An Introduction to Alternative Lending
Have You Ever Wondered?

If you were to deposit money at a bank, these days you would be lucky to receive 1% interest on a savings account, yet if you were to open a new credit card account and borrow money from the same bank, you would likely be asked to pay an interest rate of 15-20%+. Have you ever wondered how the bank can justify the huge difference between where it borrows money from savers and where it lends money to borrowers?

Roughly ten years ago, some savvy entrepreneurs from the technology and financial services industries took a hard look at this issue and found that the answer lay in a number of inefficiencies in the way that banks provided credit to consumers and small businesses. The alternative lending industry was born.

What is Alternative Lending?

Banks have been central to lending for much of history because of their traditional role in accepting deposits from savers and using this capital to make loans to borrowers at higher interest rates. “Alternative lending” simply refers to loans that are originated outside of banks. Rather than using deposits to make loans as a bank would, alternative lenders typically use technology to match up borrowers directly with investors seeking to earn interest. This was initially known as peer-to-peer lending and is more broadly known today as alternative lending.

While non-bank loan channels have always existed in parallel with traditional banking, these channels were historically small niches in the overall economy. Over the past decade, alternative lending has grown to become a significant presence in the market. Growth in the space hit an inflection point after the 2009 financial crisis, driven by a severe contraction in traditional bank lending, an acceleration of online financial services, and an increasing mistrust of (and dislike for) traditional banks.

Borrowers have increasingly turned to alternative lenders for a better application experience and a more competitive interest rate. Investors have been attracted by the potential for higher yields in a protracted low interest rate environment. You may be familiar with some of the larger alternative lending platforms in the US like Lending Club, SoFi, and Prosper (Fig. 1).
Figure 2 shows the rapid growth in alternative lending in the US. At an estimated $100 billion of loans outstanding in 2017, the market is sizeable, yet it is still small relative to the multi-trillion dollar market for consumer and small business credit at traditional banks.

Lending Club, Federal Reserve, FDIC, Cambridge Center for Alternative Finance, Stone Ridge analysis. Note: “US Consumer Credit” includes revolving consumer credit (e.g., credit cards) and non-revolving secured or unsecured loans, such as for auto, mobile homes, or education.

How Does Alternative Lending Work?

Alternative lenders perform the same core lending functions that a bank would: they interface with borrowers to originate the loan; they perform underwriting to gauge a borrower’s creditworthiness and assign a risk-based interest rate; and they service the loan by collecting principal and interest on behalf of the lender/investor for the duration of the loan’s life.

They typically make money by charging a loan origination fee (paid by the borrower) and an annual loan servicing fee (paid by the investors who hold the loans).

Drawn to the growth and innovation in alternative lending, many heads of credit risk and underwriting from well-known lending institutions like Capital One and JP Morgan Chase have left their roles at traditional banks to take senior positions at alternative lenders.
Technology Drives Cost Savings

Though there are many similarities to traditional banks, alternative lenders often differ from banks through their innovative use of technology in the core functions described above. Because most alternative lenders started with a clean slate in the past ten years, their systems were designed with modern architecture from the ground up. Banks, on the other hand, are notoriously beholden to legacy systems/processes and slow to change and adopt technology. They are also saddled with costs from thousands of physical branches.

Alternative lenders have no physical branches, and they rely heavily on technology for tasks like gathering financial documents, which can be very human-capital intensive at banks.

Alternative lenders employ traditional, “old-fashioned” underwriting but use state-of-the-art technology to create a significant operating cost advantage relative to traditional banks (Fig. 3). These cost savings can be passed on to borrowers (via lower interest rates) and to investors (via higher yields). Above and beyond the economics, a mostly-online process can provide a better user experience. Many of today’s borrowers prefer not to visit a physical bank branch in order to get a loan.
Loans Designed to be Repaid

Though you may not personally carry a credit card balance, almost 40% of US adults currently do.¹ Credit cards have a number of features that can make it difficult for consumers to dig themselves out of debt. Credit cards do not have a set repayment schedule – borrowers are left to choose when to pay back the debt. Credit card interest rates are typically variable and can increase significantly in certain situations, particularly if a borrower misses a payment.

In contrast, alternative lending typically offers borrowers a preset loan size with a fixed interest rate, decided up front. These loans are amortizing, meaning that borrowers are expected to make regular payments of both principal and interest to repay the loan on a set schedule, typically over 3 to 5 years for consumer loans.

As another example of how the alternative lending industry makes innovate use of technology, monthly payments are usually direct-debited from a borrower’s checking account rather than requiring someone to remember to make payments. This is both convenient for borrowers and risk-reducing for investors. In fact, a recent Transunion study of over two million borrowers showed that people prioritized the repayment of these types of installment loans over credit cards, auto loans, and even mortgages.

A Fundamental Shift in the Fixed Income Landscape

Though banks have engaged in profitable lending to consumers and small businesses for decades if not centuries, for most individual investors fixed income has been limited to corporate bonds and government bonds. With the recent growth in alternative lending, many investors are now able to invest in consumer credit and small business credit for the first time. This way of making money has been around for a long time, it was just previously inaccessible. Stone Ridge believes that we are witnessing a fundamental shift in how investors will think about fixed income going forward. By offering higher yields with less interest rate risk, alternative lending can provide a valuable and diversifying contribution to traditional fixed income allocations.

¹According to the National Foundation for Credit Counseling, in 2017, 39% of US adults carry credit card debt from month to month. Transunion is one of the three major consumer credit reporting agencies in the US. “Identifying and Understanding Dynamics in the Payment Hierarchy: Who Gets Paid First,” Transunion, June 2017.
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