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FEATURE

Funding takes center stage for nonbank online lenders

Cost of capital survey results

By Stephen Fromhart and Chris Moller

Nonbank online lenders have become growing participants in the lending ecosystem. But this growth hasn't come without challenges. A Deloitte-LendIt survey found that cost of funding is a major concern for these lenders.

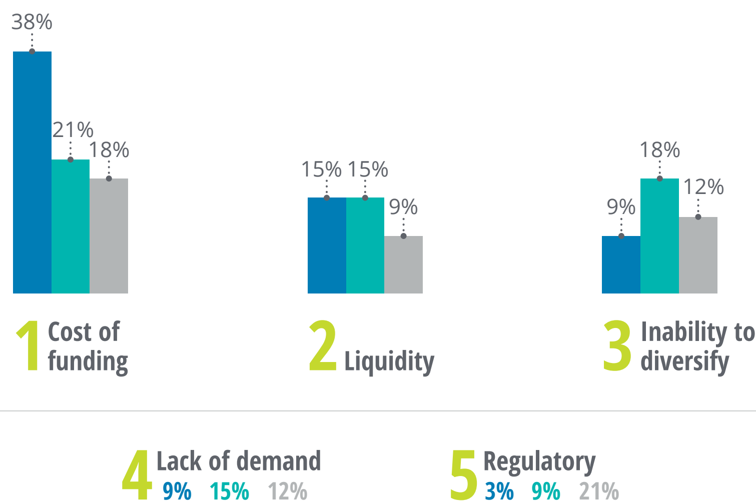
Cost of funding is a top concern

Cost of funding has become a key pain point for many nonbank online lenders—a central theme in the results of a recent survey conducted by the Deloitte Center for Financial Services (DCFS) and LendIt Fintech (LendIt) leading up to the LendIt Fintech USA 2018 conference (see sidebar, "About the survey").

A full 77 percent of respondents listed *cost of funding* as among their top three concerns, while 38 percent listed it as their top concern. Only 39 percent listed any other issue among their top three concerns, let alone their first concern (figure 1).

FIGURE 1

Top three concerns for 2018



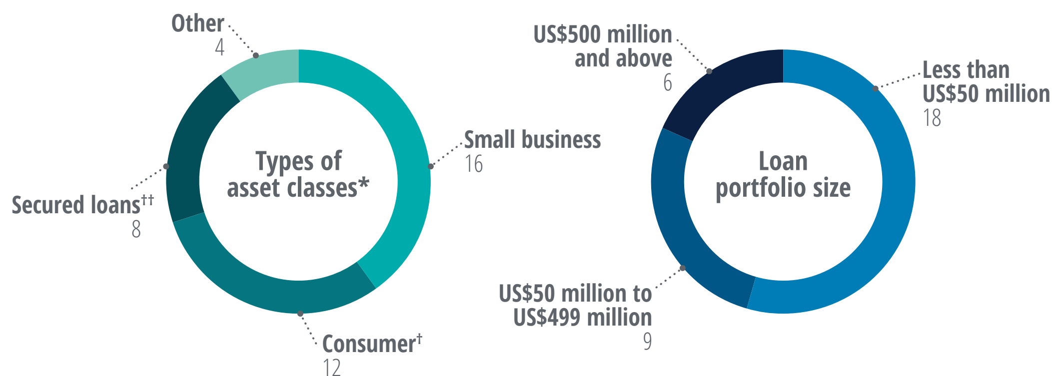
Source: "Online Lending Cost of Capital Survey," Deloitte Center for Financial Services and LendIt Fintech, April 2018.

ABOUT THE SURVEY

Of the 34 nonbank fintech online lender respondents surveyed, the distribution was roughly equal to the market landscape: a small number of large players and mostly smaller players. Also similar to the market, small business and consumer unsecured business were the dominant asset classes that showed up in the survey. As seen in figure 1, the majority of survey participants had loan portfolios of less than US$50 million and half a dozen had portfolios of more than US$500 million (only four had portfolios more than US$1 billion). Also consistent with the industry in general, respondents mostly specialized in lending one type of asset class (figure 2).

