IDC PlanScape

IDC PlanScape: Digital Lending Modernization

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IDC PLANSCAPE FIGURE

FIGURE 1

IDC PlanScape: Executive Summary of Digital Lending Modernization

WHY	Lending is one of the last areas to modernize, leading to a failure to respond to high demand for credit during economic shutdowns.
WHAT	Modern applications, automation, and AI-driven analytics improve decisions and remove delays/errors from loan processing.
WHO	Retail and small business commercial banks, mortgage lenders, credit unions, building societies, thrifts, and collection organizations are included.
HOW	Gather current state data, analyze process flows for weakest areas, and work with IT partners to update or refresh technologies that support lending.

Source: IDC, 2020

December 2020, IDC #US47094420

EXECUTIVE SUMMARY

2020 saw a number of weaknesses exposed in the bank's infrastructure worldwide. Consumer behaviors were forced to change as social distancing became the norm in many countries. This led to the closure of many bank branches, placing stress on the contact center – itself forced to adapt to work-from-home environments – and the bank's digital channels. As retail store locations also closed, global payments volume plummeted, but digital payments spiked as online shopping replaced physical visits to stores. This, in turn, led to an increased incidence of card-not-present fraud.

In a larger sense, as the world's developed economies succumbed to the COVID-19 pandemic, the numerous business shutdowns driven by fear of and laws governing social contact forced many small businesses to look to government subsidies and financial institutions to keep them afloat and to continue to pay for staff. Many individual consumers also needed financial assistance in the form of credit to replace lost wages.

Unfortunately, this need for credit, and the urgency with which the demand sprung, and the scale of consumers and small business owners looking for relief stressed the ability of banks to respond due to antiquated, legacy lending operations. For example, the Paycheck Protection Program in the United States forced banks to deploy a new type of small business loan that challenged existing solutions and the ability for the institution's IT group to develop and/or modify existing applications in inherently inflexible infrastructures.

This IDC PlanScape describes the need for modernization of critical workloads based on market conditions that are compelling a response, or in anticipation of a predicted event that will prevent a disruption or leverage a coming benefit in a changing market. This IDC PlanScape on digital lending modernization describes such an environment that happened in 2020, and why institutions are being forced to accelerate modernizing their lending operations.

"Lending is arguably the most challenging environment in the bank's business model in 2020," said Jerry Silva, vice president, IDC Financial Insights. "The relative low priority of lending transformation prior to 2020, in combination with the urgent need for expanded credit due to the COVID-19 pandemic, is forcing institutions to reprioritize lending transformation to survive this crisis and avoid the next one."

WHY IS DIGITAL LENDING MODERNIZATION IMPORTANT?

At the end of March 2020, IDC fielded a survey of the impact of COVID-19 on consumers (IDC Insights' *Cross-Industry Consumer Response to COVID-19 Survey,* March 2020). In the survey, one of every four consumers said they expected their need for credit would increase. Many institutions immediately (April–May 2020) created loan forgiveness programs that gave consumers and small business temporary relief of outstanding credit balances on loans, mortgages, and credit cards.

But this was during the initial effects of the crisis. Globally, countries are experiencing their second and third waves of the COVID-19 pandemic; industries like retail, dining, and travel are in worse shape, and it may be another 6-12 months before they begin to recover to a "new normal." Whether or not governments consider subsidizing the credit needed to keep these industries operating at even minimal levels, financial institutions must be prepared to originate, service, and recover funds loaned out to consumers and businesses globally.

The problem is that unlike in previous years, when modernization of the lending platforms seemed to be represented by marginal efforts based on the cost to modernize versus the benefit of faster, more efficient operations, the COVID-19 pandemic and the challenges it brought in supplying credit efficiently while minimizing risks are forcing institutions to rethink the platforms supporting this important function. In 2018, growth in spending on consumer lending origination and servicing (5.75% annually, IDC's Worldwide Banking IT Spending Guide, May 2018) lagged overall IT spend growth globally (6.7% annually, IDC's Worldwide Banking IT Spending Guide, August 2020). Clearly, other areas of the bank's infrastructure were deemed more important than lending.

