absent innovative new business models."[3] Similarly, from 2007 to 2014, lending through bank-originated consumer finance loans has declined roughly 2 percent per quarter, and lending through bank-originated credit cards has fallen by 0.7 percent per quarter.[4]

As traditional financial institutions balked, online finance platforms have filled the credit gap faced by small businesses and consumers starved for capital. The result: The industry has doubled loan origination each year since 2010 and may have the potential to generate nearly half a trillion dollars in loan value globally by the end of this decade.[5] With its remarkable growth, the industry could take $11 billion in annual profit from the traditional banking system.[6]

As dramatic as this expansion has been, the industry has entered a tumultuous period. Regulators are heightening scrutiny at both the state and federal levels. Legal issues, along with uncertainties regarding business models, credit underwriting practices, and the underlying loans included in securitizations, threaten to pose challenges to the nascent industry. And overall, there are plenty of unknowns in the United States' economic outlook. In the following landscape, I have offered observations on the headwinds that online, non-bank finance platforms could face in the months or years ahead.

However, the goal of this report is to identify the new operators, explain their business models and practices and how they became involved in the space. This paper, and the landscape, are an attempt to

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[1] Karen Mills and Brayden McCarthy. "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game." July 22, 2014. Available at http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf

[2] U.S. Department of the Treasury. June 10, 2013. Available at https://www.treasury.gov/press-center/press-releases/Pages/jl1979.aspx

[3] Association for Enterprise Opportunity comment letter submitted to the U.S. Department of the Treasury in response to its request for information on online marketplace lending (P. 2). September 30, 2015. Available at https://www.regulations.gov/#!documentDetail;D=TREAS-DO-2015-0007-0054

[4] Yuliya Demyanyk. "Peer-to-Peer Lending Is Poised to Grow." The Federal Reserve Bank of Cleveland. August 14, 2014. Available at https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2014-economic-trends/et-20140814-peer-to-peer-lending-is-poised-to-grow.aspx

[5] "Can P2P Lending Reinvent Banking?" Morgan Stanley. June 17, 2015. Available at http://www.morganstanley.com/ideas/p2p-marketplace-lending

[6] "The Future of Finance: The Rise of the New Shadow Bank." Goldman Sachs. March 3, 2015. Available at http://www.betandbetter.com/photos_forum/1425585417.pdf. The $11 billion estimate includes consumer lending, small business lending, leveraged lending, mortgage banking, commercial real estate and student lending.

inform the discussions taking place at the state and federal levels and broaden stakeholders' perspectives on an industry that is reshaping how consumers and small businesses access capital.

Methodology

A primary motivation for producing the landscape was to identify the various platforms that have developed innovative models to meet the demand for capital. The starting point was the Treasury Department's 2015 request for information on the online marketplace lending industry,[7] in particular, and the comments submitted by an array of non-bank finance platforms,[8] not just marketplace lenders—which are a subset of the online, non-bank financing industry.

The landscape contains individual profiles of more than 70 predominantly U.S.-based platforms that offer credit to consumers and/or small businesses. They were pulled from news articles, reports, and responses to Treasury's request for information.

The information is relevant as of May 31, 2016. Information on funding rounds and the firms and individuals involved in each round were provided largely by the website Crunchbase.[9] Additionally, each profile drew information from the platform's website, including press releases, blogs, media references, FAQs, and the platform's terms and conditions and privacy policies (that's right, I even went through those). Information was also obtained by using news distribution websites including PR Newswire, PRWeb, Business Wire, and Market Wired. In some cases, information was also pulled from filings retrieved from the U.S. Securities and Exchange Commission's EDGAR portal.[10]

Findings

Based on the landscape, I have provided a few findings that I believe warrant attention.

