zensar

Retail Lending

Key Industry
Trends & Insights for
2022 & beyond

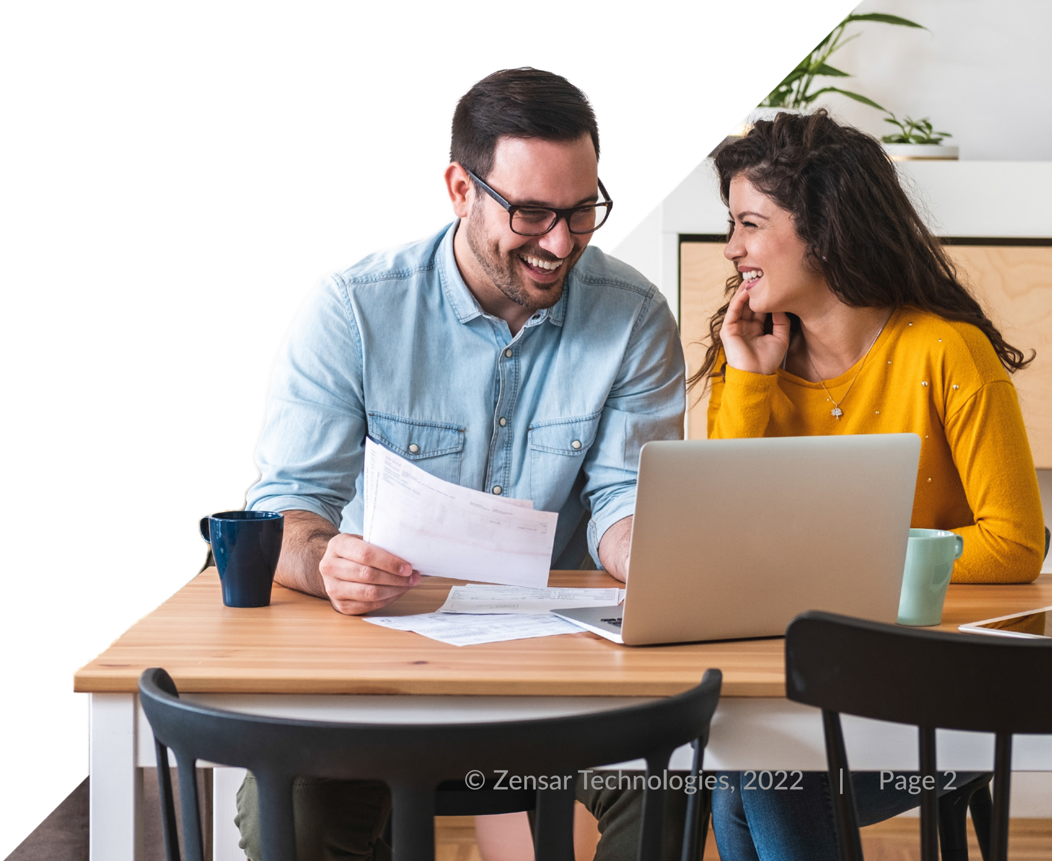
White Paper

As we look back, 2021 was an exciting year for retail lending. The industry continued its overwhelming transformation and innovation initiatives as restrictions on traditional lending channels pushed many consumers to digital lending for the first time. The new trend is here to stay for 2022 and beyond.

Last year was the year of transitions in the face of pandemic-struck markets. As an example of this transition, digital channels accounted for 61 percent of US banks' total loan sales in the three months ending February 2021 [1], a 56.4 percent year-over-year (YoY) growth. Also, 43 percent of all searches for homes on sale in the US in 2021 started online. Out of which, 76 percent of buyers used a mobile or tablet device [2] for home searching, with 60 percent of the purchase and refinanced borrowers open to completing their entire mortgage application online.

Let's see what has been and will be driving these transitions and tailwinds.

- The US lending markets are facing challenging headwinds
- Customer Stickiness concerns across Millennials and Gen Z
- Contextualized Lending with Human Touch driving sales
- BNPL – the Embedded Lending revolution
- Metaverse – the new frontier for finance
- Pivot to Servicing Portfolio consolidation
- Regulators are playing catch up



1. The US economy:
A changing lending landscape

The economy and labor market in the US rebounded in 2021 even though the overall growth fell short of expectations, slowing down consumer spending.