FIGURE 2

Breakdown of survey respondents and loan portfolio size



* Four respondents loaned two asset classes, and one loaned three asset classes.
† Consumer unsecured and student loans
†† Commercial real estate, residential real estate, and auto loans

Source: "Online Lending Cost of Capital Survey," Deloitte Center for Financial Services and LendIt Fintech, April 2018.

Size generally translates into funding advantage

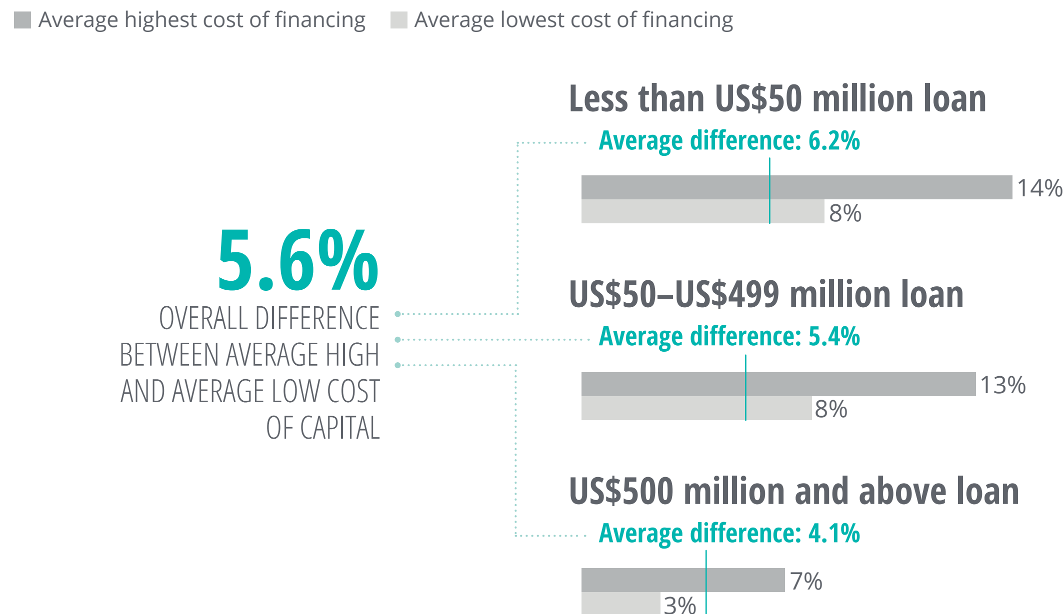
Another key finding involved the role that size played in a nonbank lender's ability to lower costs. While the average weighted cost of financing reported by the respondents ranged widely from single-digit to double-digit percentages, the survey confirmed larger nonbank lenders had greater ability to lower their cost of funding than smaller players could. From our other research, we know that the big nonbank lenders tend to be older, more established companies, so this result was not completely surprising.

As figure 3 shows, not only do the lowest and highest cost of funding percentages decline as companies grow and scale, but also the difference between the average highest and average lowest cost of funding sources shrinks considerably. This trend appears to indicate that as a company gains scale and lowers its cost of capital, it can also considerably rein in its range. When lenders are able to narrow the band of cost of funding with some level of predictability and maintain profits, it creates an attractive value proposition for second-stage investors, such as securitization, which could create a snowball effect of lowering funding costs.

FIGURE 3

The difference between the average highest and lowest cost of funding sources declines as companies grow and scale.

Average highest versus average lowest cost of financing



Source: "Online Lending Cost of Capital Survey," Deloitte Center for Financial Services and LendIt Fintech, April 2018.

Furthermore, the results of the survey also suggest that a company's scale affects its ability to competitively offer products at a discount in the market. With their lower cost of funding, larger companies seem to be able to operate with lower gross asset yields, which translates into lower rates for customers. Not only do the yields decrease by company size, but also the difference between their lowest and highest gross yields shrinks by size as well (figure 4).

A company's scale affects its ability to competitively offer products at a discount in the market.

