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Marketplace lenders and banks: An inevitable convergence?

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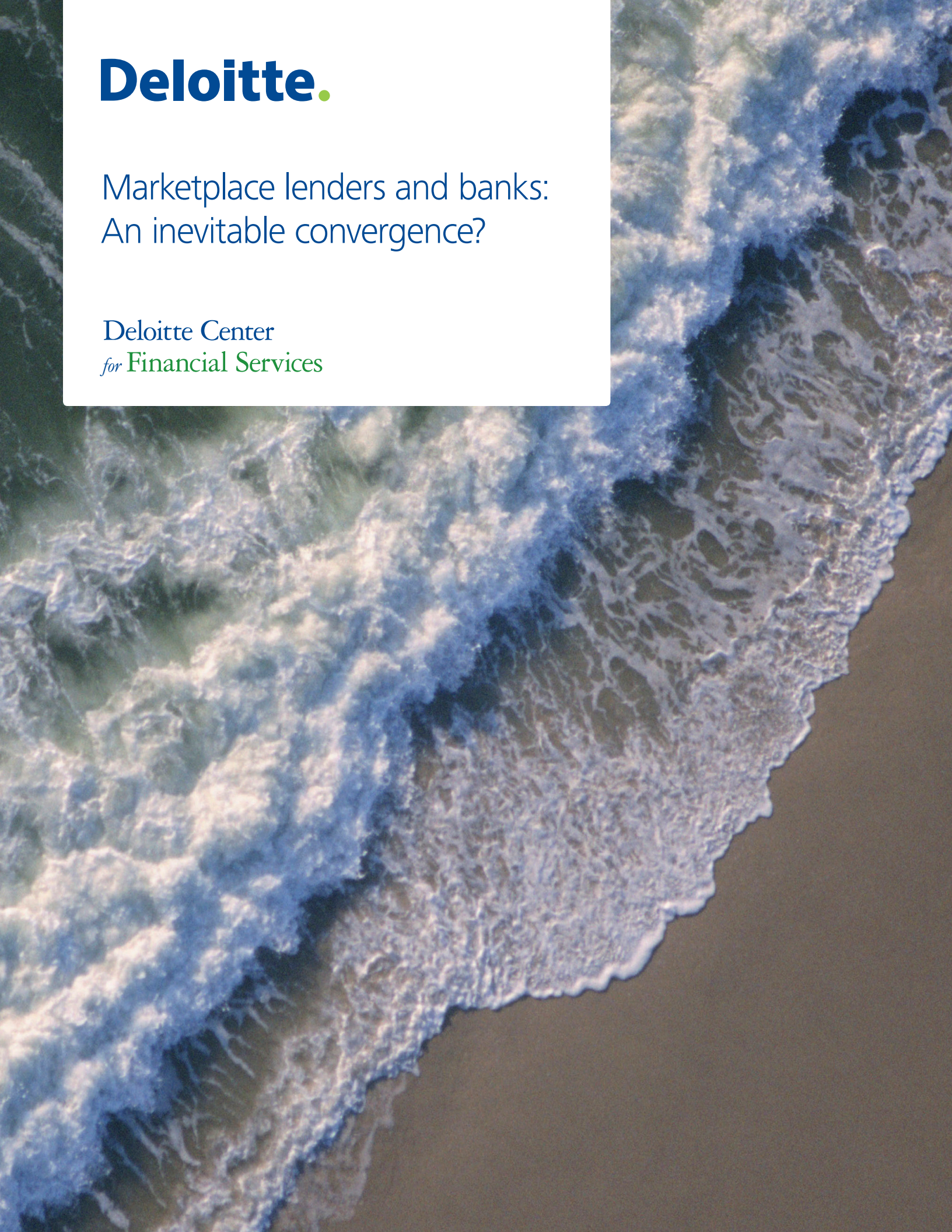

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At the crossroads of convergence

Let's get this straight upfront: Marketplace lenders (MPLs) have already disrupted the lending industry. Whether or not this disruption will lead to bank disintermediation is a topic for debate, but we at Deloitte think not. Instead, we expect a growing convergence of banks and MPLs. In this paper, we discuss how this future is already foreshadowed in every phase of the current marketplace lending lifecycle, including funding, originations, underwriting, servicing, and securitization.

