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Marketplace lending: disruptors and the new credit paradigm

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**This report was written by freelance journalist Jean Haggerty and edited by SCI editor Corinne Smith*

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.

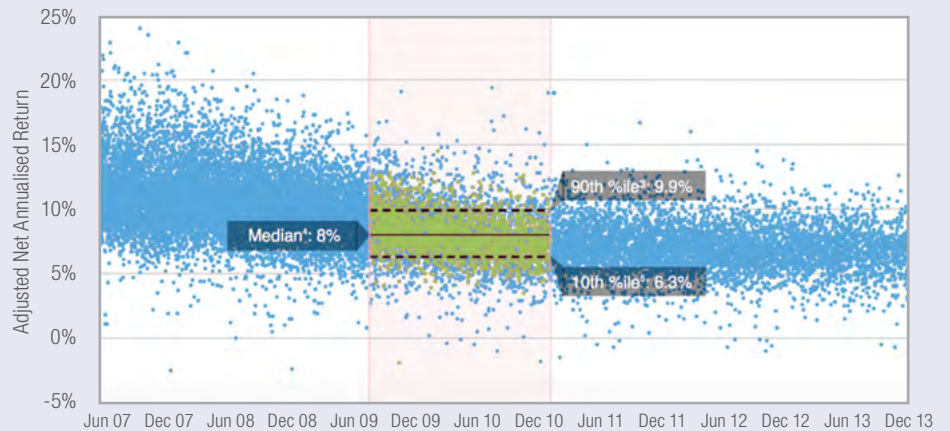
Because many marketplace lending services are largely automated, platforms can operate with a lower overhead than traditional brick-and-mortar financial institutions (see exhibit 2). The ability of these technology start-ups to provide services more cheaply than traditional banks often means that borrowers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

“Because many marketplace lending services are largely automated, platforms can operate with a lower overhead than traditional brick-and-mortar financial institutions”

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

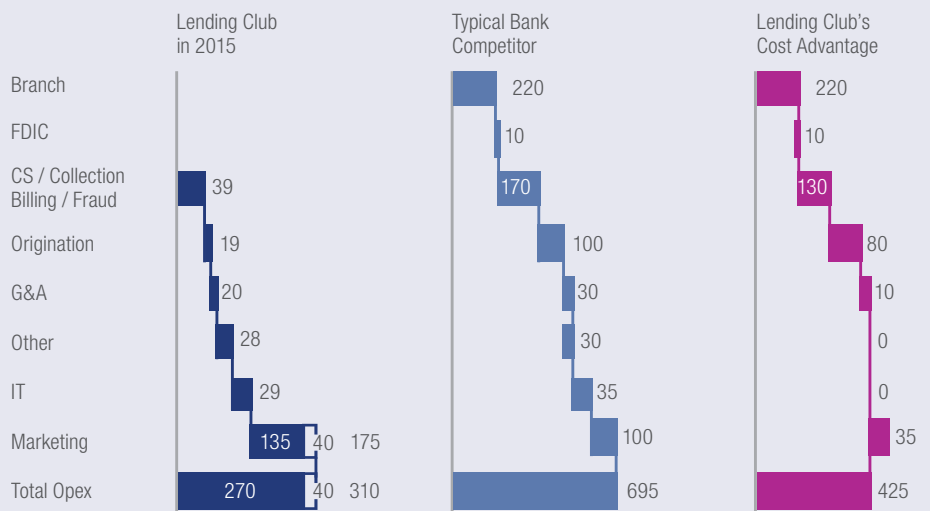
and diversification offered by marketplace lending securitisation is appealing to institutional investors (see box on survey, page 10).

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

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.

Exhibit 4: The Global P2P Landscape

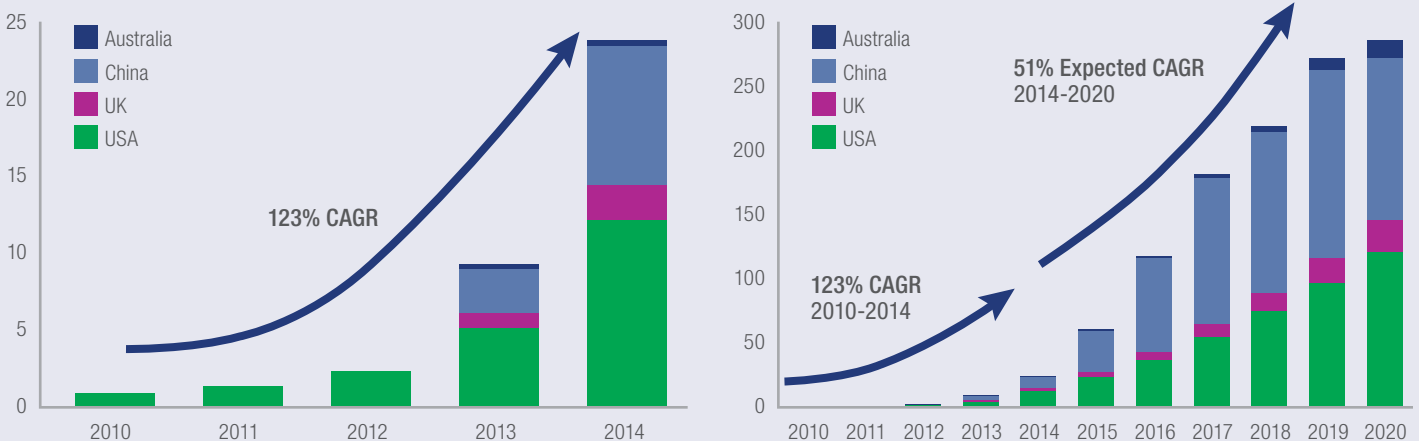


Source: Fitch Ratings

“Several US banks – including Goldman Sachs and Citi – are exploring ways to edge into the booming online loan marketplace”

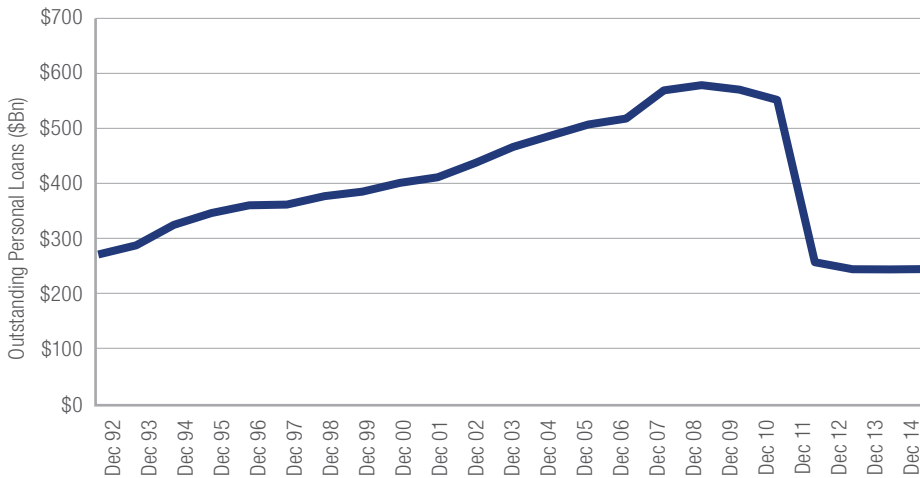
The US Treasury Department has also taken note of the rise of the marketplace lending industry (see box on RFI, page 11). But the main source of regulatory scrutiny for the sector has arisen following the Madden vs Midland Funding ruling, which has cast doubt on the efficacy of the pre-emption of state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

Exhibit 5: Global Marketplace Loan Issuance (\$bn)



Produced by Morgan Stanley

Exhibit 6: Personal Loans Outstanding – Bank Balance Sheets



Produced by Wells Fargo

Silicon Valley is coming

In 1994, Bill Gates said that banking is necessary, but that banks are not. This April, JPMorgan’s ceo Jamie Dimon offered a more pointed warning to his bank’s shareholders: Silicon Valley is coming.