With the rebound in the US economy, all areas of consumer lending have seen improvements.

- The housing market has seen rental occupancy rates hitting 97 percent with a 17 percent [3] rise in rents, a comeback of the 40-year mortgage, borrowers exploring home equity line of credit (HELOC) and reverse mortgages, and an improving mortgage servicing rights (MSR) market.
- The auto loans industry is returning to pre-pandemic levels, with auto loan originations increasing by 17.46 percent 4 YoY to 7.4 million, even though new car financing has fallen in 2022 due to supply issues. Meanwhile, record-low subprime financing and stable delin quencies have been seen. Used car financing has increased sharply in 2022, while captive lenders are increasing their market share for new purchases and leases.
- Credit card originations in the unsecured loan industry [5] witnessed a dramatic rebound in Q3 2021, increasing by 63.5 percent YoY to a record 20.1 million new accounts. Up to 45 percent of originations were from below prime consumers, the highest proportion of originations occurring in this market segment since 2010. In Q4 2021, the number of consumers with credit cards reached 196 million. For personal loans, the origination volumes returned to pre-pandemic levels with 5.1 million in Q3 2021, exceeding the 5 million loan originations in Q3 2019. The borrower-level delinquency rate (60+ DPD) stood at 3 percent in Q4 2021.
- Student loans [6] are expected to grow as total balances have increased by 12 percent to $1.57 trillion in 2021. There was a total of 165 million student loan accounts.

2. Retention of millennials and Gen Z:
Stickiness with the primary bank as a lending partner is at risk

Millennials, Gen Zs, freelance and gig economy workers, and new immigrants often lack the credit profiles traditional financial institutions (FIs) require. However, as the sharing of banking data by open banking APIs has provided easier access to alternative financial options — digital-only competitors (neo and challenger banks) and bigtechs — customers, especially younger ones, are more ready than ever to move away from their primary lending/banking partners where they have their primary CASA/checking accounts. Since Gen Z constitutes 40 percent of the market or 65 million people in the US [7], traditional banks and non-bank lenders need to fully embrace digital lending with the same panache as the incumbent fintech companies if they don't want to be left behind. This doesn't just apply to larger banks and lenders/FIS. FIS' most recent PACE Pulse survey [8] shows that digital banking is more appealing to new regional or community bank customers than others — 26 percent of respondents started a new relationship with a regional or community bank for digital banking services. Naturally, this extends to lending as well.

3. Experience at the forefront:
Contextualized and human touch in digital lending

During the pandemic, consumer preferences for digital lending have become more contextualized. Consumers may use digital channels for routine activities like mortgage rate shopping, completing credit applications, paying loan EMIs, etc. But for more complex services like servicing, forbearance support, and repayment structuring, customers still like in-person, "human touch" interactions, including co-browsing via video/voice call or text, video assistance, etc. A systematically redesigned, contextualized customer journey-driven lending can increase customer satisfaction by at least 15 to 20 percent, which is vital given that 32 percent of all customers in the US [9] will stop doing business with a brand they love after one bad experience.

4. BNPL:
A lending instrument that has taken the world by storm

As a challenge to the existing world of unsecured lending, buy now, pay later (BNPL) has taken the small and medium business (SMB) and e-commerce world by storm in the face of challenges like supply chain issues, labor shortages, and rising prices in the holiday season of 2021. PayPal reported a 400 percent YoY growth amounting to 750,000 BNPL transactions on Black Friday 2021. PayPal also reported having more than a million first-time users in one month during the same period. BNPL users have grown 6x to 36 percent for Gen Z, 2x to 41 percent for Millennials, and approximately 3x for Gen X from 2019 to 2021. In the US, this market is expected to grow approximately 40x to $124 billion by 2023 from $3 billion in 2019. While lenders are still figuring out the regulatory landscape, the entry of more significant players l ike card networks and banks, along with further consolidation, is expected to standardize this space.