In each phase, marketplace lending has seen exceptional maturity. Although the industry is only a decade old in the United States, and having had to effectively restart after the global financial crisis,[1] originations alone have grown by a compound annual growth rate of over 75 percent since 2010.[2] This brisk development has created tremendous buzz, generating diverse theories on the future of this neophyte industry. Some say MPLs are going to disintermediate banks for good, while others believe MPLs are too small to matter. Then there are those who think MPLs will pose a systemic risk to the economy,[3] and even some who see MPLs saving the financial services sector.[4] In this paper we put these disparate prognostications into perspective.

First, it is useful to note that while marketplace lending currently accounts for just a fraction of the consumer and small-business lending markets today,[5] banks and MPLs are already actively engaged with each other. While the pioneers of peer-to-peer (P2P) lending may have viewed banks as slow-moving and process-heavy, the now more aptly termed marketplace lenders are seeing opportunity in banks' funding channels, balance sheets, compliance expertise, and in the millions of captive deposit customers with proprietary data. Meanwhile, banks recognize the regulatory and infrastructure constraints that limit their ability to profitably originate and process small loans—yet they also know that a good many of their customers would rather deal with their banks directly for most of their financial services.

Second, as with any industry evolution, there will be winners and losers, although they do not have to align as banks on one side and MPLs on the other. Instead, the MPLs that "win" will likely be those that are right now building either scale or niche expertise through strategic partnerships, while the banks that will win are collaborating with MPLs, and simultaneously enhancing their operating models and performance.

We believe consolidation and specialization will be inevitable in the industry. In the medium term, we envision three major MPL business models, including: 1) Fewer MPLs with either scale or niche expertise, or both; 2) Banks with specialized MPL divisions; and 3) MPLs as white label vendors of marketplace lending as a service (LaaS).[6]

In the medium term, consolidation and specialization

Thus far, most MPLs in the United States (with very few exceptions) have only operated in an environment of historically low interest rates, declining unemployment, and investment-friendly capital markets—a perfect storm for these nonbank lenders to thrive as they satisfy borrowers' need for credit along with investor appetite for high yield. The likelihood that this perfect storm will persist is remote given the countless factors that can affect any, all, or a combination of these three conditions.

For example, low commodity prices and faltering global growth, driven by emerging market malaise and other global macroeconomic uncertainty, have already driven investors to safe-haven investments. Widening spreads on below-investment bond yields is an indicator that flight from high-yield in particular is underway. Yet another scenario that would end the perfect storm is a coordinated global economic recovery that would prompt the Federal Reserve to be more firm in raising interest rates.

So, in the absence of the perfect storm that attracted more than a hundred MPLs to enter a market where only two existed nine years ago, the MPL industry will consolidate, and we believe the resulting market landscape will be characterized by the following three business models (see Figure 1).

Figure 1. Three business models characterized by marketplace lending

Stalwart MPLs

Based on the data and trends that we currently observe along the marketplace-lending business lifecycle, we believe MPLs that have developed operational strength and efficiencies from scale or niche expertise, or both, will absorb other smaller or weaker MPL players that fit their strategies. These stalwart MPLs will have institutional experience, established funding commitments, and entrenched networks, with national and even international reach (see "A global phenomenon" sidebar).

A global phenomenon

China, the United Kingdom, and Australia already have well-established, expanding marketplace lending markets. Recently released data from a report by the University of Cambridge and Nesta showed that 25 percent of UK marketplace lending is funded by banks, an indicator that the industry is highly evolved and ripe for participation by MPLs from other mature markets.[7] In China, MPL origination volume has already far surpassed that in the United States. Yet, whether the same marketplace lending evolution will occur in China as in the United States and Europe is another story, as China's marketplace lending industry has grown largely without bank participation. US MPLs that do expand their reach abroad will likely acquire or establish local entities, retaining local legal ownership status and indigenous expertise to operate most efficiently in each country's unique regulatory and cultural environment.

