CAPTON

3 WAYS BANKS CAN

Increase Lending Without Adding Risk

Banks are under chronic pressure to grow revenue by finding new opportunities to profitably expand their loan portfolio. With the rise of fintech competitors to traditional banks, this pressure is only growing stronger.

The underlying challenge to increased lending is almost always risk management. Lenders must not only find new markets with an unmet demand for loans but follow best practices to ensure these loans avoid default and continue generating revenue across their full lifecycle.

Doing so is never easy.

- New markets often lack the deep credit histories needed to analyze lending risk using traditional metrics like FICO scores.
- Black-swan events like the COVID crisis make it extremely difficult to forecast loan non-performance, which can lead to excessive loss allowances and constrained lending.
- Lenders have extensive financial data, but often lack a reliable method for transforming this raw information into timely sales recommendations.

In this white paper, we explore three ways banks and other lenders can overcome these challenges. AI-powered enterprise software is opening up new capabilities that enable banks to expand lending without sacrificing robust risk management (or customer experience).

Keep reading to learn three ways that AI can help banks increase their lending without adding risk.

The Competitive Imperative to Expand Lending

While Balancing Bank Profitability and Financial Stability

Banks are facing more vigorous competition for profitable lending opportunities than ever before. JP Morgan Chase Chairman and CEO Jamie Dimon writes in his 2020 letter to shareholders that:

> **"Banks already compete against a large and powerful shadow banking system. And they are facing extensive competition from Silicon Valley, both in the form of fintechs and Big Tech companies (Amazon, Apple, Facebook, Google and now Walmart), that is here to stay. As the importance of cloud, AI and digital platforms grows, this competition will become even more formidable.**

Banks retain important competitive strengths including brand, extensive physical infrastructure, regulatory protections for consumers, economies of scale, proven profitability, and strong existing customer relationships. However, fintech companies have successfully leveraged new technology tools like social media and AI to level the playing field. Now, banks and other traditional lenders are increasingly seeking to adopt these same technologies, working to ensure that legacy systems and business processes do not become a long-term competitive disadvantage.

To keep up with the increasingly fierce competition for profitable lending opportunities, banks ultimately need to issue more loans. And to find profitable lending opportunities, banks need to:

1. Access new markets.
2. Find and market attractive loan offers to new customers.
3. Maximize loan business with their existing customer base.

These requirements, however, do not come with a straightforward solution. The competitive imperative to expand lending runs up against the fundamental operational challenge at the heart of banking: **issuing more loans without adding excessive risk to the loan portfolio**.

Untapped markets for loans have often been underserved by lenders for a reason. For example, customers in a given market segment may be seeking funds but lack the credit history to justify a loan using a traditional credit score. Banks may have voluminous financial data for their own customers, but lack a dependable capability for translating this data into actionable sales recommendations. In other cases, excessive non-performing loan (NPL) projections can lead to excessive loss allowances that unnecessarily limit a lender's working capital.

How can banks issue more loans without compromising best practices for risk management?

AI can help directly address each of the problems discussed above, providing enhanced risk management capabilities across the entire loan lifecycle, opening up new markets, and even creating novel opportunities for sales automation.

In the sections below, we explore three ways banks can leverage AI to increase lending while improving loan profitability (and all without compromising long-term financial stability). An AI-powered bank not only has the ability to make more loans but the ability to operate with unprecedented transparency into the riskiness of its own loan portfolio.

Use Enhanced Credit Scoring to Speed Up Loan Decisions, Tap More Data Sources, and Access New Markets

Most lenders have access to more data than ever before (whether stored internally or readily available from external sources). Much of this data can be potentially useful for evaluating the risk of new loans. But when making loan decisions, lending personnel do not have time to dive into exploratory data analysis. Instead, they need a quick, readily calculable metric like a FICO credit score that can support a fast “yes or no” loan decision.

Standardized credit scores are a functional tool for evaluating risk without slowing down loan decisions. But they leave many potentially valuable data sources untapped, limiting their accuracy and their ability to effectively analyze markets with a limited credit history.

By leveraging AI, lenders can generate **loan recommendations that can improve decision-making without slowing it down**. Drawing on diverse data sources, AI can quickly distill complex indicators into a single, “smart” credit score and loan decision.