5. Metaverse:
A new frontier of contextualized embedded lending opportunity

The Metaverse, a market pegged at $783.3 billion [10] in 2024 and growing at a 13.1 percent CAGR, is also at the forefront of creating seamless anywhere omnichannel lending experiences. JPMorgan recently opened Onyx Lounge, a lounge in metaverse which it plans to operate as a general bank. With this, customers can virtually experience a complete in-bank experience which further paves the way to an experience-driven, anywhere-lending vision. Metaverse also has an exciting opportunity for real estate lending as prices of metaverse real estate has risen by 500 percent since October 2021. New metaverse-based lenders are emerging with completely digital non-fungible token (NFT) value appraisal systems, especially for assets like metaverse real estate, to enable person-to-person (P2P) lending. However, regulatory oversight may remain a grey area.

6. Leveraging M&A for scaling the business and servicing portfolio consolidation

The lending and fintech space has and will be highly prevalent in 2022. While specialty lenders (BNPL, payday loans, etc.) are looking to scale and vertically expand, mortgage lenders seek to shore up some revenue from servicing portfolios.

- For mortgages, as interest rates increase, MSR portfolios will get more lucrative but with more servicing-related complexities driving higher servicing costs. This would be an opportunity for larger lenders with existing servicing infrastructure to acquire and consolidate servicing portfolios of smaller banks/lenders. This may even happen via FDIC LSAs.
- Fintechs and challenger banks are looking at merger and acquisition (M&A) to differentiate their offerings like payday loans and paycheck-integrated point-of-sale (POS) lending while attaining scale. BNPL, a space where growth/scaling fast is a critical key performance metric (KPI), M&A has always been the answer to defend margins at the cost of growth, and in 2022 it has been picking up across the BNPL value chain.

Larger players like existing BNPL players and banks with funding advantages and an understanding of regulatory headwinds have been acquiring to scale up. For example, Paypal acquired Bill Me Later and Paidy, Santander announced Zinia, and Apple announced a BNPL partnership with Goldman Sachs.

The other theme has been positioning B2C BNPL brands as strong consumer brands/super apps via M&As. These brands are moving away from solely a payment method toward a comprehensive shopping experience for consumers. For example, Klarna offers a complete price comparison (PriceRunner), shopping (Spring), and BNPL value chain on one Klarna app to its customers.

7. Regulatory challenges in the face of global events

As Federal Housing Finance Agency (FHFA) oversight unwinds with the Biden administration and Consumer Financial Protection Bureau (CFPB) looks forward to providing an update on open banking APIs, compliance with anti-money laundering (AML), and countering the financing of terrorism (CFT) obligations remains a high priority area. AML/CFT compliance issues are also vital considerations in various BNPL and cryptocurrency initiatives. The Financial Crimes Enforcement Network (FinCEN) is looking to implement provisions of the Anti-Money Laundering Act of 2020 and the Bank Secrecy Act. Regulations around digital assets will also be essential as more and more lenders look into digital assets, including NFT-based Metaverse and real estate.

As BNPL expands, it creates the risk of consumer debt and defaults. Last year, Australia's Afterpay reported a loss of $156.3 million, while Zip had losses of $652 million in just one financial year due to delinquency. Since the wave is primarily driven by small fintechs (who may not be well-financed), there is a potential risk to these companies, which possibly extends to merchants as well. The concerns are amplified more due to continuous innovative BNPL products, exponential growth, and the lack of a globally overarching regulatory framework. However, regulatory authorities are looking for frameworks that may change the BNPL landscape and business models. Still, the complexity of the products remains.

For example:

Fitting BNPL into the US regulations is relatively challenging since laws vary by state. The loan regulations can't be fully applied to BNPL providers owing to their definition of their business odels, which often states they facilitate and support the installment plans on behalf of the customer but don't extend any credit.

BNPL providers like Afterpay unilaterally increase consumers' credit limits over time based on repayment behavior, while the EU directive currently appears to ban this forcredit cards and overdrafts. There is a risk that Afterpay and other BNPL providers may be prohibited from doing this.

BNPL is largely unregulated in the UK. Many BNPL providers and retail partners never had to be FCA authorized or follow consumer credit conduct rules. This may change soon.

So how is the future shaping up across 2022 and beyond

The US economy, especially the housing and mortgage market, has always been an important area impacting both US and the global economy. With inflation elevated, unemployment rates dropping 2.4 percentage points YoY to approximately 4 percent, and tapering asset purchases by the Federal Reserve, mortgage lenders, and borrowers should be expecting rising mortgage interest rates over the next year. Interest rates have now touched 5 percent [11] — the highest since November 2018.