In the United States, this consolidated field of MPL players will continue to serve a sizeable market for small loans, satisfying increasing demand from multiple segments. They will also likely leverage their expertise in specific markets to provide value-added services. The niche operators will be particularly well positioned for the latter; an MPL specializing in small construction loans, for example, could provide business advisory services to small contractors and architects, helping their customers' operations while also monitoring their credit profile.

Scaled MPLs will likely seek specialization in multiple ways, depending on their evolution and acquisitions. Some will focus on only one major asset class, such as consumer unsecured lending, student financing, or small business, while others will include more than one. A tendency to gain niche expertise within these asset classes will also be likely. As an example, the first acquisition by the historically unsecured-consumer-loan-focused Lending Club was a medical financing company, Springstone Financial; we foresee more such acquisitions that help MPLs achieve penetration into different niche asset classes. Foreshadowing a possible international model is UK-based, small-business-focused Funding Circle, which acquired the small-business MPLs Endurance Lending Network in the United States and Zencap in Germany, maintaining their local talent expertise and ownership registration.[8]

Banks with their own MPL platforms

Although many banks will likely be content to partner or contract with MPLs, some will want to bring marketplace lending in-house. While it is not unlikely that a bank could build a marketplace lending platform organically, the temptation to take on a ready-made model will be great in a market where many MPLs become available for acquisition. There are already firms that specialize in due diligence intelligence on MPL players, providing interested banks with the knowledge to make informed purchases (see "MPL funding to date is a strong indicator of the future that includes banks" section on page five). There is already at least one example in the market in which a bank has acquired a marketplace lender and established it as a standalone business division with its own brand name.[9]

As the MPL business model is predicated on lean, technology-enabled processes, these MPL business divisions within banks, with their fintech-oriented staff, could also help in streamlining their parent banks' lending operations, with a favorable consequence of positive customer experience. They may also be helpful in expanding their parent banks' small-lending market reach, again with technology-enabled marketplace origination.

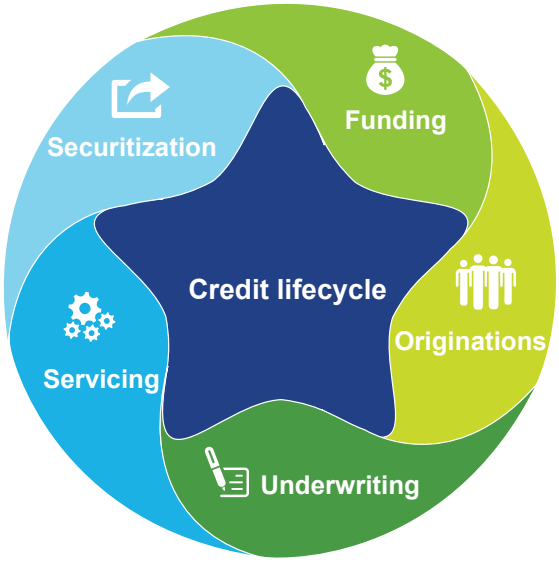
MPLs as white-label service providers

To enhance their institutions' balance sheets with small-loan portfolios that are originated and serviced through MPLs with strong brand recognition, community banks and credit unions will likely continue to partner with the scaled MPL players. But based on current examples in the market, we believe that midsize banks with large staffs, significant operational capacity, and strong regional brands will opt to develop small-loan portfolios through white label MPL vendors. Already many MPLs provide white label marketplace LaaS, either on an ad hoc basis to certain banks or as their primary business. Given the growing bank appetite for small-loan assets, the white label MPL market will likely become a much more developed sector than it is today, with myriad combinations of bundled and unbundled services, including marketing, originating, underwriting, and loan servicing.