Intelligent, AI-powered software offers multi-faceted capabilities that help improve credit scoring (and ultimately increase profitable lending):

1. AI-powered credit scoring can generate a **data-backed loan decision in a minute or less**. This speed allows lenders to serve customers better. And it helps streamline lending operations, allowing banks to process new loans more quickly and handle a higher volume of loan applications without risking delays that could harm customer relationships.

2. Because AI-powered credit scoring draws on much more diverse data sources than traditional metrics like standard FICO- scores, it allows for **robust credit scoring for markets that traditionally lacked the credit background to qualify for loans**. AI-powered credit scoring solutions can draw on dozens of external data sources to provide a loan decision, including novel data sources such as social scoring (LinkedIn/Facebook) and message-based scoring (SMS/docs).

3. Finally, near **real-time loan decisions help ensure prospects don't drift away while waiting to qualify for a new loan**. Ultimately, maximizing new loans requires providing a streamlined customer experience that ensures qualified applicants aren't lost to other firms (like a fintech lender willing to provide an online loan decision in seconds).

Taken together, these capabilities not only allow banks to make more loans but improve the overall quality of the loan portfolio over time. By allowing for improved filtering of loan quality at origination, AI can bring down NPL rates over time. In the next section, we explore how AI can also help manage existing loans more effectively.

Use A Non-Performing Loan Prediction Model to Provide an Early Warning System for NPLs

By harnessing techniques like machine learning and behavioral analytics, AI-powered software can offer lenders the novel ability to detect non-performing loans early, before a customer begins missing payments.

Early NPL detection offers lenders two advantages. First, an early warning of non-performance gives lenders more time to proactively seek a constructive resolution. In many cases, non-payment is rooted in a simple issue like an expired credit card or outdated email address. In these cases, early NPL detection can help directly decrease delinquency rates (we take a deeper look at this topic in our blog here) while protecting customers' credit ratings.

Second, more accurate NPL projections allow banks to employ their capital more efficiently. Because banks must set aside a loss allowance to cover the risk of non-performing loans in the portfolio, excessive NPL projections can cause banks to set aside excessive loss reserves. Overshooting on NPL forecasts means increasing the ratio of loss allowances to actual non-performing loans. Ultimately, this means fewer new loans and less revenue compared to an accurate NPL projection. For a deeper look at this topic, please see our blog here.

Accurate NPL early detection simultaneously protects lenders' financial stability (ensuring that losses can be covered) and profitability (allowing the lowest possible loss allowance to NPL ratio). Leading AI-based early warning systems for NPL detection can leverage hundreds of data points (covering both core lending operations and dynamic external sources) to generate highly accurate NPL forecasts over various time horizons.

Leverage Predictive Analytics to Generate Personalized Customer Sales Recommendations

Lenders are often sitting on a treasure trove of untapped data on the financial needs of both current and prospective customers but lack a reliable method for translating this potentially valuable data into actionable sales recommendations.

AI-powered software is the perfect tool for sifting through voluminous data to generate personalized "best fit" product recommendations, tailored to individual customer needs. This capability enhances lenders' ability to successfully market new loans while streamlining the customer experience with highly relevant offers.

The most impactful recommendation engines should offer the ability to either truly automate sales (perhaps feeding a customer-facing automation interface like a chatbot) or flexibly support existing sales workflows.

Learn More About Capton AI

In its report on the "AI-bank of the future," McKinsey notes that, although AI technologies could potentially deliver up to $1 trillion of additional value for banks each year, "many banks...have struggled to move from experimentation around select use cases to scaling AI technologies across the organization."

While bridging the gap from a promising pilot technology to a fully-fledged operational solution can be challenging, more and more lenders are finding valuable use cases for AI-powered software.

In addition to the applications discussed in this paper, AI is generating real ROI in applications ranging from customer support chatbots, to fraud detection, to process automation for repetitive workflows.

Founded by Silicon Valley entrepreneurs, Capton works to bridge the gap between future potential and present business value with fully scalable AI-powered software solutions, carefully aligned to core operational challenges for lenders.

If you're interested in seeing what Capton AI can do, you can request a demo using the button below.

For more information contact Capton Inc.

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