

MARKETPLACE LENDING: DISRUPTING THE DISRUPTORS

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An IBM report shows that the Web and app-based businesses are disrupting all retail businesses. The largest taxi company in the US doesn't own any cabs (Uber), the largest accommodation provider owns no hotels (Airbnb), the largest phone company has no telco infrastructure (Skype), the largest software vendors do not write apps (Apple and Google), the most popular media provider creates no content (Facebook) and now, the fastest growing consumer lenders are not banks and do not have branches (Lending Club and Prosper). These changes are in addition to the "old news" of tech disruption to brick and mortar retail stores, music and video distribution and services, and this year is the first holiday season that consumers are spending more online than in stores, and most of those purchases are being made on smart devices.

There are many reasons why this shift away from traditional retail is occurring, most of which address an enhanced shopping

experience. The proliferation of smart devices, the wide availability of Wi-Fi, the use of big data to provide an intuitive shopping experience, the adoption of cloud technology to reach consumers wherever they are, electronic wallets and other mobile payment systems and the use of social media and device notifications to stay in touch with customers. These are only a few examples of how technology coupled with changes in how customers want to use the Web and apps are causing disruption in the retail space at extraordinary speeds.

This same type of disruption is already happening in banking. Our job is to disrupt the disruptors.

The entire retail banking marketplace is under attack with payments, checking operations, branch utilization and our core lending business are now all targets for disruption. The numbers are extraordinary; Prosper and Lending Club alone will fund over \$8B in consumer

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loans in 2015, compared to less than \$1B just three years ago. Only two or three credit unions in the United States produce that much business. Quicken, which just announced a completely online application and decision process, is often one of the top three mortgage originators in every major market. FinTech companies and large financial institutions are investing billions, including consumer, small business and mortgage lending platforms, digitalization of processes, data analytics, big data, lead generation, mobile first, omnichannel and every other form of marketing and processing across the Internet. New technologies are appealing to the younger demographics and to the entire digital-oriented marketplace, which is now a wide cross section of consumers in the U.S. Think about how many devices each of us use on a daily basis including, laptops, smart phones, tablets, satellite radios and televisions. Many households have more than ten devices, which was unheard of only a few years ago. So much of our business now begins and ends on the Web. Our customers do most of their product research on the Web, and then use their smart devices to apply for our core products. How long will it be before more lending business is completed online rather than in

branches? In our view, it will be soon. If you agree, then it is imperative that your credit union start to invest in the digitized platforms necessary to provide your members with the online services that they have come to expect from other retailers.

The game is on and we need to jump in and attack, especially as our core business, consumer lending, is now being usurped on the Web by new entrants, marketplace lenders and exchanges.

What is amazing about the new marketplace lenders is that they provide a much-improved member experience, the process is significantly more efficient and they are more effective at managing risk. The digitization of the loan processes that they have created is easy, intuitive, fast and informative. They use big data to analyze risk and validate everything from credit to income to home ownership, and can do so within minutes.

A description of the peer to peer lending process.

Consumers and small business apply for loans on a Web site, a decision engine automates the underwriting and then renders a decision and, if approved, notifies individuals to fund a

portion of the loan. When the exchange identifies enough individuals with the capital to fund the loans, the loans are then approved and funded. This process has been so successful that institutional investors and financial institutions have replaced individuals as the primary funders because they have confidence in the process and are in search of the higher performance and yield that these loans represent.

Credit Unions were the original peer-to-peer lenders; this is our model

We need to adapt to these models now, disrupt the online lenders and get ahead of the banks. We need to create a marketplace lending platform that is uniquely designed for credit unions and can offer a better price point, through a platform that creates a credit union brand, delivers loans to our balance sheets, supports member growth and leads to new relationships. In our view, the formation of a new CUSO that uses the market place lending automation, across all major product lines but is designed and branded exclusively to serve our members is an approach worth investigating.

Credit unions have a window of opportunity to grab significant market share from the “disruptors” because of our inherent price, service and trust advantages. The ultimate winner in each of the Web based retail

models will offer better service at a better price. We can form partnerships today, utilize the proven technologies and processes, build a marketplace lending brand and set a winning price. We have spent a great

time researching these options and have put together a digital game plan for credit unions. If you are interested please contact Edge.