“There are hundreds of start-ups with a lot of brains and money working on various alternatives to traditional banking. The ones you read about most are in the lending business, whereby the firms can lend to individuals and small businesses very quickly and – these entities believe – effectively by using big data to enhance credit underwriting,” Dimon said in a letter to JPMorgan’s shareholders.

In the letter, he noted that his bank is comfortable with partnering where it makes sense. “[These lenders] are very good at reducing the ‘pain points’ in that they can make loans in minutes, which might take banks weeks,” he added, while pledging that his bank will work hard to make its services as “seamless and competitive” as marketplace lenders’ platforms.

Marketplace lending origination in the US has doubled every year since 2010. Volumes reached US\$12bn in 2014, with consumer and SME lending leading the way.

The sector flourished in the years following the financial crisis because banks – caught in the credit crisis clean-up and the crosswinds of a major regulatory overhaul – left portions of the lending market up for grabs (see exhibit 6). Technological advances that have allowed marketplace lenders to tap into big data analytics and rapidly assess and approve or deny loan applicants online have also had a hand in driving marketplace lenders’ market share (see exhibit 7).

On the consumer loan side, in particular, the rapid growth of the US marketplace lending industry may be attributable to two of the benefits it provides. First, it can improve access to credit for individuals who have short credit histories; second, it allows consumers to consolidate credit card debt and lower their interest rate more than they could by going through traditional lenders.

A Federal Reserve Bank of Cleveland report issued last year suggests that most US marketplace loans are used to consolidate high-interest rate credit card debt. Using data provided by Lending Club, the bank calculated that 83.3% of marketplace loans were personal one-time loans that were largely used to consolidate high-interest rate credit card debt.

Interest rates on P2P loans have been lower than those on credit cards since 2010. Marketplace lenders’ ability to operate quickly and from a lower cost base has enabled them to price loans at lower interest rates.

To date, the vast majority of marketplace loans in the US have been made to prime and near prime borrowers (see exhibit 8). For example, Prosper reported that the average credit score of its total originations since inception was 700. For Lending Club, the average credit score for all public policy loans originated since inception through 31 March 2014 was 702 (see exhibit 9).

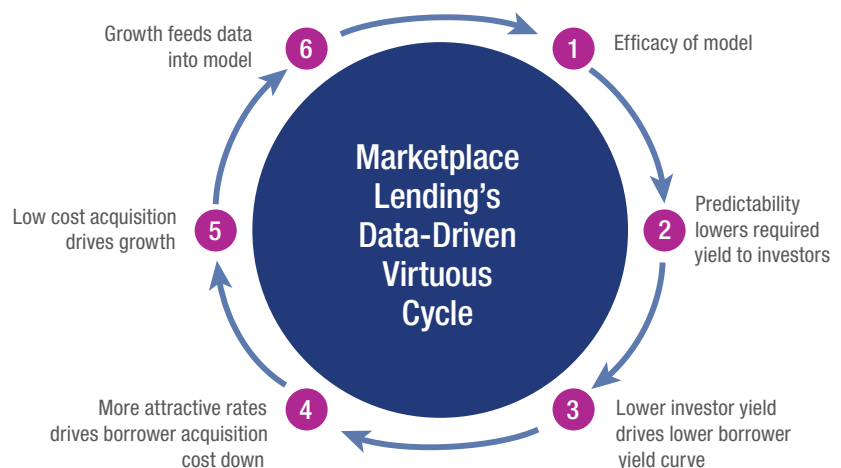
Partner-bank model

But perhaps marketplace lenders’ greatest advantage over traditional banks is that they typically use a partner-bank model, which hives them off from bank regulations. In a partner-bank model, the partner bank originates the loans and the marketplace lender buys those loans and sells them on to investors (see exhibit 10).

The partner-bank model shields marketplace lenders from bank regulations that require them to hold capital against the loans that they originate because the marketplace lender is not assuming credit risk. Essentially, this hands a loan pricing advantage to marketplace lenders.

Earlier this year, Goldman Sachs estimated that marketplace lenders’ market share is growing by 31bp per quarter. Assuming that this 31bp per quarter market share gain rate continues, marketplace lenders’ market share could reach 8% by 2019, the bank noted in an equity research report on the future of

Exhibit 7: Credit Model Improvements Accelerate Growth



Source: Foundation Capital

“The manner and extent to which banks respond and engage with marketplace lenders will play a critical role in the marketplace lending industry’s future”

finance (see exhibit 11). At this growth rate, US\$360m of the banking industry’s profit pool could be at risk in five years.

According to Morgan Stanley estimates, the top 10 banks in the US – which account for 84% of unsecured consumer credit card debt outstanding – have the most to lose to marketplace lenders. Just the same, major banks remain in a strong position.

“Banks have better loan origination, servicing and risk management skills (and centuries of experience) than the upstart marketplace lenders,” Citi analysts noted in their ABS report.

Banks can also adapt their underwriting and lending techniques, invest in technologies that would enable them to speed up loan application processes and make better use of the data that they already have on existing customers. “Banks need to invest in technology across the front, middle and back layer. Spending is needed to make borrowing faster and more intuitive, with faster feedback for the borrower and integrated with legacy systems,” Morgan Stanley analysts said in a recent research report, adding that banks also need to invest in IT to facilitate loan-level analysis and management. Bank incumbents investing

today should be able to achieve faster growth payback starting in 2017, the analysts predicted.

For banks, when competing against marketplace lenders, other strategies – like leveraging off their brand and other service offerings, or pointing out that most marketplace lender platforms are untested – could also be deployed. Additionally, if squeezed, banks could use lobbyists to urge regulators to increase oversight of the marketplace lending space.

But major banks are not generally viewing marketplace lending platforms as formidable rivals at this stage. “In the long run, we think that some marketplace loan businesses will carve out a market niche, but we do not see these entities meaningfully capturing banks’ best business,” Citi analysts said in their report.

Bank engagement

Nevertheless, traditional lenders are also not prepared to sit idly by and watch a portion of their lending market share erode (see exhibit 12). The manner and extent to which banks respond and engage with marketplace lenders will play a critical role in the marketplace lending industry’s future.

Even though Goldman Sachs has been staunchly tight-lipped about its plans in the market lending space, for instance, its hiring this May of Harit Talwar – a former executive at Discover Financial Services – has given rise to conjecture about the bank’s marketplace lending plans. Many have read Talwar’s hire as a signal that the bank will soon start originating marketplace loans in direct competition with marketplace lenders. Such a move would be significant because it would make Goldman the first big bank to compete directly with marketplace lenders.

Strategies aimed at disrupting the marketplace lender disruptors are not that likely, however (exhibit 13). Increasingly, major banks are working with marketplace lenders in ways that benefit both parties.

During the last few years, bank involvement in the marketplace lending arena has increased considerably. Banks have been buying up marketplace loans. They have also been partnering with marketplace lender platforms and extending warehouse credit to investors.

Ultimately, all three of these strategies play a similar role: they help keep banks engaged in the growing marketplace lending industry (for information, influence and contacts) and they help keep banks in the marketplace lending industry revenue chain.

Warehousing – which helps investors accumulate loans to create a sufficiently large and diverse portfolio – is interesting for banks because it is fee- and interest income-generating. Furthermore, warehousing is sometimes a precursor to securitisation and securitisation can be beneficial to all parties.

