Marketplace lending: disruptors and the new credit paradigm

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Transformative technology

Aided by regulatory changes, a low interest rate environment and new data-driven technologies, marketplace lenders are transforming global credit markets and reinvigorating the securitisation industry. This SCI research report* examines the factors behind the rapid growth of these platforms, the regulatory scrutiny they're attracting, the proliferation of bank partnerships and investor demand, and the emergence of financial products linked to the underlying loans.

Executive summary

Marketplace lenders, formerly known as peer-to-peer (P2P) lenders, are internet-based non-bank financial institutions that rely on technology to match prospective borrowers directly to interested lenders/investors. Marketplace lenders generate revenue by servicing and originating unsecured loans.

Current interest rates available on marketplace lending platforms in the US imply a source of yield that is hard to match *(see exhibit 1)*. Rates on three- to five-year Prosper and Lending Club debt tend to be in the teens or 20s, for instance, while OnDeck Capital – which focuses on small business lending – can offer returns of up to 100% on three- to five-year debt. Marketplace loans usually carry a roughly 1% servicing fee.

A US interest rate increase appears imminent and that may render other, more familiar debt capital more appealing. But rates have some way to go before the comparable attractiveness of marketplace loan yields are impaired.

Because many marketplace lending services are largely automated, platforms can operate with a lower overhead than traditional brick-and-mortar financial institutions *(see exhibit 2)*. The ability of these technology start-ups to provide services more cheaply than traditional banks often means that borrowers can borrow at lower interest rates and lenders/investors can earn high returns.

Nearly every sub-sector on the lending spectrum – consumer, small business, student loans, real estate, equipment finance and factoring loans – either already has a thriving marketplace lending market or is being examined for whether it has the potential to be revolutionised by marketplace lending *(see exhibit 3)*. And the industry is not just a US phenomenon *(see exhibit 4)*.

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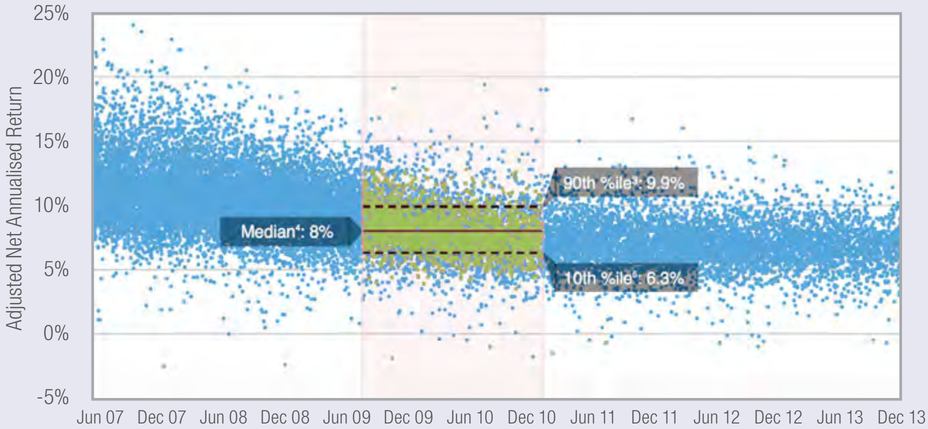
Exhibit 1: 92% Of Investors in Lending Club Have Earned 6-18% Annual Yields Since its Inception

Distribution of Lending Club monthly returns, from inception to December 2013



Source: Foundation Capital

According to Morgan Stanley, the industry might reach as much as US$290bn in global marketplace loan issuance by 2020 *(see exhibit 5)*. Outside the US, China, the UK and at some point Australia are pegged as markets to watch.

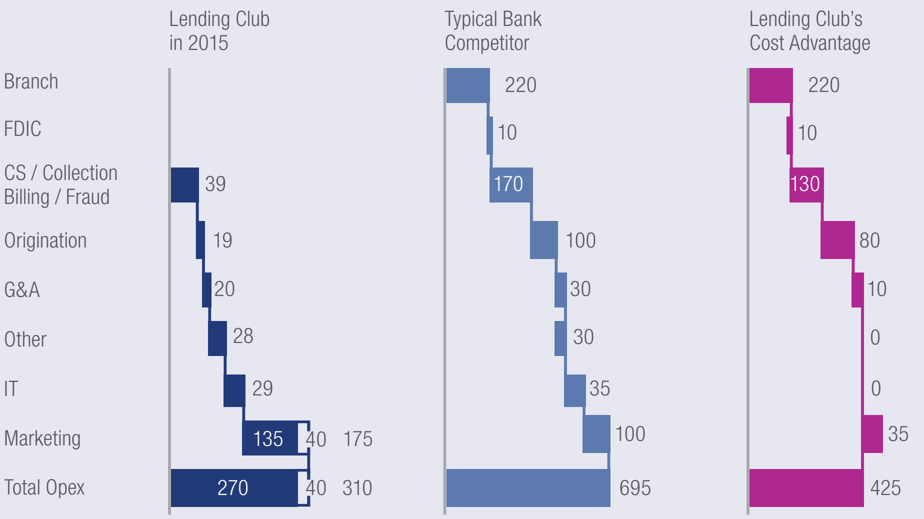
Interest in tapping the rated ABS market is growing among some marketplace lending platforms because securitisation offers a way for them – as originators of cashflow assets – to finance their assets and attract a new class of investors. At the same time, the yields and diversification offered by marketplace lending securitisation is appealing to institutional investors *(see box on survey, page 10)*.