The survey confirmed that larger companies primarily have lower funding costs because of their access to additional and more diverse sources of financing. Figure 5 shows how larger companies are typically able to rely less on more costly types of financing, such as equity and bank lines of credit, and have moved increasingly to the lowest cost of financing: securitization.

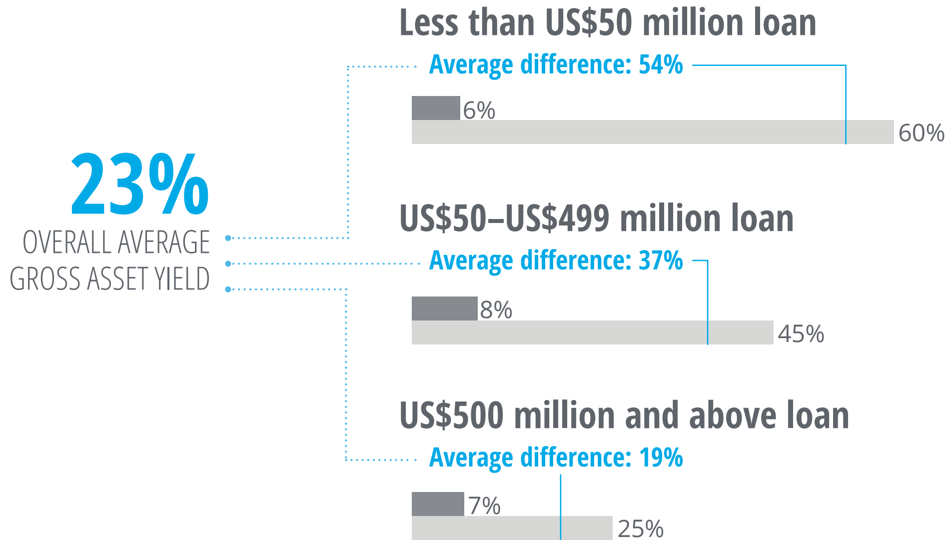
One interesting finding was the predominance of warehouse lines of credit from banks. Not too long ago, the interaction between banks and online lenders seemed to be limited to partners, competitors, investors, or a combination of the three. Now, these relationships have expanded; in some instances, banks are now providing online lenders their credit facility products without the trade-off of a loan origination partnership for those credit facilities. This pure provider-customer relationship is yet another compelling example of just how intertwined the ecosystem has become.

Another survey result that seems to reflect the ecosystem affecting the cost of capital turned out to

FIGURE 4

As companies grow in size, both the average gross asset yields and the difference between averages decrease.

Average highest versus average lowest gross asset yields

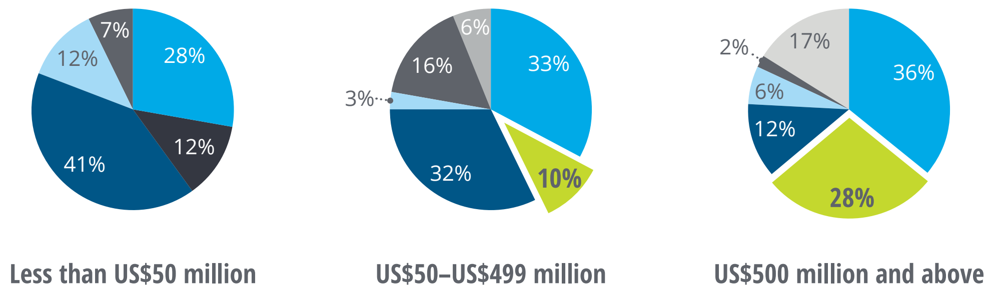


Source: "Online Lending Cost of Capital Survey," Deloitte Center for Financial Services and LendIt Fintech, April 2018.

FIGURE 5

Larger companies are increasingly able to move to the lowest cost of financing: securitization.