Evidence that banks have more than a passing interest in marketplace lending is mounting, albeit at a measured pace. In April, Prosper announced that it raised US\$165m in a new round of financing that was led by Credit Suisse NEXT Investors and included among its investors JPMorgan Chase, SunTrust Banks, USAA and BBVA Ventures.

Partnerships

For a few of these institutions, which could have once been listed as competitors to marketplace lending platforms, this is not their first foray into marketplace lending. For example, BBVA subsidiary BBVA Compass last May entered into an arrangement with OnDeck, under which the bank will use the OnDeck Score and technology to provide qualifying business clients with short-term loans of as much as

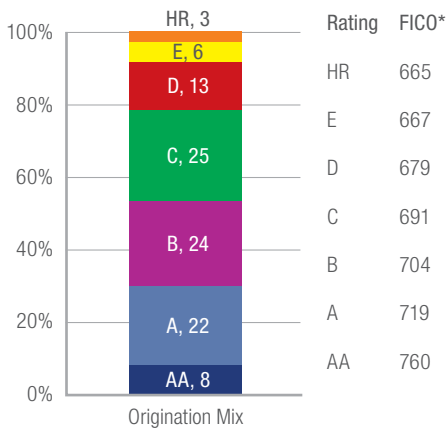
Exhibit 8: Credit Criteria and Underwriting Summary

Lending Club	Prosper
Borrowers must first pass an anti-fraud and identify verification process	Borrowers must first pass an anti-fraud and identify verification process
Minimum credit score of 660	Minimum credit score of 660
Debt-to-income ratio (excl. mortgage) below 35%	Debt-to-income ratio below 50%
Have an acceptable debt-to-income ratio (incl. mortgage and P2P loan amount)	Have a stated income greater than \$0
Credit Report Reflecting	Credit Report Reflecting
At least two revolving accounts currently open	At least 2 open trades reported on their credit bureau
Six or fewer inquiries (or recently opened accounts) in the last 6 months	Fewer than 7 credit bureau inquiries within the last 6 months
A minimum credit history of 36 months	No reported delinquencies of 30 or more days within the last 3 months
	Have not filed for bankruptcy within the last 12 months
Employment and Income Verification	Employment and Income Verification
Not standard	Not standard
Income and employment information is verified for a subset of borrowers	Income and employment information is verified for a subset of borrowers
Lending Club verified employment or income for approximately 79% of the listed applicants in 2013	Verified employment and/or income on approximately 76% of all loans (on a dollar basis) originated from July 2009 through Dec 31, 2013

Note: For illustrative purposes only. Exhibit is based on public disclosures and may not include all underwriting criteria.

Source: Fitch Ratings

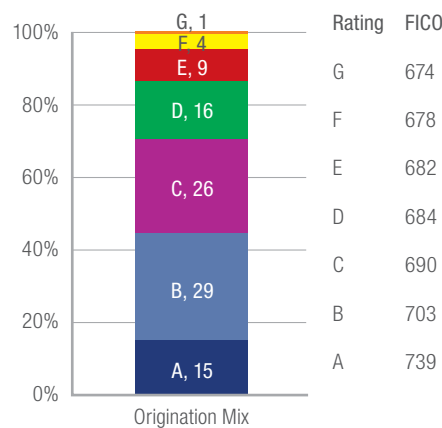
Exhibit 9: Prosper Origination Mix by Rating



Note: Borrower loans originated from 13/7/09 - 31/3/14
*Experian FICO08 credit score

Source: Fitch Ratings

Lending Club Origination Mix by Rating



Note: loans issued from inception through 31/3/14

In both instances, RBS said that it would refer the small business borrowers in the UK that it cannot serve to marketplace lenders that might be better placed to help. Santander and Funding Circle set in place a similar corporate client referral agreement in 2014.

While some major banks are also investing in 'disruptors' through their venture capital operations, other banks are responding more directly. SunTrust Banks, for example, in 2012 acquired the assets of online consumer lending company FirstAgain and relaunched the business as LightStream a year later. LightStream is a marketplace lender that allows consumers to borrow funds for purchases that had previously required collateral or that fell into categories where few or no loan options existed.

Customer acquisition

For their part, mid-sized and small US banks that have seen their market share slip for more than a decade seem keen to pair up with non-bank online lending platforms. This trend shows no sign of abating. For marketplace lenders, these partnerships can help lower their cost of customer acquisition while helping them expand their reach.

For example, when Lending Club and the community bank consortium BancAlliance announced an alliance in February, Fitch Ratings noted that from Lending Club's perspective, the alliance enables the company to expand its origination channels and diversify its funding sources by accessing the stable, lower cost deposits of community banks while also gaining access to their loyal customer base. For the participating BancAlliance banks, the arrangement with Lending Club could introduce new risks, but it could also present an opportunity for these smaller banks to regain greater presence in the consumer lending segment, Fitch Ratings said. Through this partnership, members of BancAlliance can offer access to co-branded personal loans to their customers and others for their portfolios.

Marketplace lenders' customer acquisition costs have been accelerating because of the eye-popping growth in the number of the marketplace lending platforms. And this has been occurring at a time when platforms have been striving to build scale (see exhibit 14).

The prospect of an interest rate hike further heightens the stakes because it could increase credit risk and possibly reduce loan volumes and lead to a decline

US\$250,000 that can be approved within one business day. BBVA Compass operates 688 branches in Alabama, Arizona, California, Colorado, Florida, New Mexico and Texas.

Increasingly, the alliances struck between banks and marketplace lenders are taking a variety of forms. For example, Union Bank and Lending Club last May entered into a strategic alliance under which Union Bank purchases personal loans through the Lending Club platform, with the two companies working together to create new credit products that are available to both companies' customer bases.

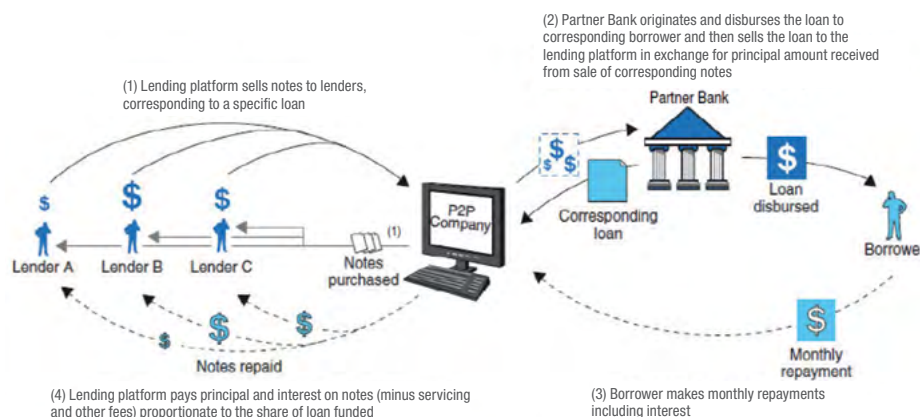
Citi Community Capital, the group within Citi that focuses on financing affordable housing and community reinvestment projects, also has an arrangement with Lending Club. In

April, Citi Community, Lending Club and Varadero Capital entered into an arrangement aimed at facilitating up to US\$150m in loans designed to provide more affordable housing to underserved borrowers and communities.

"We're excited to expand the use of the Lending Club platform to make this process easier for Citi and other banks, and help lower the cost of credit for borrowers," Renaud Laplanche, ceo of Lending Club said when the partnership was announced.