Signs of things to come along the credit lifecycle

Funding is essential to the MPL, and the first step to building a portfolio of assets to be funded is customer acquisition, i.e., originations. And then, of course, solid underwriting is necessary to convert these customers into credit opportunities that suit both lenders' and investors' risk appetites. After the loan is underwritten, it must be serviced. Finally, once a track record has been established, a securitization market emerges. We will examine these credit lifecycle factors to search for clues as to how the marketplace lending market will evolve, particularly as it pertains to the blending of MPL and traditional bank ecosystems (see Figure 2).

Figure 2. The credit lifecycle offers insights into the future of marketplace lending



MPL funding to date is a strong indicator of a future that includes banks

Within just over half a decade, the P2P model went from being entirely funded by individuals investing in fractional loans (retail investing), to a model that sees heavy investment by institutional investors buying whole loans.[10] As an example, individual retail investors funded 100 percent of Lending Club's loans at year-end 2010, while by calendar year-end 2015, approximately 54 percent of loans facilitated through the company's marketplace were sold in whole loan sales transactions which are likely made up largely of institutional investors.[11] Also, a 2015 survey by Wharton FinTech and Richards Kibbe & Orbe LLP polled 300 institutional investors and found that 85 percent were interested in marketplace lending.[12]

While the aforementioned buzz has certainly helped attract the attention of these investors, MPLs' track record of quick underwriting turnaround and modest default rates to date has played the largest role. For example, from first quarter 2010 to fourth quarter 2015, Lending Club charged off 3.68 percent of its loans; from first quarter 2013 to fourth quarter 2015 it charged off 3.13 percent.[13] The short-term nature of MPL loans has provided investors with relatively seasoned portfolios, yet they are far from seasoned enough to reliably inform future performance given that MPLs have only seen a favorable market environment thus far. On this note, there are also critics who say that investors are simply seeking high yields in a low-interest-rate environment, but this assertion is belied by the range of institutional investors and the varying tranches of yields that are packaged to suit heterogeneous investor risk tolerance.

As testament, the number of marketplace lending securitizations are increasing rapidly (see "MPL securitization to mature rapidly" section on page eight). There are also various types of aggregator services, such as Biz2Credit and PeerIQ, that specialize in providing in-depth intelligence and data to marketplace lending investors and originators, performing due diligence tailored to varying types of investor and originator preferences. Orchard is a particularly high-profile facilitator, with the industry's only benchmark index, while also providing technology, data, market research products, and a platform that enables investors and loan originators to connect with each other and transact efficiently.

An emerging risk in the MPL funding picture is that investor demand for MPL-originated assets is outstripping MPL supply, leading to the potentially dangerous territory of MPLs reducing origination and underwriting rigor to meet this demand and offer higher yields down the credit spectrum. But based on what we are seeing, we believe that the successful MPL of the future will find further scale and efficiencies through strategic partnerships with a variety of players, the most prominent being banks, to provide a diversified asset mix: enough to supply both cautious, mainstream institutional investors and risk-tolerant investors.

We also predict that another significant participant in the MPL investment ecosystem will be mutual funds, which would in effect redirect a portion of MPL assets back to retail investors. The closed-end fund applications that RiverNorth Capital Management and VanEck Global have filed with the SEC are the beginning of this journey in the United States.[14] In the United Kingdom there are already three marketplace lending funds listed and trading on the London Stock Exchange; Funding Circle listed its SME Income Fund as recently as February 2016, raising £150 million.[15] As for retail investing, a next logical step in the industry's maturity in the United States would be direct retail investing in a secondary market trading platform akin to the current bond market, making it easier for retail investors to enter and exit the market.[16] The liquidity generated from a healthy securitization and retail secondary market would enable marketplace lenders to offer even more competitive rates to small-loan borrowers.