For hedge funds acting as sponsors, securitisation can help them target risk/return levels to suit their needs. For banks, securitisation offers a further source of revenue while providing market intelligence in a sector of the loan market that is at risk of moving away from them.

Meanwhile, plans to launch derivative products referencing marketplace loans are also underway. The aim is to facilitate

Exhibit 2: Marketplace Lending Could Generate >400bp Cost Advantage vs Banks

Opex / total balance outstanding, basis points



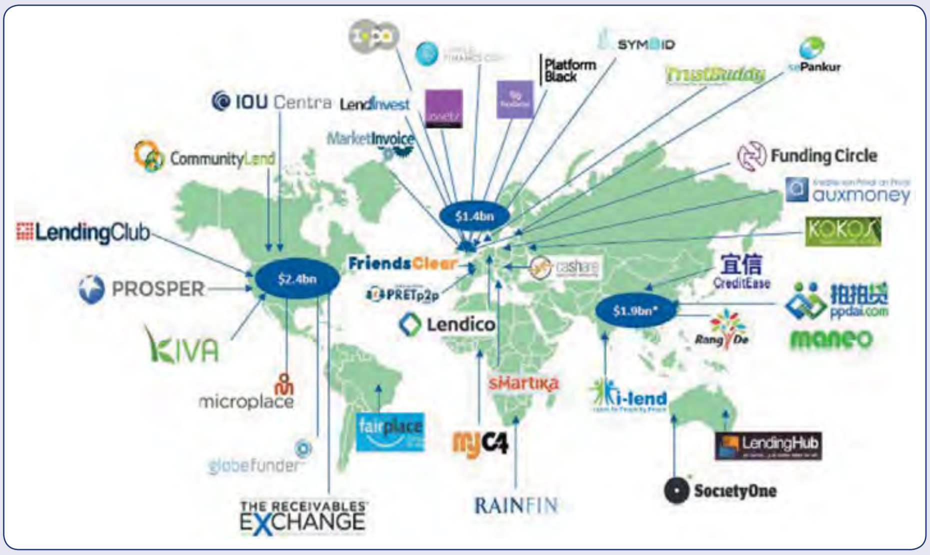
Cost advantage drivers (in bp):
- 220: Lack of branch network
- 40: Online back-office and support, outsourced collection fees
- 40: Automated origination and leaner operation

Source: Foundation Capital

Exhibit 3: Marketplace Lenders

Source: Foundation Capital

Exhibit 4: The Global P2P Landscape



Source: Fitch Ratings

liquidity and provide investors with a range of hedging tools.

Whether marketplace lenders will have the transformative power to reduce banks to bookstores – as Citi analysts asked in an ABS research report in August – is a valid question, but one to which major banks resoundingly respond "no". Credit card data shows that banks are not losing meaningful business to marketplace lenders, the analysts point out.

Against this backdrop, however, several US banks – including Goldman Sachs and Citi – are exploring ways to edge into the booming online loan marketplace. Strategies include buying up marketplace loans, partnering with marketplace lending platforms and extending warehouse credit to investors.

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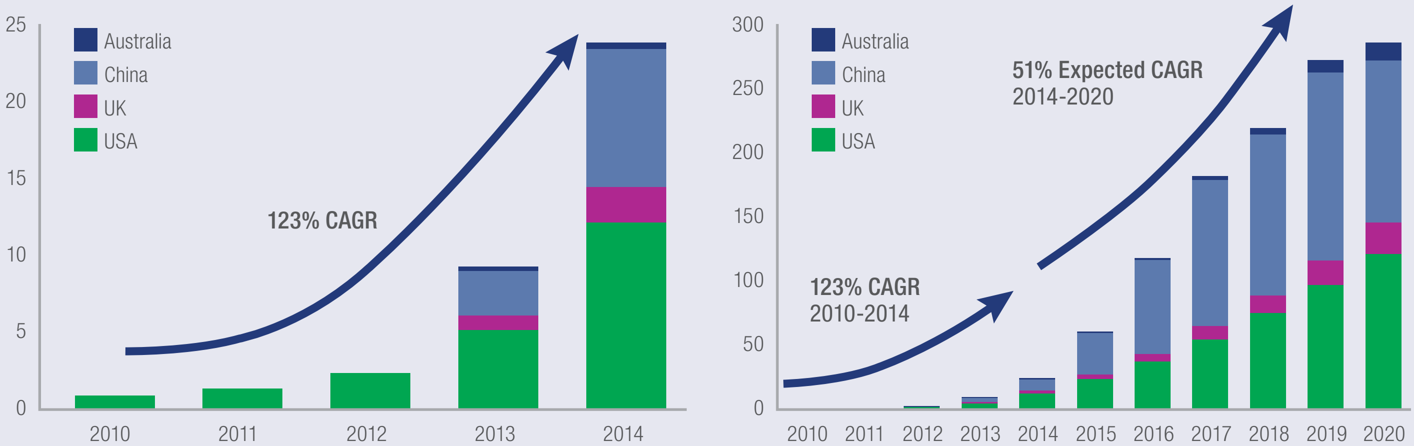
The US Treasury Department has also taken note of the rise of the marketplace lending industry *(see box on RFI, page 11)*. But the main source of regulatory scrutiny for the sector has arisen following the Madden vs Midland Funding ruling, which has cast doubt on the efficacy of the pre-emption of state usury laws that many platforms rely on.

Exhibit 5: Global Marketplace Loan Issuance ($bn)



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