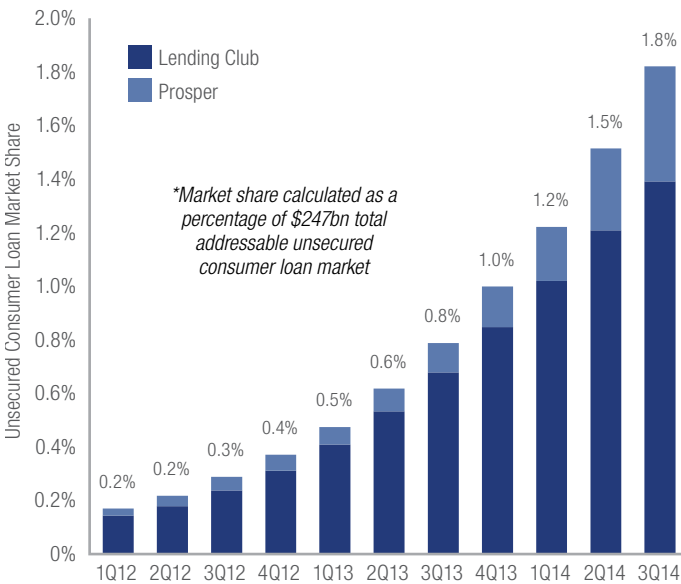
Both marketplace lenders and banks seem to view partnerships as a way to increase their exposure and grow their slice of the pie without making a big financial investment. For instance, RBS in January announced partnerships with the marketplace lenders Funding Circle and Assetz Capital.

Exhibit 10: Typical Marketplace Lending Platform

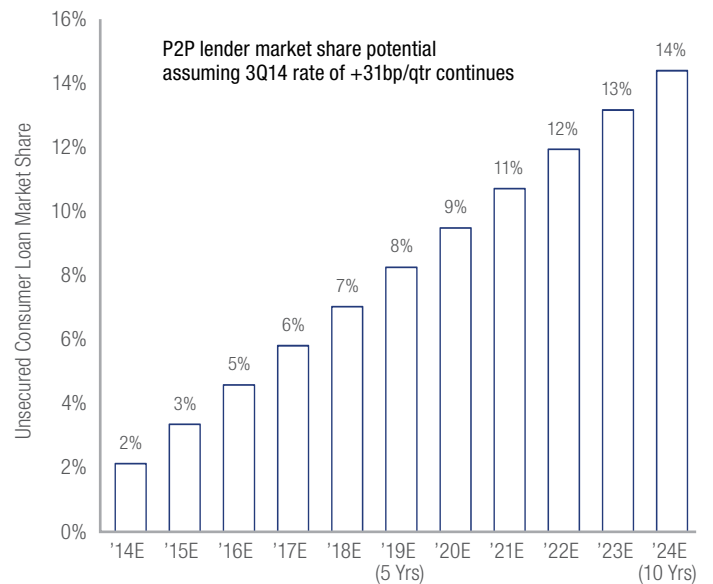


Source: DBRS

Exhibit 11: The P2P lenders are growing their share of outstanding by 31bp/qtr



...which if maintained, would mean a 8% market share in 5 years or 14% in 10 years



Produced by Goldman Sachs

in customer demand. Consequently, Morgan Stanley notes that marketplace lenders have begun linking up with affinity partnerships, including: schemes similar to those used by US credit card lenders years ago (SoFi/ top 100 universities in the US); technology partnerships, where the platform inserts itself into another marketplace (Lending Club/Alibaba, Lending Club/Google and Zopa/Uber); and partnerships with data integration that help generate leads and enhance underwriting (OnDeck/MYOB).

Lead generation partnerships are also proliferating. For example, Lendio – an automated service that works with marketplace lenders and tries to match small business owners with the right type of loan and lender for their business – earlier this year partnered with Staples to help small business owners find the best small business loans for their business.

Regulatory risks

Increased competition – either from traditional banks or from new platforms – and the possible effect that credit losses might have on marketplace lenders’ business models when the credit cycle turns are often cited as significant marketplace lending industry risks. Among some market participants, regulatory and legal uncertainties present the greatest marketplace lending industry risks, however.

Today, the US marketplace lending industry operates in a heavily regulated and very fragmented regulatory environment. On the regulatory front, one of the main challenges is figuring out how this relatively new and fast-growing industry – with its ever-evolving business models and partnership arrangements – fits into a regulatory structure that was developed before it existed.

“It’s not entirely clear which [federal and state securities] laws will apply or will not apply to marketplace lenders or, more specifically, which laws are not currently interpreted to apply to marketplace lenders today, but could in the future,” Morgan Stanley analysts wrote in their recent report. “Both company disclosures and legal experts have indicated [that] it is possible that the industry could be subject to more existing laws, given broader interpretations,” they added.

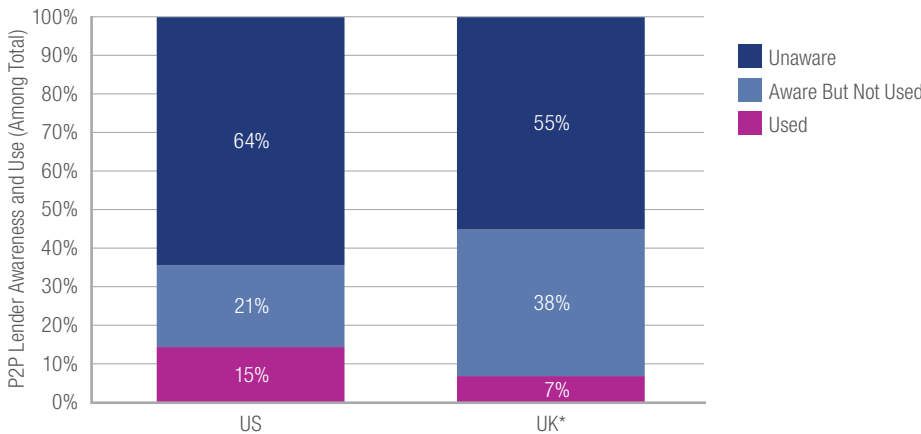
One potential regulatory issue that could come under scrutiny is the marketplace lending industry’s use of ‘rent-a-charter’ relationships. “If ‘rent-a-charter’ relationships were to be viewed by regulators as a method for circumventing direct regulatory oversight, it’s possible that they could challenge the legality of these relationships or seek to

Exhibit 12: Profit Pools at Risk

Type	Total Market Size	Market Size Type	% Inside Banking System	Amount in Banking System	% in Banking System at Risk of Leaving	Amount at Banks at Risk of Leaving	Total banking profit pool at risk	Select Disruptors / New Entrants	Competitive Advantage?
Unsecured personal lending	\$843bn	Loans O/S	81%	\$683bn	31%	\$209bn	\$4.6bn	Lending Club, Prosper	Lower capital requirement, technology
Small business loans	\$186bn	Loans O/S	95%	\$177bn	100%	\$177bn	\$1.6bn	OnDeck, Kabbage	Technology (drives time, convenience)
Leveraged lending	\$832bn	Loans O/S	7%	\$57bn	34%	\$19bn	\$0.9bn	Alternative AM, BDCs	Regulatory
Student	\$1,222bn	Loans O/S	5%	\$65bn	100%	\$65bn	\$0.7bn	SoFi, Earnest, CommonBond	Regulatory, technology, convenience
Mortgage origination	\$1,169bn	Ann'l volume	58%	\$678bn	100%	\$678bn	\$2.1bn	Quicken, PFSI, Freedom	Regulatory, convenience
Mortgage servicing	\$6,589bn	Loans O/S	73%	\$4,810bn	6%	\$300bn	\$0.1bn	OCN, NSM, WAC	Regulatory, cost
CRE	\$2,354bn	Loans O/S	56%	\$1,322bn	9%	\$118bn	\$0.8bn	Comm. mREITS, alt. lenders	Regulatory, market dislocation
Total	\$13,195bn		59%	\$7,792bn	20%	\$1,566bn	\$10.9bn		

Produced by Goldman Sachs

Exhibit 13: Awareness of Marketplace Platforms is Higher in the UK, But Usage Lags vs the US; Partnerships are a Key Opportunity to Increase Awareness



* Source: University of Cambridge Nov. 2014

Produced by Morgan Stanley

expand their authority to more directly oversee the marketplace lending industry,” the Morgan Stanley analysts observed.