Most importantly, the 2020 crisis has shed light on factors that become critical to making credit decisions that have not traditionally played a role in credit risk management. The link between external factors arising from natural crises and the overall risk to reserves has never been stronger, the need to more intelligently manage credit forgiveness and forbearance policies has never been tested this much, and the need to think ahead to an environment of under- or nonperforming loans and the correlated need for sensitive and socially aware collections and recovery strategies have never been as vital to the bank's continuous success.

The modernization of the lending operation is critical to the institution's overall success even after the COVID-19 pandemic wanes. IDC calls the new normal "future enterprise," and it needs to include a new way of operating lending as one of the three primary business lines in banking (deposits, lending, and payments).

WHAT IS DIGITAL LENDING MODERNIZATION?

Digital lending, as defined in this IDC PlanScape, is the digitization of legacy processes and technologies that support the lending in consumer, small business, card, and corporate lending. This document will not cover risk policies or reserve requirements — only to describe the need to improve functions such as those by supporting them through technology.

Origination

The first part of the lending process is the origination of the credit relationship with the customer. This itself can be broken down into many subunits, including:

- Marketing/sales
- Prequalification (where applicable)
- Application processing
- Document management
- Risk analysis
- Underwriting
- Decisioning
- Regulatory compliance
- Funding
- Closing

Until relatively recently, the processes to implement loan origination hadn't changed for decades. In many institutions, the process is still "informal" and carried out manually, often with paper documentation sent from department to department. The first step to modernization is to create automated flows for this overall process, using RPA or artificial intelligence (AI)/machine learning (ML) technologies to reduce human involvement, reduce errors, and automate adjustments where needed, all in *support* of human activity where desired. Second, there is a benefit to reviewing the data needs in this process and improving the quality and quantity of data the institution can use to make better informed decisions and expand the market for credit.

Servicing

After the loan has been funded, the relationship between the bank and the customer relies on loan servicing to ensure that repayment is efficient, and that any changes to the loan or customer information are made. Loan servicing tends to be a commodity business, based on scale and efficiencies. This means that servicing, more than originations, has already benefited, to a large extent, from automation.

Modernization of this area of lending is less about automation as it is about the direct impact of disruptive events like the one experienced in 2020. Loan forgiveness and mortgage forbearance are not new elements of loan servicing, but those areas have reached a scale hitherto unknown in the industry. What is therefore needed is additional data and analytics to be able to make better decisions about loan modifications and the potential impact to the institution's risk and capital. AI-enabled analytics will be useful only if the bank has the data with which to support decisions.

An example of a real benefit in the use of alternative data comes from 2016, when severe flooding affected homes for which a regional bank held the mortgages. Instead of waiting for the homeowners to default on flooded or destroyed homes, the bank sought the help from a mapping and analytics company to confirm flood-stricken homes against the bank's mortgages. In this way, the bank was able to use the data to get a much better sense of the risk to its portfolio from this event. And the institution was given the tools with which it could proactively reach out to the customer to arrange forbearance or offer other support to the homeowner.

Collections/Recovery

Notwithstanding the possible subsidies that governments will offer financial institutions in the wake of the COVID-19 pandemic, loan losses will be high. While the crisis in 2008 affected mainly mortgages, the 2020 crisis will potentially affect student loans, car loans, credit cards, small business loans, and even corporate loans. In the past, financial institutions were just as likely to write bad loans off as part of "normal" business strategies and/or sell the nonperforming assets for pennies on the dollar to specialty collection organizations.

IDC believes that the scale of loss will be such that it will not be feasible to do that this time around. What is needed in collections modernization is, again, better data and analytics to determine, at the individual loan level, what the best approach is to try to improve the loan to normal status, renegotiate the loan terms to maximize return, and, where desired, maintain relationships with the institution's best clients that suffered under unusual circumstances from the global pandemic.

Along with automation and, importantly, AI-assisted staff, collections, as part of the lending operation, will prove to be as much art as science. But as author Arthur C. Clarke once said, "Any sufficiently advanced technology is indistinguishable from magic." And it will require this kind of magic, supported by technology, that will help institutions minimize losses and recover more quickly.

WHO ARE THE KEY STAKEHOLDERS?

As a primary product that forms the very basis of banking, almost every role at the institution is affected by, or is responsible for, the lending function (see Table 1).