Lastly, MPLs with scale may eventually wish to become institutional investors themselves to add a source of income beyond origination and servicing fees. Just as an insurance company's two main sources of income are premiums and investment income, MPLs with scale could feasibly add investment income to their income statements and investment assets to their balance sheets. Their asset management would likely take different forms than that of an insurance company, such as holding tranches of securitized marketplace lending assets or emerging asset classes, which could also satisfy risk retention requirements, should that become a regulatory issue (see "Regulations are a mixed bag" sidebar on page nine).

The future requires flexible partnerships to originate and platforms with rigor to underwrite

Already, MPLs have had to plumb greater depths to originate profitable customers, which have included large (and ironically) "offline" initiatives such as direct mail campaigns.[17] But thriving MPLs have found a solution to their marketing challenge: partnerships, at all levels and of all types (see Figure 3). At face value, the high-profile partnerships with large banks seem to defy logic. In the following two examples, however, we show how these high-profile banks and MPLs choose to overlook their competitive overlap to exploit market-expanding synergies:

Lending Club-Citigroup: A bank with one of the world's largest credit card divisions partners with an MPL that generates up to 80 percent of its business from credit card debt consolidation. But the partnership satisfies Citi's Community Reinvestment Act (CRA) obligations, overcoming both the limitations of its branch reach and high cost of servicing small loans in-house. By buying loans processed and underwritten by Lending Club, originated by WebBank and purchased by Varadero Capital, the bank's Citi Community Capital group taps a market in which it previously could not easily participate.[18]

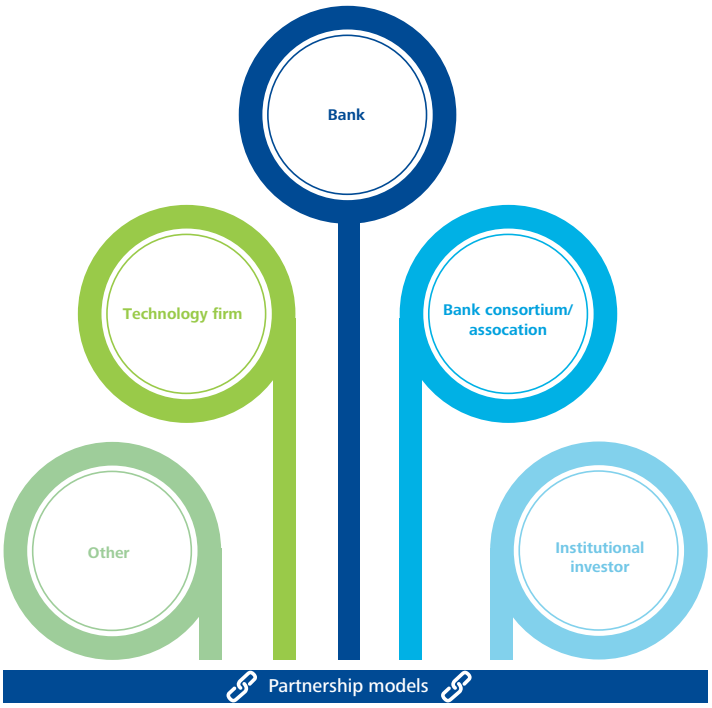
OnDeck-JPMorgan Chase: OnDeck reported 47,000 unique small-business customers before its partnership with JPMorgan Chase. With the partnership, the MPL gained access to JPMorgan Chase's 3.9 million small-business checking account customers.[19] Although OnDeck generally retains balance sheet risk, in its arrangement with JPMorgan Chase, the bank originates, brands, and holds the loans that OnDeck underwrites and services.[20] JPMorgan Chase gains the ability to better transact with its customers, while OnDeck expands its reach.