This has multiple implications:

1 While this indicates a contraction in both refinance and purchase volumes, the higher rates increase borrower interest in ARMs, seen by the rise in applications, the highest since June 2019 [11]. Refinances are expected to fall by 64 percent to $841 billion this year, followed by another 20 percent drop in 2023.

2 Higher mortgage rates mean fewer prepayments and a more extended revenue stream of servicing fees combined with higher MSR valuations. However, as many COVID-19-related forbearances elapsed and a rising need to place borrowers into post-forbearance workouts, servicing costs may increase significantly.

3 For lenders with large forces and financial service organizations that offer to outsource mortgage operations, attrition and layoffs have been significantly rising owing to the contraction in overall origination volume, which is forecasted to drop by 36 percent to $2.56 [12] trillion.

This immediately indicates a contraction in both refinance and purchase volumes. Higher mortgage rates mean fewer prepayments and a longer revenue stream of servicing fees combined with higher MSR valuations. However, servicing costs may rise significantly with the expiration of many COVID-19-related forbearances and the need to place borrowers into post-forbearance workouts.

In 2022, purchase originations may see favorable developments with more homebuying demand from millennial households, especially first-time homeowners approaching prime homeownership age to avail credit, seeking more space, and low mortgage rates once building material shortage is curbed, for-sale inventory grows, and home-price growth is moderated. Further, as FHFA and the Biden administration bring affordable housing and apartment projects to life — that can be afforded at a 30 percent or lesser mortgage [14], plus utility payments to gross income ratio — prices can be expected to settle and purchases to improve with up to 4 percent annual growth in the purchase origination volume.

Similarly, for auto loans, while the Fed Benchmark Rate hikes can increase the lending rates, ongoing supply chain issues may offset any savings that consumers could potentially realize in a still low-rate environment. According to the National Automobile Dealers Association, the global chip shortage continues to impact vehicle availability. US inventory is down dramatically — as much as 65 percent compared to the beginning of the year. This translates to more expensive vehicles and fewer dealership deals, which can continue for the rest of 2022.

However, product innovations in anywhere lending, BNPL, etc., and the emerging possibility of leveraging Metaverse as a digital marketplace will reshape consumer experience to improve business operations and drive consumer lending in 2022.

For example:

Innovative business models - Vertical-specific POS lending, debit/credit card with built-in BNPL options, bundled customized personal finance for BNPL consumers, etc.

Digital experience - Reducing the number of clicks to the final payment screen to less than five across any platform. Touch-and-go BNPL/payments by partnering with acquirers/schemes.

Innovative financing for large ticket items – Meeting and maintaining trade margin using BNPL, BNPL for in-game purchases, high street fashion, remarketed vehicle purchase with BNPL, healthcare products/services financing, vacation financing/vacation house purchase/air ticket financing, etc. For example, Delta airlines offer Amex BNPL for air tickets.

Embedded finance to create opportunities for merchants - Around 75 percent of consumers who finance large-ticket purchases decide to do so early in the purchase journey, before the actual purchase, and integrating embedded financing solutions offers an avenue to capture sales by lifting conversion by 20 percent while also increasing average order value by 60 percent.

Loans/BNPL solutions via metaverse stores powered by Ethereum, Polygon, Binance, etc., support real estate like decentral and finance metaverse assets/NFT for collectibles, art, real estate, etc.

The digital lending leaders of 2022 are re-thinking their strategies

Redesigned digital lending experience strategy and expanded digital offerings while retaining and increasing customer loyalty will be the focus of the lending leaders of tomorrow. From personalizing omnichannel experiences to alleviating security risk concerns, FIs, banks, and lenders are looking at many things while humanizing the lender-borrower interactions across channels.

Their key customer-facing focus areas will be:

- High-tech and high-touch driven B2C marketing that thrives on empathy and re-imagining customer experience by blending great in-app/website experience with digital contact centers, AI-enabled chatbots, co-browsing, mobile banking experience, etc.
- Capturing the attention of younger customers while facing competition from digital competitors by integrating intelligent automation and alternative data-led credit decisions and personalized loan products for millennials and gig workers, automated spending insights for credit cards/BNPL, P2P vpayments functionality, etc.
- Human touch to reinforce relationship and stickiness while servicing customers using AI models and NLP-led sentiment analysis, co-browsing to humanize experiences, personalized financial recommendations, data security, and reinforcing financial wellbeing with education by sending small in-app notifications to consumers, etc.