TABLE 1

Key Stakeholders in Digital Lending Transformation

Role	Responsibility	Benefit from Digital Lending Modernization
CEO/board	Overall health and resiliency of the institution	A more resilient and innovative organization
Head of retail bank	Overseeing all consumer and small business products and services	Increased market share and defense against fintech lenders
Head of mortgage	Managing mortgage portfolio	Maximizing profits while reducing market risks
Head of small business	Maintaining relationships with community-based businesses	Increased market share and defense against fintech lenders
Underwriters	Ensuring the health of the organization's credit profitability and risks	Evidence-based decisions that ensure compliance while reducing risks
Lending staff	Operationalizing the lending business line	Transition to higher-value contribution to the institution

Source: IDC, 2020

HOW CAN MY ORGANIZATION TAKE ADVANTAGE OF DIGITAL LENDING MODERNIZATION?

Prior to 2020, lending was an area of business that was already under attack from fintech and nontraditional lending organizations. Seemingly, and based on lackluster response from most institutions, the banking industry was content with the changing competitive landscape, relying primarily on the relationships it had built with its customers to ensure continued success of its lending programs. A few banks did respond by implementing turnkey lending platforms in certain subsegments such as small business or automobile lending.

But 2020 has changed that. Credit has become a component of survival for both consumers and businesses. And the institution's ability to manage the scale of additional lending, its ability to respond to credit quickly (hours instead of weeks), and its management of the risks involved in this line of business demand that the underlying platforms that support lending be as modern as possible. The impact of inaction is as dire for the community as it is for the institution.

Guidance for institutions with an eye toward modernizing its lending infrastructure would be to start with one of the subsegments. In 2020, the natural candidate has been small business lending. While the temptation will be to consider a single platform for all aspects of lending, and it's been a topic of consideration for years, the market requirements and compliance needs make it difficult to manage to that end. Given the current technology architectures of open API, microservices, cloud, and modern data platforms, it is unnecessary to "boil the ocean" with a single platform that can achieve all. Interoperability is much improved, and it may make more sense to solve one market challenge before moving on to the next.

One word of warning, however. It is sometimes the case that, in its quest to modernize, an institution will try to adapt modern infrastructures to existing processes. In the case of lending, it is paramount to be open to completely restructuring its existing processes, not to mold to the technology being brought in, but to best practice in the industry, supported by IT.

ADVICE FOR TECHNOLOGY BUYERS

Digital lending transformation will be guided by the same tenets driving all of digital transformation in the financial services industry, whether it is core system modernization or mobile banking:

- Open API
- Modern languages
- Microservices and containers
- Cloud deployment
- RPA and AI-supported business operations
- AI-enabled analytics

These technologies form the basis of the modern banking platform, one that will enable the institution to accelerate its recovery and return to innovation. Cloud, in particular, will be an important technology on the path to lending transformation. The 2020 crisis impacted lending to a disproportionate degree as the increased need for credit generated massive numbers of applications that overwhelmed most legacy lending platforms. IDC's *Worldwide Industry CloudPath Survey* (May 2020), done during the pandemic, shows that 50% of the banks that responded plan to deploy lending origination to the cloud in 12-24 months. And more than half, 58%, of the banks plan to move loan processing to the cloud in the same time frame. These are clear-cut responses to the disruption seen in this key product in financial services as well as how institutions plan to address recovery of the lending lines of business.

However, with modernization comes some new skills that the institution will need to staff. The modernization of the critical platforms at the organization using the aforementioned technologies requires expertise and knowledge in:

- Automation
- Orchestration
- Security
- Compliance
- Governance

But by beginning with a single line of business and working with technology partners that support these technologies and the skills necessary to maintain a modernized lending infrastructure, the institution will ensure that a key part of its business remains solvent and successful.

RELATED RESEARCH

- *IDC FutureScape Webcast: Worldwide Financial Services 2021 Predictions* (IDC #US47001020, November 2020)
- *U.S. Sentiment Around COVID-19 and Impact on Engaging Banking Customers* (IDC #US46986220, November 2020)
- *Banking on the Cloud: Results from the 2020 CloudPath Survey* (IDC #US45822120, November 2020)

About IDC

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