Capital source types to fund lending activity, by company size



Source: "Online Lending Cost of Capital Survey," Deloitte Center for Financial Services and LendIt Fintech, April 2018.

be something relatively abstract at first glance: companies that did or did not use third-party backup servicers. By nature, most online lenders pride themselves on their technology prowess and their ability to perform tasks more efficiently than incumbents could. Yet securitization presents the lowest cost of funding available to nonbank online lenders and, for the handful of online lenders whose assets are backed by securitizations, a third-party backup servicer has increasingly become a favorable factor in market-influencing credit ratings. Accordingly, all of the larger participants in the survey, with more than US$500 million loan portfolios, reported having backup servicers. Furthermore, and not so surprising given the previously stated data, across all asset classes, respondents from companies with backup servicers reported significantly lower average cost of funding percentages than those that did not use backup servicers. For unsecured consumer lending, for example, the weighted average cost of financing was 14 percent for lenders that did not have third-party backup servicers and 5.8 percent for those that had them; for small business lending, the percentages were 10.7 percent and 6.5 percent, respectively.

Investors are still very interested in online lending

Although the survey affirms that large companies with scale have a cost of funding advantage, especially through sophisticated vehicles such as securitization, the investment appetite for online lending overall seems to continue to grow steadily. Using global data outside of the survey and applying our own analysis, we found that investments into fintechs that are involved in lending are forecast to increase to almost US$11 billion in 2018, versus US$9.3 billion in 2017 and US$9.4 billion in 2016.[1] And this annual forecast appears exceptionally conservative when comparing the four months of actual data that was available for 2018 versus the data for the same periods in the previous four years.

Remarkably, the actual number of startups has decreased, implying that the market as a whole is maturing, and that online lending has become a fixture of the overall lending ecosystem.

Remarkably, the actual number of startups has significantly decreased, implying that the market as a whole is maturing, and that online lending has become a fixture of the overall lending ecosystem. The number of startups dropped from 100 in 2014 to 63 in 2015 to 30 in 2016 to only four in 2017.[2] Investors seem to feel comfortable with the business model of online lending companies, but, also, they appear to be happy to invest more into a market in which an increasing number of participants have established track records.

Diversification to weather a credit down cycle

At face value, the results of the survey would seem to indicate that nonbank online lenders with the most scale, given their access to a wider diversity of capital sources and at lower costs than their nonbank competitors, would be best positioned to weather a credit down cycle. This story would also include niche online lending players as survivors of a credit down-cycle, as they would retain customer bases that the big players and banks do not feel are cost-efficient enough to service.[3] These niche customers would include certain varieties of subprime borrowers on the unsecured side or highly specialized small business types on the secured side.

However, the story may not be so straightforward. The online lending market has maintained a

tight spread, which is a good sign of rigor in the industry in general. Hence, if a credit fallout squeezes profits, these large online lenders could have difficulty competing with traditional banks through discount pricing in a down cycle's shrunken consumer pool. Banks, with their federally insured deposits, should have the flexibility to cap their rates and lean on these deposits, and, most importantly, could court customers with whom they have relationships beyond lending.

In this scenario, nimble, smaller nonbank players in the online lending market could fare well in a down cycle by pivoting to lending as a service (LaaS). These fintechs are already increasingly using LaaS and the middle banking market has been receptive. And nonbank online lenders can continue to partner with one another, with other types of fintechs, and with banks to expand their relationships with customers and develop products and services that could include budget apps, wealth management, and even deposits.

Therefore, as interest rates increase, the debt market continues to grow faster than earnings, and the next inevitable credit cycle draws closer, we believe nonbank lenders are well positioned to continue to add value for customers if they choose their paths wisely. When faced with these challenges, we suggest nonbank lenders of all sizes focus squarely on optimizing their capital structure (cost and diversification). To do so, they must strategically partner and integrate with a broad financial services ecosystem to ensure a promising next chapter for their customers and the online lending industry as a whole.

Endnotes

1. Venture Scanner data, Deloitte Center for Financial Services analysis and forecast.
2. Ibid.
3. Stephen Fromhart and Val Srinivas, *Marketplace lenders and banks: An inevitable convergence?*, Deloitte Center for Financial Services, 2016.

About the authors

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