This transition in digital strategy to achieve the required digital lending maturity and offer experience-led digital lending extensions and marketplaces will be determined by how lenders work with their digital infrastructure and data in 2022. This can be achieved through:

Seamless customer experience

Enabling customers to pick up from wherever they had left in the journey across any device or channel.

Treating data as currency

Developing data-driven and data-backed lending programs leveraging behavioral and alternate customer data through ecosystem partnerships, creating personalized lending products, and monetizing data for lending data marketplaces.

Automated decisions and AI-led monitoring

Machine learning (ML) algorithm-driven intelligent underwriting and automated decisions by accessing customer's behavioral as well as financial data and usage of alternate data like geospatial analytics, mobile metadata, customer's intent to pay, and post origination AI/ ML-led intelligent automation for servicing and portfolio monitoring.

Elastic cloud infrastructure

Cloud-first technology strategy to quickly scale and support digital lending, especially during seasonal/sale events, to minimize technical dependencies and security and fraud concerns.

As the retail lending space expands further in 2022, lenders will be looking at some fantastic opportunities while reinventing to match customer expectations. It will be interesting to see how these developments reshape the lending world.

References

1. https://www2.deloitte.com/us/en/insights/industry/financial-services/digitalization-in-banking.html
2. https://www.nar.realtor/sites/default/files/documents/2021-home-buyers-and-sellers-generational-trends-03-16-2021.pdf
3. https://www.housingwire.com/articles/49838-multifamily-occupancy-rates-keep-rising/
4. https://www.experian.com/automotive/auto-credit-webinar-form
5. https://www.transunion.com/blog/all-signs-point-to-a-healthy-credit-market-in-2022
6. https://studentaid.gov/data-center/student/portfolio
7. https://review42.com/resources/gen-z-statistics/
8. https://ibsintelligence.com/ibsi-news/community-and-regional-banks-embrace-digital-transformation-by-selecting-fis/
9. https://www.pwc.com/us/en/services/consulting/library/consumer-intelligence-series/future-of-customer-experience.html#:~:text=In%20the%20U.S.%2C%20even%20when,loved%20after%20one%20bad%20experience
10. 1) https://www.outlookindia.com/outlook-spotlight/easyfi-launches-metafi-that-enables-loans-for-metaverse-assets-news-121363

    2) https://www.forbes.com/sites/ronshevlin/2022/02/14/the-coming-boom-in-metaverse-lending-for-banks/?sh=3b0b86fc5984

    3) https://www.bloomberg.com/professional/blog/metaverse-may-be-800-billion-market-next-tech-platform/
11. https://www.cutimes.com/2022/04/13/mba-lowers-mortgage-outlook-through-2023/?slreturn=20220321021800
12. https://apah.org/housing/what-is-affordable-housing/

    https://www.smartcitiesdive.com/news/affordable-housing-funding-would-expand-in-bidens-fy23-budget/621186/

Authors

Ashutosh Sharma
Global Head, Banking
BFS Industry Solutions Group

Sayan Hari
Banking Consultant
BFS Industry Solutions Group

This article is published by Zensar BFS Industry Solutions Group (BFS-ISG). The BFS-ISG team focuses on delivering client advisory & implementation services, building domain-based frameworks & solutions, domain product competency and Industry thought leadership in the Banking & Financial Services space. The group proactively works to understand and preempt the industry dynamics, and regularly publishes viewpoints about key business and technology trends shaping the future of the financial services industry.

zensar
An RPG Company

We conceptualize, build, and manage digital products through experience design, data engineering, and advanced analytics for over 130 leading companies. Our solutions leverage industry-leading platforms to help our clients be competitive, agile, and disruptive while moving with velocity through change and opportunity.

With headquarters in Pune, India, our 10,000+ associates work across 33 locations, including San Jose, Seattle, Princeton, Cape Town, London, Singapore, and Mexico City.

For more information please contact: **velocity@zensar.com | www.zensar.com**