Diverse business models concentrated geography

There are far more online, non-bank financing platforms in the U.S. than the roughly 70 firms I have profiled. That said, the attachment provides insight into how these companies operate, their cost structures, the borrowers they serve, the locations of their markets, and the products they offer. There are balance-sheet lenders, there are platforms that operate at the point of sale, and there are platforms that simply provide a bridge or matchmaking space between lenders and borrowers. Some platforms focus on the retail investor and others focus solely on accredited/institutional investors, while some focus on both. There are platforms that predominantly offer short-term financing, while other lenders offer long-term finance. Some have branched out from one product or service into many and/or

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[7] "Treasury Seeks Public Comments on Marketplace Lenders." U.S. Department of the Treasury. July 16, 2015. Available at https://www.treasury.gov/press-center/press-releases/Pages/jl0116.aspx

[8] Nearly 100 comments were submitted in response to Treasury's request for information on online marketplace lending. Responses can be viewed here: https://www.regulations.gov/#!docketBrowser;rpp=50;po=0;dct=PS;D=TREAS-DO-2015-0007

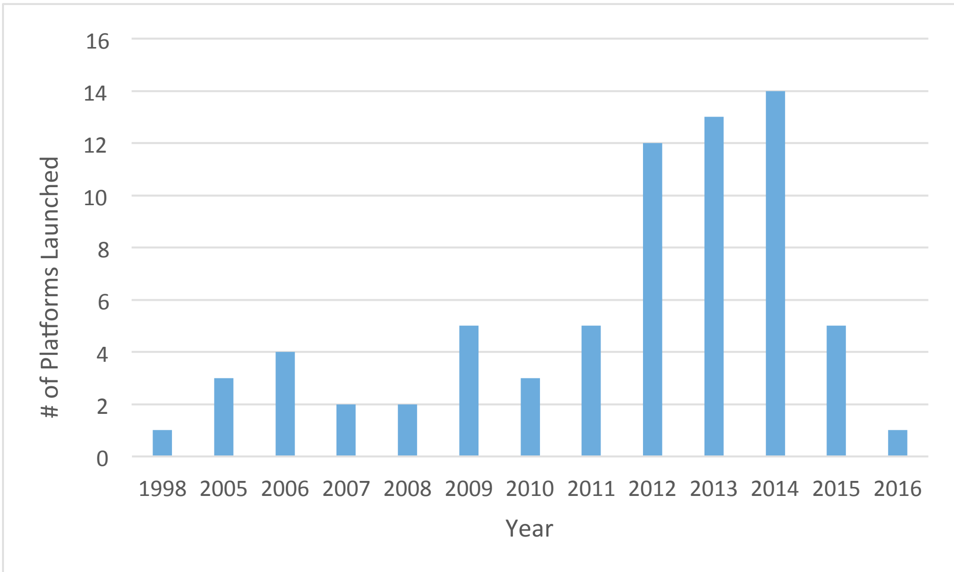
[9] Available at https://www.crunchbase.com/

[10] I would also like to thank the platforms I connected with at LendIt 2016 in San Francisco and through e-mail and various social media outlets. Your help is greatly appreciated.

partnered with leading traditional financial firms to expand credit access and scale up.[11] Both options have become increasingly prevalent within the last few years.

As illustrated in Figure 1 below, the field is relatively young. Growth in the number of platforms launched in the U.S. has accelerated in the last five years, especially for the platforms included in the landscape. In fact, more than half of the platforms profiled in the following landscape were launched between 2012 and 2014.

FIGURE 1: Launch of Online, Non-Bank Platforms[12]



Additionally, the industry remains geographically concentrated in well-known FinTech hotspots. For instance, of the 72 platforms[13] profiled, nearly three-quarters operate in California or New York (Figure 2).