Both the Lending Club and Prosper platforms generate most of their originations through WebBank, which manages the bank requirements of the lending process. WebBank is an FDIC-insured state chartered bank based in Salt Lake City.

Madden ruling

The US marketplace lending industry also has to contend with legal issues that could significantly alter its future. “[This summer, the Madden vs Midland Funding ruling] has entered into every conversation that we have had about marketplace lending,” William Black, md for structured finance at Moody’s Investors Service comments.

Soon after the Second Circuit’s May decision in the Madden vs Midland case, initial alarm about the ruling gave way to a hope that the decision could be reversed through an ‘en banc’ review. In the weeks after the 29-page unanimous Madden ruling, trade groups – including the American Bankers Association, the Independent Community Bankers of America, the California Bankers Association, the Utah Bankers Association, the Structured Finance Industry Group, the Securities Industry and Financial Markets Association, the Loan Trading Association, the Consume Bankers Association, the Financial Services Roundtable and the Clearing House Association – submitted ‘friend of the court’ briefs on the case.

As the summer wore on, however, hopes for a reversal – via an en banc review – were dashed. The US Court

of Appeals in Manhattan in mid-August declined a rehearing en banc to reconsider its controversial decision in Madden vs Midland.

Now that a rehearing of the case has been refused, many expect the Madden ruling – which is generally inconsistent with case law elsewhere in the US – to be appealed in the US Supreme Court (SCOTUS). There is no guarantee that the appeal would be accepted, however.

SCOTUS might decide that it is satisfied with the Second Circuit’s ruling and simply decline to review, notes Richard Kelly, md at NewOak Capital.

In Madden vs Midland, the plaintiff alleged that the debt collection firm Midland violated the US’ Fair Debt Collection Practices Act because New York’s usury law caps annual interest at

25% and Midland tried to collect defaulted credit card debt – which Midland had purchased from a bank – that included interest at 27%. In its May ruling, the Second Circuit held that Midland – which is not a bank and was not acting on behalf of a bank – was not entitled to the benefit of the rate export provisions of the National Bank Act (NBA), Kelly explains.

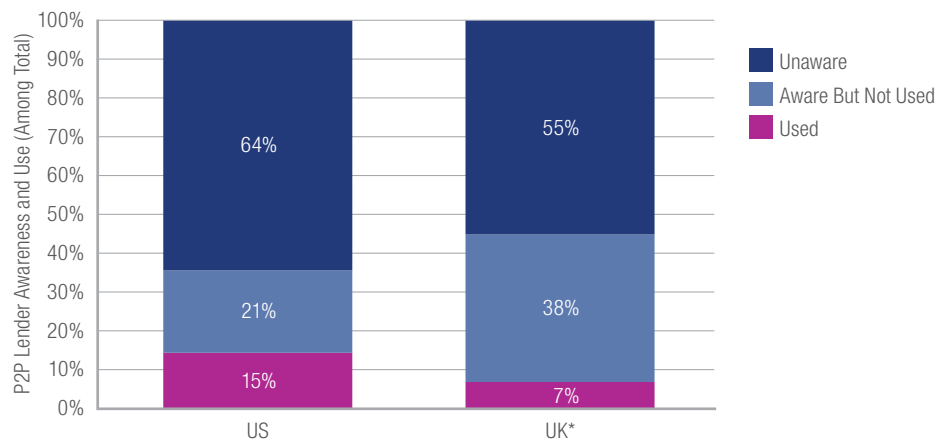
“In other words, while the bank that originated the loan could collect interest at 27%, the non-bank holder of the loan was subject to the usury law of the borrower’s domicile,” he continues.

The consensus view in the banking, securitisation and loan trading industries is that the Second Circuit’s Madden vs Midland ruling adds uncertainty where certainty was presumed. Some also worry that the ruling holds the potential to seriously disrupt the lending markets and that it could have significant ramifications



William Black, Moody’s

Exhibit 14: Annual Loan Originations for 3 Largest Marketplace Platforms 2007-Q1 2015



* Source: University of Cambridge Nov. 2014

Source: DBRS

Institutional investors polled

Only 29% of US institutional investors polled in a recent Richards, Kibbe & Orbe and Wharton FinTech survey have invested in the marketplace lending space. Roughly 85% of respondents expressed an interest in investing in the sector, however.

“The point that jumped out at us [in the survey] was the gap between interest and actual investment – only a relatively small percentage of survey respondents have actually put capital into this space, either by putting equity into platforms or by investing in loan assets,” says Scott Budlong, partner at Richards, Kibbe & Orbe in New York.

While some institutional investors interested in the marketplace lending space may be waiting on internal investment committee approvals, others are still examining this new asset class. Before devoting capital, they want to learn more about it, Budlong adds.

Survey participants said that they are most interested in gaining marketplace loan exposure in small business loans (accounting for 31% of respondents), consumer loans (28%), real estate (24%), education (24%) and other (17%).

On a scale of one to 10, respondents assigned the risk of adverse selection a 7.79, making it their top concern when examining the marketplace lending industry. Some market participants speculate that the

newness of the sector, and the associated trust issues, might explain this ranking.

Market-wide events (7.26), liquidity risk (6.85), competition from other marketplace lending platforms (6.56), regulatory uncertainty (6.4) and competition from banks or established non-bank lenders (5.78) rounded out respondents’ concerns.

When asked what developments would lessen their concerns about investing in marketplace lending, respondents said that the presence of a mature secondary trading market would have the greatest impact. Other developments that would increase their comfort with investing in marketplace lending are: if platforms included provision funds for bad debts; if platforms took steps to improve recoveries from defaulting borrowers; if a mature securitisation market existed; in the presence of greater regulatory clarity from securities, banking and consumer finance regulators; and if a “deposit insurance” product was made available to investors. However, the degree to which marketplace lending securitisations will be able to deliver more liquidity to investors will depend largely on the ratings assigned to structures and how large those transactions are.

The Richards, Kibbe & Orbe/Wharton FinTech survey polled more than 300 institutional investors and was published in June.

bank had when it made the loan – will be in a difficult position as a receiver if it cannot rely on the valid at inception doctrine in the future, law firm Pepper Hamilton points out.

Some market participants also suggest that, if affirmed, the Madden ruling could have a significant impact on the secondary market for consumer loans by impairing banks’ ability to move assets off their balance sheets via securitisation and dispose of non-performing assets through discounted sales to debt collectors, Kelly says, noting that he does not share this view. According to Kelly, if the securitisation market remains relatively broad and deep, the current Madden vs Midland ruling should have no material impact on the availability of consumer credit.

“In the securitisation context, if the originating bank retains an interest in the pool (i.e. the residual equity), Madden indicates that the NBA protection applies,” he adds. “However, even if this were not the case, the securitisation structure would allow the usury risk to be priced in with a level of comfort by a minimal increase in overcollateralisation.”

Typical overcollateralisation for triple-A credit card ABS bonds, for example, is currently around 18.5% – excluding the excess spread. “Given this amount of credit enhancement, the usury risk should not have a material effect on either rates or liquidity,” Kelly says.

Risk retention

Meanwhile, in a recent request for information (RFI) on the marketplace lending industry, the US Treasury asked if marketplace lending platforms should be required to have ‘skin in the game’ for the loans that they originate or underwrite. Requiring them to have skin in the game would help align platforms’ interests with those that acquired the debt of the marketplace lenders through their platforms.

