

Win in the Flat World

Think Flat

The evolving face of consumer lending

– Balaji Yellavalli

The rules of consumer lending are being simplified through web based technologies that offer intelligent configuration and eliminate information asymmetries in consumer lending business.

Balaji Yellavalli, AVP & Head of Solutions, Banking and Capital Markets, Infosys Technologies believes that the changes like financial democracy, disintermediation through the internet and flattened hierarchies of decision making have paved in the way for new business models like Peer to Peer lending which has broken down barriers to entry into lending and Investing.



Infosys: What are the changes that Consumer Finance and Lending business is experiencing in this era of Globalization and volatile lending market?

Balaji: The 3 most important changes which this business is experiencing are financial democracy, disintermediation through the internet and flattened hierarchies of decision making. The rules of the game are being simplified through web based technologies that offer intelligent configuration and eliminate information asymmetries in lending.

These changes have paved in the way for new business models like Peer to Peer lending which has broken down barriers to entry into lending and Investing.

Today I don't have to be a qualified banker or a credit analyst to make a decision whether I want to lend my money or not.

Infosys: What is "peer-to-peer" lending business model and how does it work?

Balaji: "Peer-to-peer" lending is an internet based consumer lending model. Simply put, these websites are the eBay equivalent of consumer finance wherein people who want money post their need on the site and willing lenders then bid to finance all or a portion of that debt.

The prospective borrower lists his or her credit rating determined by the company, based on past repayment behavior of the person, credit reporting agency evaluation, etc., debt to income ratio and the interest rate he or she is willing to pay and the purpose of the loan or where the funds are expected to be deployed.

This model also provides ability to build a portfolio of "units" of debt across categories of borrowers, or lenders' ability to pick a combination of risk. The company makes money from commissions or transaction fees, akin to e-Bay.

Peer-to-peer lending is attracting a distinct category of borrowers and investors, who keep returning, based on their positive experience. It offers a compelling model with the potential to challenge established players in the so-called "sub-prime" lending space.

"Business models like peer-to-peer lending will emerge as the biggest threat to traditional, organized financial services industry"

Infosys: What are the current transaction volumes in Peer-to-Peer lending market?

Balaji: With loan sizes on peer to peer lending websites ranging from \$5000-\$15,000, these are at best micro-players. Peer-to-peer lending may not be a big force today in terms of transaction size, volume or market share. But the fact of the matter is that it is creating a non-traditional and sustainable channel for marginal borrowers or borrowers whose end uses may not be justifiable for a traditional unsecured lender like a credit card issuer.

Infosys: How is this model going to change the consumer lending market?

Balaji: With the US mortgage market being what it is now and even unsecured "managed" loan portfolios across various hues of lenders – from Banks to Credit Card Issuers - under pressure, there are clear signs that the sub-prime borrower will no longer be courted by large lending institutions.

There are two consequences of this: One, the sub prime or marginal borrowers will still need money and increasingly they will turn to peer-to-peer lending vehicles. So the lenders who have

appetite for risk, will probably lend at a usurious rate to these marginal borrowers, live with the risk of defaults and may be even make a net recovery, post charge-offs, higher than traditional investment channels. As time progresses, these lenders will settle into equilibrium and may be even diversify to other channels.

The second consequence – having said that sub prime borrowers will be forced out of the organized market, there are still loads and loads of sub prime portfolios, which have been turned into mortgage backed securities by hungry investment backs, to feed the hedge fund industry!

Today defaults have started to hit the roof and investment bankers are trying to get these securities off their books or revoking purchase contracts with loan originators. We have seen the New Century and Fremont Investments' collapse in the US! While this may not trigger a "Domino" effect, it will definitely change the sub-prime market dynamics and leave some deep scars!

If peer-to-peer sites find a way to securitize loans, hordes of "private" or individual investors would probably flock to such a portal to diversify their risks and, as transaction sizes increase, may be even larger hedge funds would jump on to the band wagon.

"I think "peer to peer" lending models are the harbinger of the Flat World in consumer Finance and Investing"

Infosys: Why do you think this model is "the future" of consumer lending business?

Balaji: Well, for one, this is financial democracy and micro-credit at its best, where borrowers and lenders share information free of cost rather than pay for it.

As I said earlier, business models like peer-to-peer lending are breaking down traditional barriers to entry into lending and investing and flattening hierarchies of decision making by simplifying the rules of the game.

Secondly, this is all about building loyalty through innovation as opposed to the traditional "stick-with-us-because-we-offer-superior-service compared to the competitor around the block." Business model innovation is attracting a distinct category of borrowers and investors, who keep returning, based on their positive experience.

And finally, peer-to-peer lending offers a great way to race ahead of competition when the industry is down, essentially enabling the Financial Institution to win while its competition copes with industry downturns.

Is "peer-to-peer" lending changing the face of consumer lending in the flat world? Discuss at <http://blogs.infosys.com/thinkflat>

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