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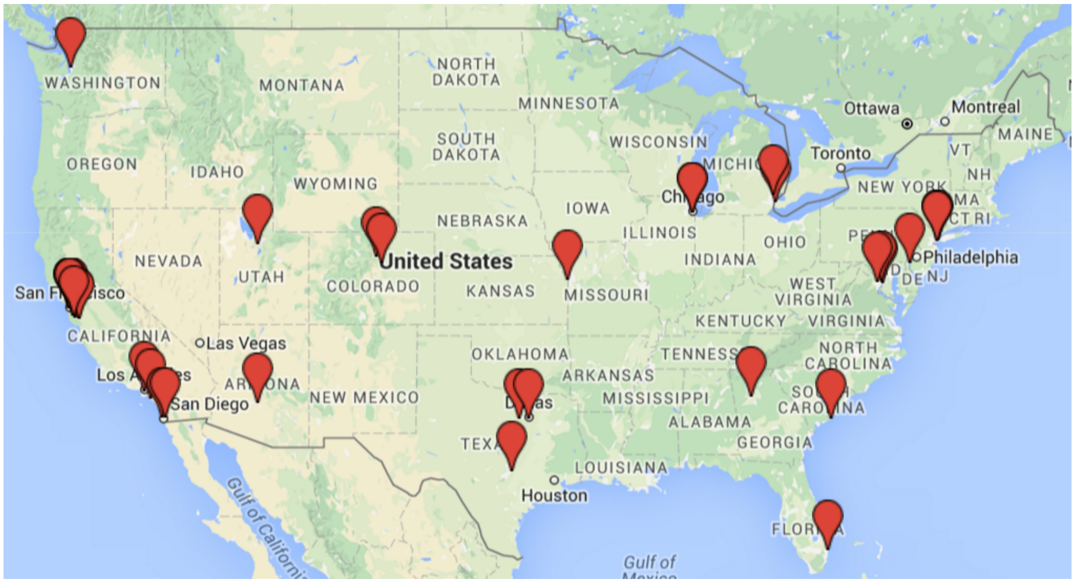
[11] As we noted in an earlier white paper, *FinTech: Views from the Market*, banks "view marketplace lenders as potential competitors and also as potential partners. Banks have entered into agreements with marketplace lenders to allow mutual referrals and cobranded or co-distributed products. The idea is that this allows banks to maintain the relationship with their customers, even if they cannot loan to them directly, while allowing the marketplace lender to leverage the bank's network of potential borrowers."

[12] Accion USA launched in 1991, but I've recorded Accion in the chart as launching in 2006, when the organization launched its online loan application. Although Kiva was founded in 2005, the organization did not launch its online microfinance pilot program in the U.S. until 2009, which I have marked as the date of launch. Funding Circle originally launched in the UK in 2010 but came to the U.S. in 2013, which I have marked as the company's launch date given the landscape's focus on U.S.-based platforms. Intuit was founded in 1983, but the company introduced Quickbooks Financing in 2013, the date I have used in the chart. I4 Commerce was founded in 2000, before rebranding to Bill Me Later in 2007. Bill Me Later rebranded to PayPal Credit in 2014. I have used 2014 as the date of launch for PayPal Credit. Capify came to be through rebranding in 2015, even though AmeriMerchant was founded in 2002. I used 2015 as the date of launch for Capify. Wells Fargo launched its FastFlex Small Business Loan in 2016, but the company first tested the product in 2015, which is the date I used. The chart does not include Goldman Sachs, which has yet to launch an online lending product, or the U.S. Small Business Administration.

[13] Lending Club and PayPal were counted twice as they operate in both the small business and consumer finance spaces.

FIGURE 2: Location of Online, Non-Bank Finance Platforms

Red markers indicate the location of one or several platforms



Formation of industry-driven initiatives and trade groups

As regulatory headwinds gathered force over the past year, so too have initiatives to educate policymakers and regulatory officials. Several trade groups, coalitions, and initiatives were formed, particularly focused on small business finance, in response to Washington's interest in the online, non-bank finance space. They are, in order of launch date:

The Small Business Finance Association[14] (April 2015)

- Known as the North American Merchant Advance Association before rebranding in April 2015.
- "A not-for-profit 501(c)(6) trade association representing organizations that provide alternative financing solutions to small businesses. SBFA provides guidance and helps to influence and shape the small business alternative financing industry through leadership, education and risk monitoring tools."
- Hires Steve Denis as executive director in December 2015.
- Releases best practices for the alternative finance industry in April 2016.

The Responsible Business Lending Coalition[15] (August 2015)

- Original founders: Accion, the Aspen Institute, Fundera, Funding Circle, Lending Club, MultiFunding, Opportunity Fund, and the Small Business Majority.
- "The mission of the Responsible Business Lending Coalition is to drive responsible practice in the small business lending sector. We do this by creating awareness of

[14] http://www.sbfassociation.org/. Lending Club and PayPal counted twice as they operate in both small business and consumer finance. Incumbent firms Goldman Sachs and Wells Fargo also profiled due to their online finance ambitions, along with the U.S. Small Business Administration.