BLOCKCHAIN IN THE CREDIT UNION MARKET

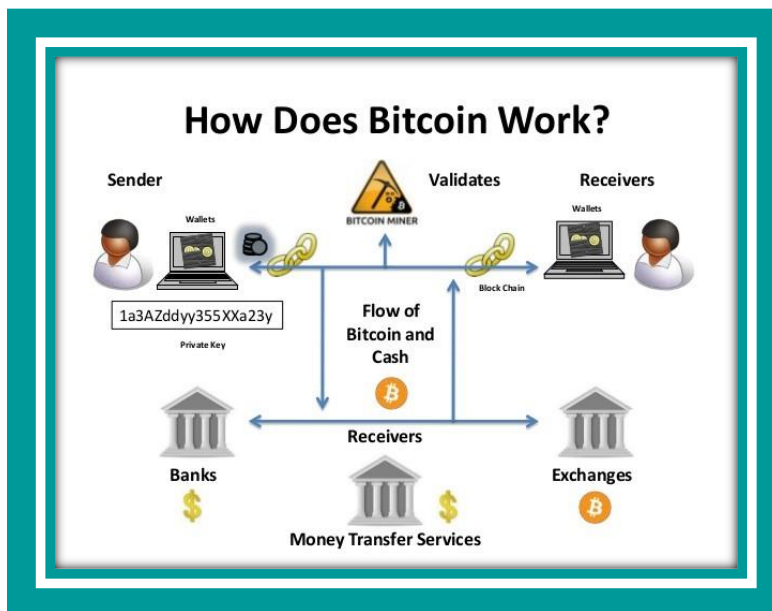
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More than 90% of the people in the US have no idea what blockchain is. Even the widely-publicized Bitcoin is foreign to 80% of people in the US.

While the US embraces Bitcoin and blockchain, Russia and other countries have banned Bitcoin. A world map of the state of Bitcoin by country shows a pattern that, in many ways, defies logic.

Why the variance? The absence of controls; whether the control objectives are to create a trusted system, or to have control over the system. To ensure that this article can be read in roughly 5 minutes, it will focus only on the financial transaction component of blockchain.

The diagram below pictorially explains how blockchain works in the context of Bitcoin.



Component Definitions

- **Wallets** – the wallet is similar and arguably the same as an account. The wallet holds the balance and is effected by debits or credits. The wallet exists through the installation of an app.
- **Blockchain** – (displayed as chains in the diagram) for one entity to connect to another entity to transact requires a network; blockchain is the network. It is comprised of volunteer entities that will store ledger (debit/credit) transactions.
- **Miner** – the entity that validates all the pieces are in place and that a transaction is real.
- **Banks, Money Transfer Services, and Exchanges** are generally outside the Sender to Receiver flow

While the diagram describes a rather simple process, a fully deconstructed blockchain is not.

The Gartner Group states:

Blockchain is a complex technological system, and can lack the clarity of oversight and auditability that more traditional systems offer. As an additional complication, blockchain lacks common standards or regulations.

A breakdown of the statement:

"complex technological system": variances in hardware infrastructure components, often down to the chip level, must be tested and any work-arounds put in place. Hardware vendors generally do not admit that specific chip-runs can cause problems. Additionally, the OS, NOS, applications, etc. all may need to be on the same version, release, patch, etc. Complexities relating to differences in operating systems may cause additional problems: can Unix, Linux, Windows, etc. all work in the network/system?

"clarity of oversight": exposure occurs whenever data are Created, Altered, Transferred, Destroyed, or Stored (CATDS). Oversight requires the ability to "see" the entire process.

"auditability": auditability is often viewed as an enforcement component; however, it has much more of a "prove it" viewpoint.

"common standards": a technology must be supported by standards for it to be viable; particularly for the movement of money in any form.

"regulations": pragmatically necessary to prevent entities from cheating one-another. Two key assumptions are: determination of non-compliance by an independent entity – and – the ability to enforce a penalty for non-compliance. Summarizing the above, blockchain presents risks that are currently not well controlled. Using the language of Enterprise Risk Methodology: the residual risk of blockchain is not acceptable. A deep-dive into the first step in any technology system: obtain and install an app. This step

applies to the Sender, the Receiver, the Network Participant, and the Miner.

The first step is to download an application.

- Where does the application originate?
- Where do I get it and how do I know of its efficacy?
- Will the application require updates? Assuming so, will they be automatic?
- What testing will be done by the originator of the application?
- Is there an independent certification authority for the application (eg: SSAE16)?
- What testing of the app must be done?
- What are the infrastructure requirements for the app?
- What happens if all in the network are not on the same version of the application?
- What happens if many in the network are down? Is there a minimum number of nodes in the network that must be up?
- If the network is not available, how is an individual node notified?

The above is a short-list of challenges to cryptocurrency.

Blockchain is also used as a "ledger system". Easily understood by switching currency with documents; titles, architectural drawings – anything that requires a high level of control or certification. An example:

Crypto-titles: the current vehicle titling process is arcane. It is slow, expensive, and bureaucracy-burdened. Blockchain can significantly improve the entire process through "crypto-titles".

The risk profile for crypto-titles is straight-forward when compared to that for licensing, real estate, or medical records. The use of blockchain will continue to outpace the necessary control structures.

The current state of blockchain does not include some of the controls necessary to manage associated risk.

Control structures will be present in Volume 2 of this edition.

Edge Consultancy is uniquely positioned to assist the financial services industry understand the opportunities and risks associated with blockchain.



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