An aspect of the successful MPL's ability to partner with various institutions is its flexibility. Lending Club offers term loans averaging about $15,000 at high, single-digit, as well as double-digit, fixed rates[21] to replace higher interest rate, revolving consumer credit card obligations. But the company also offers term loans at low, single-digit rates to customers with plus-740 FICO scores, a scenario that a process-heavy bank may find difficult to justify.[22]

Further evidence that this partnership and platform flexibility is foreshadowing the future are the MPLs that serve the midsize bank having enough reach to want to preserve its brand while capturing the small-loan consumer and small-business markets. LendKey, Microexchanges, Cloud Lending Solutions, and Cognical are examples of white-label service providers that are content to forgo pushing their own brands at borrowers, and instead collect contracting fees as marketplace LaaS vendors.

The successful MPL with the flexibility to partner and contract, and bundle and unbundle services does not stop at bank relationships. At about the same time OnDeck announced its partnership with JPMorgan Chase, it also announced a less ballyhooed partnership with Intuit, giving the MPL access to four million small businesses that use Quickbooks. And in this partnership, OnDeck originates, underwrites, services, and retains the balance-sheet risk.[23] Lending Club, which has to-date originated predominantly in the unsecured consumer-loan space, has developed a secured small-business credit-facility product in conjunction with Alibaba, and it also partners with Google for small-business term-loan products, servicing these assets that the tech giant puts on its balance sheet.[24]

Figure 3. Partnership models MPLs are embracing



There are also negative trends that foreshadow the future, the foremost being the deterioration of origination and underwriting models. The perfect storm environment that we discussed earlier, besides welcoming new MPL startups, can also be a recipe for volume–trumping rigor as the market becomes crowded and borrowers become more difficult to find. But we believe that in addition to platform and partnering flexibility, rigorous underwriting methodology will determine MPL success.[25] Although alternative data (e.g., telecom and utility payments, social media, rent history), analytics, and modeling are potent tools for unique MPL algorithms, they are still secondary to the credit standards (i.e., FICO scores, debt-to-income ratios, and credit histories) that should remain core algorithm inputs. Not surprisingly, key management personnel and even founders of many MPLs come from traditional lending backgrounds that prioritize these credit standards.

That said, the expanding number of boutique data providers, which in the medium term will likely merge in line with the MPL industry's consolidation, will continue to mine, harness, and model data that targets different questions for different clients. This ecosystem will enable MPLs to hone their origination and underwriting capabilities; for example, nontraditional data metrics and machine learning will increase their ability to serve customers with varying credit histories, including those lacking one, but with excellent credit potential. As an example, the marketplace lender Upstart has already made the latter a target client base. And augmenting these big data are the proprietary customer data from banks with which the marketplace platforms are affiliated either as partners, subsidiaries, or contractors.

As data analytics and machine learning evolve, so will MPLs' already adept capabilities to segment borrowers within specialized asset classes. So far, they have mastered unique segments in unsecured consumer, small-business, and student lending, and they have already gained a foothold, albeit small, in residential mortgages. Regarding the latter, agile customer experience will likely appeal to greater numbers of customers within this currently process-heavy asset class, particularly with the first obvious origination target audience, the mass affluent with plus-740 FICO scores and low debt-to-income ratios.

Finally, a consolidated and integrated MPL marketplace opens the door wider for microcredit, which sources the industry's P2P roots. Companies such as Kiva, Affirm, Ledge, Zopa (UK), and even P2P payment provider Venmo (recently acquired by PayPal) are tweaking models that enable loans as low as $10 by using technology that keeps borrowers directly accountable to friends, family, and colleagues. With mobile devices so proliferative, affordable, and standardized, in five years the time will have come to pull these credit-historyless people into the fold.