[15] http://www.responsiblebusinesslending.org/

predatory practices emerging in the marketplace, and by providing information and tools that small business owners can use to identify responsible products, and that lenders, brokers, investors and policymakers can use to identify, offer and require responsible lending products and practices."

- Launched the Small Business Borrowers' Bill of Rights, an industry-driven initiative to "foster greater transparency and accountability across the small business lending sector."

Financial Innovation Now[16] (November 2015)

- "An alliance of technology leaders that are working together to modernize the way consumers and businesses manage money and conduct commerce."
- Executive director: Brian Peters (also a partner at Franklin Square Group).
- The coalition includes Amazon, Apple, Google, Intuit, and PayPal.

The Coalition for Responsible Business Finance[17] (March 2016)

- "A group of businesses and service providers that advocate for the value of alternative financing opportunities for small businesses. CRBF was created to educate state and federal policymakers, media, and communities on how technology and innovation are providing small businesses access to capital that is necessary for growth."
- Executive director: Tom Sullivan (also an attorney in the government relations practice of Nelson Mullins Riley & Scarborough LLP).
- The coalition includes the National Federation of Independent Business, the National Small Business Association, and the Small Business & Entrepreneurship Council.
- Prior to its formal launch, the coalition submitted comments in response to the Treasury Department's request for information on online marketplace lending.[18]

The Marketplace Lending Association[19] (April 2016)

- Founding members: Funding Circle, Lending Club, and Prosper Marketplace.
- "A U.S. non-profit membership organization created to promote responsible business practices and sound public policy to benefit borrowers and investors."
- Alongside the launch, the association published its marketplace lending operating standards.

The Innovative Lending Platform Association[20] (May 2016)

- Founding members: OnDeck, Kabbage, CAN Capital.
- The association "is focused on advancing small business online lending education, advocacy, and best practices."

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[16] https://financialinnovationnow.org/
[17] http://www.responsiblefinance.com/
[18] http://debanked.com/CRBFTreasuryRFI.pdf
[19] http://www.marketplacelendingassociation.org/
[20] http://innovativelending.org/

- Alongside the formation of the association, the group formed a partnership with the Association of Enterprise Opportunity to create a model small business lending disclosure called the Straightforward Metrics Around Rate and Total Cost (SMART) Box to "present a small business with a chart of standardized pricing comparison tools and explanations, including various total dollar cost and annual percentage rate metrics that enable a comprehensive pricing comparison of loans."

It is important to note that while these groups and initiatives were launched to educate policymakers and regulatory officials about the online, non-bank finance space, they provide information that reflects their own members' business models and practices. I have written that 2016 is the year in which the "great online lending schism" began, as "online lending" or "alternative finance" platforms seek to differentiate themselves within the industry, and I anticipate that these efforts to carve out individual identities and offerings will continue.[21]

Conclusion

As regulatory authorities and policymakers continue to examine the online, non-bank financing space, it is vital that they take the time to understand the diversity of the industry. The Milken Institute applauds the efforts undertaken by forward-thinking officials to broaden their understanding, and we hope this landscape will contribute to the discussions taking place.

[21] Jackson Mueller. "The Great Online Lending Schism of 2016." Milken Institute. April 8, 2016. Available at http://www.milkeninstitute.org/blog/view/970

About the Author

Jackson Mueller is the deputy director of the FinTech program at the Milken Institute's Center for Financial Markets. His focus is on capital formation policy and financial markets education initiatives. Prior to joining the Institute, Mueller was an assistant vice president at the Securities Industry and Financial Markets Association (SIFMA), where he focused on a broad range of financial services-related policies, provided legislative and regulatory updates to executive-level government relations staff, and conducted analysis of key issues relevant to SIFMA's members. He received his bachelor's degree in political science from the University of Richmond and a master's degree in public policy from American University. He works at the Institute's Washington, D.C. office.

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