The skin-in-the-game rule requires ABS issuers to retain 5% of loan risk when securitising assets. The argument for requiring marketplace lenders to adhere to the same risk retention rules as other institutions that sell securitised products is that marketplace lenders are simply selling

for the availability of credit and the efficient functioning of the credit markets.

“We are increasingly concerned with the recent developments in the Madden case and the increased attention from the regulatory agencies and Treasury,” says Mike Joplin, president and co-founder of Servatus, a ‘hot servicer’ firm that is moving into becoming an investor in marketplace loans. “We are assessing the retroactive regulatory risks of holding lending marketplace generated loans in our portfolio and at what yield,” he adds, noting that his firm is currently speaking with a number of existing platforms for compatibility with its strategies.

True lender issues

The Madden ruling also underscores the need for clarity around the ‘true lender’ status of the lending programmes of non-bank institutions that use third-party banks to originate loans. Prosper, Lending Club and other marketplace lenders that operate under this type of business model – whereby the marketplace lender uses a national bank as the ‘originator’

and then buys the loans for sale through the platform – are threatened by the Madden vs Midland ruling.

Madden vs Midland is not the first court case in which the true lender issue has been front and centre. The true lender issue was central in several other recent court cases – including Sawyer vs Bill Me Later and CashCall Inc vs Morrissey.

The difference this time around is that the Second Circuit court is based in New York and, as such, many more financial services companies and transactions are potentially affected by the decision, which runs contrary to the litany of court rulings that formed the foundation of the ‘valid at inception’ doctrine. The FDIC – which relies on the power that the originating

“We are increasingly concerned with the recent developments in the Madden case and the increased attention from the regulatory agencies and Treasury”

a new class of ABS product – one that is backed by the cashflows of marketplace lender-generated unsecured loans.

The counterargument for applying this new ABS risk retention rule to marketplace loan securitisations is that marketplace lenders are not creating the same kinds of securitisations as traditional lenders. This argument follows that the marketplace lender securitisation model is significantly different from the ‘originate to distribute’ model that accelerated the global financial markets meltdown in 2008.

For some rapidly growing marketplace lenders that already face a high cost of capital, compliance with this risk retention rule could pose real challenges. But the rule will not necessarily suppress marketplace lending securitisation. The majority of firms that intend to securitise marketplace loans plan to own the first-loss tranche to maturity and, as a result, the risk retention issues for these ABS issuers are not as applicable.

“The securitisation process provides the ABS issuer with structurally leveraged non-recourse term financing to the asset class. We have seen the yields tighten for securitisation on the secondary market. To the extent the pricing is bid substantially, it could be the case that the ABS issuer would want to sell their exposure [and would not want to be subject to risk retention],” Ram Ahluwalia, ceo of PeerIQ comments.

For RMBS, compliance with the new risk retention rule is required in December this year. Compliance with the rule for all other ABS asset classes is required by 24 December 2016.

“Congress and the Obama administration have let marketplace lenders develop in a free-market manner,” Richard Eckman, partner at Pepper Hamilton wrote in a brief after the Treasury released its RFI. “Nevertheless, even the hardest free-market advocates recognise the need for governing principles and adherence to basic ethical standards, but the questions concerning ‘risk retention’ and their ilk suggest that the requestors are thinking of these platforms as if they were banks, which they most certainly are not. There is no ‘promise’ of the return of invested capital [as there is in a bank], nor a promise of any specific return [returns are a function of the underlying investments’ performance only – in that respect they are truly peer-to-peer].”

Credit risk

If there is one thing that everyone active in the marketplace lending industry can agree on, it is that keeping investors comfortable with the nascent asset class is paramount. Should performance issues

Treasury RFI underway

The US Treasury issued a request for information (RFI) in July aimed at ensuring that both the marketplace lending model grows in a safe manner and that Treasury officials fully understand the sector, which is recognised as an increasingly important source of capital for consumers and small businesses. While some industry officials were struck by the positive tone of the RFI, others read it as a sign that additional scrutiny of marketplace lenders is on the way in the US. Still others are hopeful that US regulators will follow the UK regulator’s lead as they consider how to proceed.

“Innovation in financial services is creating new ways for consumers and small businesses to secure credit,” Antonio Weiss, counselor to the Treasury Secretary, said in a statement. “By soliciting public comments on this relatively new industry, we hope to better understand the potential for online technology to expand access to safe and affordable credit for consumers and small businesses.”

With respect to small businesses, the US Treasury noted that a number of studies have shown that these borrowers are more dependent on community banks for financing than larger firms, which have access to other forms of finance, including public debt and equity markets. While larger businesses typically rely on banks for 30% of their financing, small businesses receive 90% of their financing from banks.

More than half of small businesses that applied for credit in 2014 sought loans of US\$100,000 or less. However, according

to Federal Reserve survey data released in February, a majority of small firms (under US\$1m in annual revenues) and start-ups (under five years in business) were unable to secure any credit in the prior year.

“Non-prime consumers face other challenges in obtaining traditional bank-originated credit, particularly due to having thin or no credit files or damaged credit. Moreover, high underwriting costs can make it uneconomical to make small-value consumer loans,” the US Treasury said in its RFI.

“For example, it can cost the same amount to underwrite a US\$300 consumer loan as a US\$3,000 loan. Small-value loans to non-prime consumers thus have often come with triple-digit annual percentage rates (APR). Some online marketplace lenders, however, are developing product structures and underwriting models that might allow making loans to non-prime borrowers at lower rates,” it added.

Small business lending also has high search, transaction and underwriting costs for banks relative to potential revenue.

As the US Treasury does not have any enforcement power to speak of in the marketplace lending domain, the expectation is that it will share the information that it gathers on the marketplace lending industry with the Consumer Financial Protection Bureau, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and other US marketplace lending industry regulators. After the RFI’s 45-day comment period ends, US Treasury officials will be holding roundtable discussions on the industry.

arise in the first rated marketplace loan ABS when interest rates increase, the fledgling securitisation market for these assets will falter, they say.

For many institutional investors, such as pension funds and insurance companies, investing directly in marketplace lending platform loans is simply not an option. None of the major rating agencies rate marketplace loans and many institutional investors are prohibited from investing in non-rated securities.

Rated securitisations encourage standardisation of the underlying loan products. They also offer investors the benefit of standardising a pool of loan assets into a familiar, tradable security.

Even though investing in marketplace lender-generated loans directly offers greater transparency than investing in the asset class via a securitisation transaction, the loans available for purchase are often only accessible in increments that are too

small for institutional investors. According to market participants, many of the standardisation issues that have lingered in the marketplace loan asset class have been – or are in the process of being – ironed out, particularly in relation to data templates and legal documents.

“Addressing this on a global level will take some time, as each market needs to figure out how to make this work itself first,” Orchard Platform ceo Matt Burton says.

Marketplace loan securitisations pose well-understood risks: the typical structure of a marketplace loan transaction offers nothing that is new and the structure of the liabilities should look familiar to students of securitisation. Additionally, a wealth of performance history data exists on the underlying loan assets, particularly consumer and SME loans.

“But the credit risks are more pronounced [in marketplace loan securitisations],” Black notes. “There isn’t

a long track record [on the performance of marketplace loans] or on how issuers' underwriting algorithms will perform under more stressful times."

Marketplace lending platforms routinely back-test their algorithms using historical data, but this exercise is no substitute for going through a crisis first hand, Black adds. Marketplace lending companies originated most of their loans post-crisis and, at this stage, only a small portion of loans have fully amortised.