MPL securitization to mature rapidly

The first securitizations of MPL loans happened as recently as October 2013 and the first major credit- agency-rated securitization as recently as January 2015.[26] Since then, the number of securitizations has increased markedly. In the 12 months from third quarter 2014 to third quarter 2015, the total value of MPL securitizations grew fivefold. In just one quarter, from third quarter 2015 to fourth quarter 2015, the number of MPL securitizations increased from 25 to 41 (25 consumer, nine student, and seven small business), the number of rated securitizations from 10 to 19, and the total value from $4.3 billion to $8.4 billion, respectively. Although still a relatively small market, MPL securitizations have already become a viable source for further MPL origination funding.[27]

An emerging risk in MPL securitizations is the nascent, but growing, trend of risk-tolerant investors using leverage to attain even higher yields from marketplace lending assets, and, interestingly, large banks are providing the leverage.[28] However, mitigating this risk will be the growing number of mainstream investors[29] in marketplace lending, who, being more risk averse, will be content with just investing in the already sufficiently high yields of unlevered marketplace lending assets.

In the next two to three years, we can expect to see the total number of MPL securitizations exceed 100, including different asset classes such as small business, unsecured personal, student, medical equipment, auto, and residential mortgage. The tranches will accommodate varying risk profiles, and as such, investors will encompass the full gamut, including hedge funds, pension funds, insurance companies, sovereign wealth funds, high net worth investors, and others.

Marketplace lending, with its various asset classes, will continue to add further heterogeneity to the broader securitization market. Confidence in a mature marketplace-lending sector will in turn bolster MPL securitization to the extent that risk-retention mandates will not act as a deterrent. Along these lines, greater clarity and transparency around regulatory issues, such as risk retention, Regulation AB, the JOBS Act, the Volcker Rule, CFPB's new policy of "no-action letters," and *Madden v. Midland Funding LLC* will remove uncertainties and open the doors to more investors (see "Regulations are a mixed bag" sidebar on page nine). And as a sign of increasing maturity, other MPL index products may be soon on the horizon, including an exchange traded fund. Finally, credit default swaps will be a natural progression in adding liquidity to the marketplace lending market, especially given its asset-class diversity.

Regulations are a mixed bag

Regulatory oversight will likely continue to increase as MPLs grow in market importance; yet instead of new laws, existing regulations will most likely suffice. An open dialogue in the industry, prompted by a request for information (RFI) by the US Department of Treasury in July 2015 and a coalition of small-business and marketplace-lending ecosystem players drafting a customer bill of rights,[30] has brought the workings of the marketplace-lending industry into full view. Otherwise, the Consumer Financial Protection Bureau (CFPB) remains vigilant on the consumer side, and state regulatory agencies are following suit (California has begun an RFI from all MPLs operating within the state). The *Madden v. Midland Funding LLC* verdict is forcing many MPLs to rethink their market approach, but whether the Supreme Court decides to take on the case or not, MPLs are already taking action by changing the nature of their engagement with banks, inducing them to assume economic interest in the loans.

The most complex regulatory issues that MPLs will face regard securities laws, both federal and state. And as MPLs become further entrenched in the broader financial sector ecosystem, they will find the need for more compliance oversight and expertise to navigate these laws. Among the more straightforward will be the changes to Section 15(g) of the Securities Exchange Act of 1934, effective January 2017, mandating five-percent risk retention by the sponsor, and maybe even the operator, depending on whether a securitization structure is "horizontal" or "vertical." Otherwise, the JOBS Act will most likely have a minimal positive effect on the industry as it will appeal more to retail marketplace lending investors than institutional marketplace lending investors, as it enables issuers to sell to accredited investors before they are verified as long as reasonable steps are taken to do so.

Meanwhile, the CFPB, which has not been shy to voice concerns about MPLs, has also had positive things to say. In fact, it has already provided support to firms with its new policy allowing innovative startups and products to apply for "no action letters."[31] The federal agency generally supports MPLs converting revolving credit card debt to installment loans with fixed and often lower rates, especially in terms of the potential therein for improving FICO scores of borrowers. Similarly, with a ruling expected to cut the payday loan business by more than half, the CFPB is hopeful that MPLs can provide an alternative to those who will have been disenfranchised by the regulation. P2P lending that relies on the accountability of family, friends, and colleagues has already proved a potent tool for not only decreasing instances of default, but building credit profiles where none existed.[32]

Servicing small loans as a service

As with any type of lending, the ability to reliably service loans will be an important determinant of success for marketplace lending.