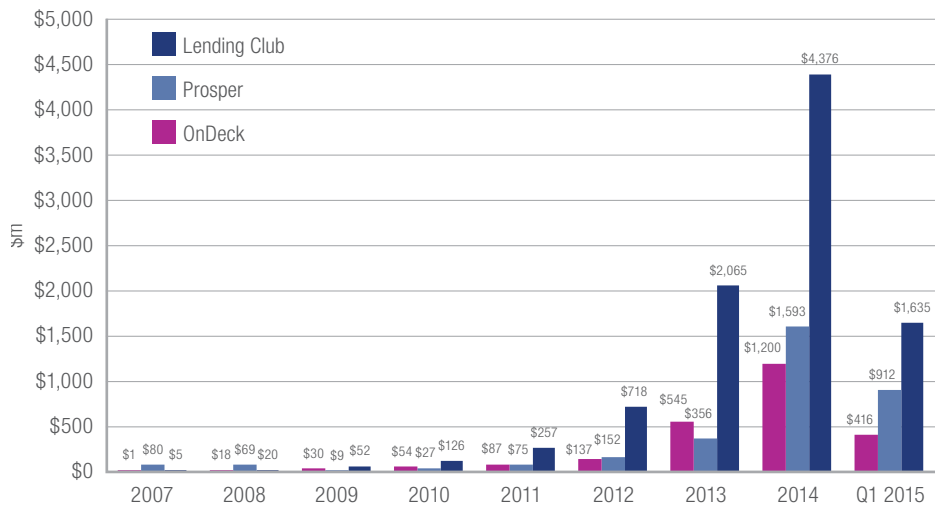
In general, rating agencies have taken a cautious approach when reviewing the marketplace lending sector and any related securitisation proposals because of the newness of the asset class. Prosper and Lending Club – the oldest and largest marketplace lenders operating in the US – were founded in 2005 and 2006 respectively, but most of the roughly 200 marketplace lenders active in the US today launched during or after 2012.

To mitigate performance risks, ABS issuers could also apply their own loan selection criteria to the borrower attributes collected by the marketplace lending companies to choose the loans with the most predictable performance, Moody's notes. Focusing on fraud detection during the underwriting process and including seasoned loans in the ABS pools would also help mitigate these risks. Finally, directly addressing how adverse selection is handled with effective loan selection criteria in the securitisation would give investors comfort that the best loans haven't been cherry-picked out of the loan portfolio.

Securitisations

Since Social Finance's (SoFi) inaugural securitisation of post-graduate student loans in December 2013, only a handful of rated marketplace loan securitisations have launched in the US. To date, rated securitisations have been executed in the student loan (via SoFi and CommonBond (see exhibit 15)), consumer loan (BlackRock's CCOLT 2015-1 and Citi's CHAI 2015-PM1 deals, which securitised Prosper loans (see exhibit 16)) and small

Exhibit 15: CommonBond Transaction Structure



Source: DBRS

business loan (via OnDeck Capital and CAN Capital) sectors.

The CHAI deal from July priced tighter than the CCOLT deal from February, despite some modest widening in the ABS market overall during the intervening period (see exhibit 17). Some of the difference between the pricing of the transactions may be due to CHAI benefiting from Citi as the sponsor and back-up servicer.

Marketplace loan ABS offers some pick-up over other non-benchmark ABS, such as subprime auto and timeshare deals. However, the spread concession does not appear to be overwhelmingly large.

Typically, securitisation transaction sizes are in the US\$350m range. "You need origination volumes to continue to grow for larger securitisations," says Ahluwalia, noting that originations are funded by a diverse set of investors.

To date, most marketplace loan securitisations have been unrated. The choice of a privately-placed 144A securitisation or a registered securitisation turns on the goals of the issuer. The 144A route has lower reporting and disclosure requirements than a registered securitisation, but consequently it provides less liquidity and deals are typically smaller in size.

So far, all the rated deals that have come to market have been oversubscribed. But, for many market participants, this might have more to do with market forces than the deals themselves.

Loan servicing

Not only are there uncertainties around how lenders and their loans will perform in a downturn and in a full economic and business cycle, but uncertainties also exist around the financial stability and long-term commitment of marketplace lenders during a downturn. Another unknown is how the various online lending platforms' infrastructure and staffing structures will be able to withstand an intense market environment and the higher servicing costs associated with a spike in loan delinquencies and defaults (see exhibit 18).

Loan servicing by marketplace lending companies poses a high operational risk

“Rating agencies have taken a cautious approach when reviewing the marketplace lending sector and any related securitisation proposals because of the newness of the asset class”

because many marketplace lenders are weak financially, due to their relatively small size and short operating histories, Moody's notes. In other ABS asset classes, issuers have mitigated their servicing risks by linking up with a strong third-party servicer, while issuers also have taken steps to protect funds that borrowers remit in the event that the originator files for bankruptcy.

"We look askance if a platform does not have [a third-party servicer that is a back-up in case of bankruptcy]. Institutional investors want that," says Dan Ciporin, general partner at Canaan Partners in New York.

For institutional investors, third-party servicer arrangements increase comfort precisely because the marketplace lending industry is new and unproven through the cycle. Also, institutional investors have to consider the possibility that the credit quality of a marketplace lending company originator might not be sufficient on a standalone basis for a securitisation structure.

"It makes sense to plan on a downturn, instead of just talking about it," Joplin observes.

One thing that occasionally jumps out at new investors when they are examining the marketplace lending space is that there is no prospect of a collection process for a borrower that defaults on a loan. There is no robust process for collections on a loan, if it defaults, because the loans are often too small. Some investors require a bit of time to get used to this aspect of the marketplace loan industry.

"The consumer marketplace lending platforms are highly efficient at generating new loan activity in a positive credit environment and they are experiencing relatively low incidents of default. As such, they have placed a low priority on development of comprehensive loan servicing infrastructure and have adopted instead to outsource collections to collection agencies," Joplin notes.

However, collection agencies do not provide solutions, only collection services. "As the platforms inevitably sacrifice borrower credit quality to keep pace with their current lending activity and market competition, the loans will become more and more risky and prone to default. We believe borrowers with pre- and post-defaulted unsecured loans are generally good people that need solutions, not haranguing," Joplin continues.

He adds that Servatus has chosen to become a marketplace loan investor because of the high yield and relatively

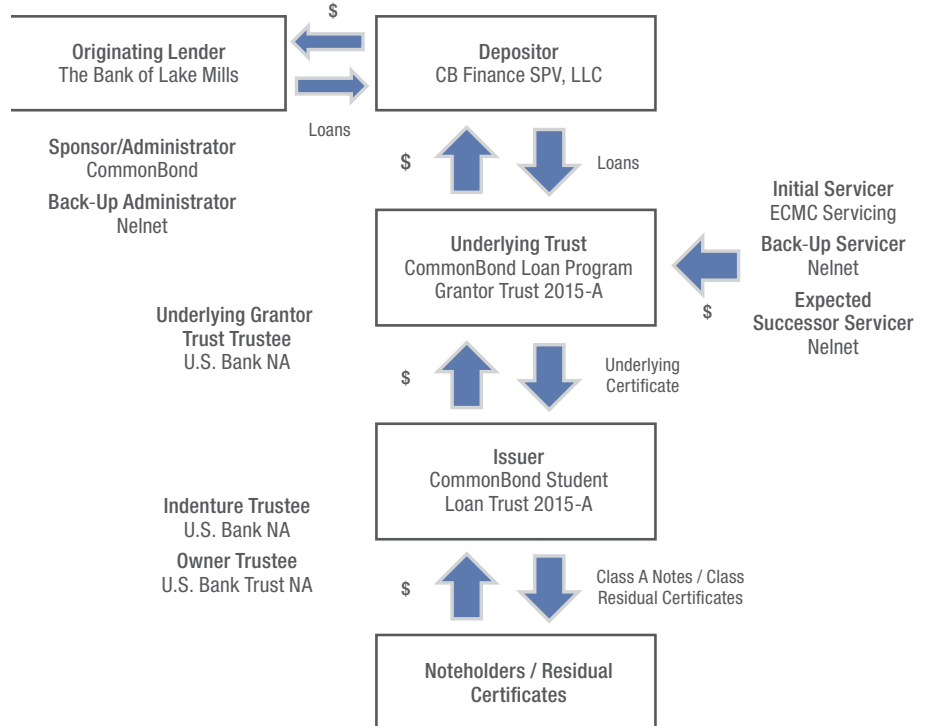
Exhibit 16: Comparing the CHAI and CCOLT Deals