MPLs can and do service their own loans, which is usually a straightforward process of payments via an automated clearing house (ACH), and for loans of short duration. But MPLs also sell servicing rights to third-party specialists that have fast become essential ecosystem players. The only sector that sees a comparable arrangement is the residential mortgage market in which mortgage servicing rights (MSRs) are sold to third parties, some of which are other banks. Of course the secured and longer-term attributes of mortgage products make servicing much more process-heavy than servicing MPL loans, and thus not worth the cost for many banks that originate mortgages. In marketplace lending, servicing companies, such as CardWorks, First Associates, and Orion First, have capitalized on servicing for MPLs that either forgo servicing as a steady fee income source or that require back-up servicing for other reasons. Regarding the latter, many securitizations, for example, are mandating backup servicers as an additional layer of rigor for obtaining favorable credit ratings. Last year, Moody's cited Prosper's servicing relationship with First Associates as part of the rating agency's justification for assigning an investment-grade rating to a securitization of the MPL's loans.[33]

An emerging risk in the servicing space is that a single third-party provider becomes so dominant that it increases concentration risk, especially as the field of MPLs becomes crowded with newcomers that prioritize chasing originations to servicing. In this scenario, the collateral damage would be customer experience, the crux of marketplace-lending success.

However, mitigating this risk of concentration to some extent are the MPLs that offer white-label LaaS. Both LendKey and the midsize WSFS Bank describe their relationship as that of the MPL providing "marketing support, credit decision information gathering, loan origination data support, and full loan servicing."[34] As these white label providers gain market share in the future, so will their loan servicing functions proliferate.

Similarly, we foresee that banks that have acquired MPLs or built them organically could bring small-loan servicing in-house. And it does seem likely that the MPL divisions would either voluntarily, or by company decree, learn how to apply their automated servicing prowess to other lending operations in these banks. In turn, further down the road, just as certain banks have developed the expertise to purchase MSRs, there could be initiatives within some banks to acquire servicing rights for different lending asset classes. Just as with MSRs, these servicing providers will have to develop expertise to handle longer loan terms, navigate different regulatory regimes, and handle secured obligations. The fact that there is already marketplace lending in the residential mortgage space makes this a not too far-fetched prediction.

An attractive future beckons both MPLs and banks

MPLs have been a boon to the small-loan borrower. They offer competitive rates and credit availability where there was none, along with speed and convenience, i.e., enhanced customer experience. For the economy, MPLs have "extended the credit market," as Noah Breslow, OnDeck CEO, succinctly phrased the phenomenon recently in a CNBC interview.[35] On the traditional side of finance, banks come to the table with assets, customer relationships, low capital costs, unique proprietary data, and regulatory and compliance expertise. Although MPLs went it alone in the beginning to prove the "genius" of their model, they did not gain their rapidly expanding market share without shrewdly leveraging every ecosystem synergy possible, both new and existing. Banks are an essential part of the latter. By itself, the marketplace lending model has proved market-expanding, demonstrated by its organic growth around the world. But while MPLs in the United States have proved innovative and disruptive, their success in continuing to expand their market reach thus far has been based on their collaboration and convergence with the banking industry, and we argue that this will be even more the norm in the future. All along the marketplace lending lifecycle, banks have proved to be natural partners, sources of funding, and even clients to MPLs, which has been essential in helping marketplace lending mature and evolve as a permanent fixture in the financial services ecosystem.

Lastly, the willingness of MPLs in the United States to ride the rails of the traditional banking industry to gain more traction and amplify their market base poses an interesting question. Why wouldn't a certain MPL take it a step further and emulate the rails? We do not think it unfathomable, for example, to see an established MPL with scale in a normalized interest-rate environment decide to become a depository institution to attract sticky retail funding. From this vantage point, the limits to how marketplace lending will contribute to the evolution of the financial services industry may be few.

Endnotes

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