Asset Pool Comparison

Metric	CCOLT	CHAI
Aggregate Current Prin Bal (\$m)	306	420
Number of Loans	25,781	30,910
Average Loan Size (\$)	11,869	13,588
Wavg Remaining Term (months)	42	43
Wavg FICO	706	703
Wavg Borrower Rate (%)	14.0	13.2
% 3-year Loans	59	63
% 5-year Loans	41	37
% CA	14.0	14.0
% TX	8.1	8.6
% NY	8.1	8.1

Note: CHAI data is as of June 30, 2015 and CCOLT's is as of Dec 31, 2014, which is the statistical cutoff date for both

Liabilities Structure



Roles and Responsibilities

Role	Responsibility	CHAI Deal Rep	CCOLT Deal Rep
Originator	- Generates the pool assets	WebBank	WebBank
Primary Servicer	- Monitors assets and provides collateral reports - Transfers asset payments and collections to trust	Prosper Funding LLC	Prosper Funding LLC
Backup Servicer	- Performs servicer duties if primary is impaired	Citibank N.A.	First Associates
Seller	- Transfers the pool assets to the PTP purchaser	Prosper Funding LLC	Prosper Asset Holdings LLC
PTP Purchaser	- Buys loans from seller and sells them to depositor	CIGPF I Corp	P2P Consumer Credit
Depositor	- Initial beneficiary and equity owner of the Issuer	CHAI, LLC	LCPCOL LP 2015-1
Issuer	- Issues the notes and is responsible for their payment	CHAI 2015-PM1	CCOLT 2015-1
Owner Trustee	- Administers the asset pool for the Issuer	Wilmington Trust	Wilmington Trust
Custodian	- Performs custodial duties for Grantor Trust	Citibank N.A.	BONY Mellon Trust Co
Indenture Trustee	- Ensures monthly distributions are made to noteholders	Christiana Trust	BONY Mellon
Paying Agent	- Ensures monthly distributions are made to noteholders	Citibank N.A.	BONY Mellon
Lead Underwriter	- Main underwriter of securitisation	Citigroup	Citigroup

Source: PeerIQ

Exhibit 17: Pricing of Rated Marketplace Lending ABS

Date Deal	3/2/15 CCOLT 15-1		29/7/15 CHAI 15-PM1		29/7/15 FCAT 15-2		4/8/15 MVWOT 15-1	
Rating	Avg. Life	Spread	Avg. Life	Spread	Avg. Life	Spread	Avg. Life	Spread
AA					1.35	130		
A			0.71	140	3.33	175	2.88	130
BBB	1.05	240	2.08	200	3.95	260	2.88	175
B	2.86	425	2.90	385	4.11	450		

Produced by Wells Fargo

low acquisition cost of the loans. “But more importantly, we know the asset class intimately. We have tracked and modeled 18 years’ transaction history of these loan types and the individual debtor lifecycles on over one million consumers that have defaulted on their unsecured, credit card, auto and [home equity line of credit] loans. We can identify who is most likely to pay and when, depending on where they are in the cycle of debt.”

Servicing and collections of unsecured consumer loans is challenged by a complex interplay between borrowers’ credit and lifestyle priorities. How they value their various credit resources – such as secured auto, home loan and revolving credit cards and lines – is at the heart of this.

“When faced with a choice between repaying a ‘one and done’ unsecured

loan and a car, house payment or credit cards, the choice is simple. Borrowers pay the accounts that offer utility. We know how to make our loan a high priority using high-touch, positive approaches during times of borrower stress,” Joplin explains.

According to Moody’s, marketplace lenders, as an industry, have revised their underwriting criteria in an effort to better predict their losses. For Ciporin, the most important aspect of a ‘good’ marketplace lender underwriting model is a demonstrated track record of at least three years.

“To the extent that a marketplace lending originator does not have this kind of record, then full transparency in how the model rates different loan parameters is critical,” he adds.

“The most important aspect of a ‘good’ marketplace lender underwriting model is a demonstrated track record of at least three years”

Back in 2007, Canaan Partners was the first investor in the marketplace lending giant Lending Club. More recently, the firm has purchased a stake in Realty Mogul, a real estate marketplace lender for accredited investors that pools money online and buys shares of pre-vetted investment properties.

Liquidity

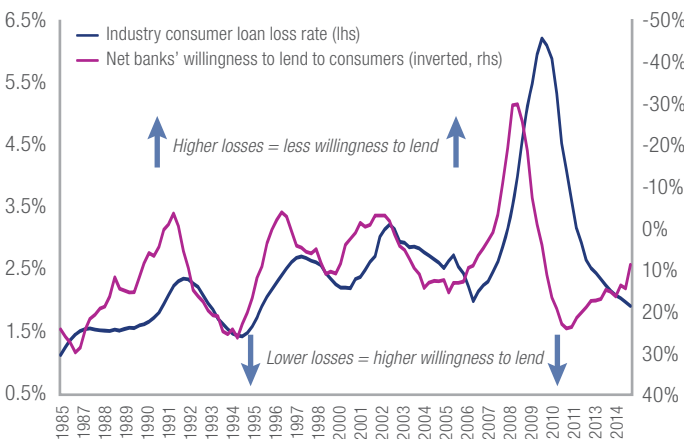
Some prospective investors in marketplace lending want a clearer sense of whether the asset class has staying power and if there is enough product available to invest in, says Scott Budlong, partner at Richards, Kibbe & Orbe. Liquidity is also a concern for institutional investors.

Certain investors, such as hedge funds, may only want to invest if there is a liquid secondary market for the assets. Jahan Sharifi, partner at Richards Kibbe & Orbe, says this is because they want to be confident that they can exit from positions in a liquid market to meet redemption requests from their investors.

As a group, institutional investors currently invested in marketplace loans would probably welcome the development of a derivative product in this space, if the product allows them to effectively hedge their long positions. Marketplace lenders are exploring this issue and there has been plenty of discussion about the possibility and importance of a secondary market.

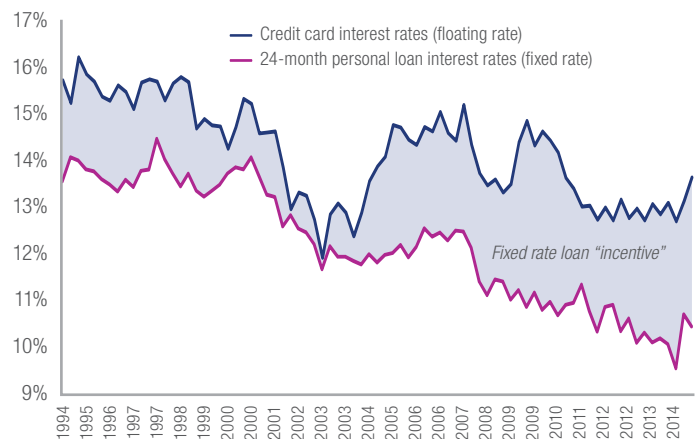
Both Synthetic Lending Marketplace (SLMX) and the risk management analytics firm PeerIQ are examining ways to create derivatives in the US marketplace loan space. “Securitisation and structured products go hand-in-hand. The [credit risk management] tools we’ve built to help institutions understand their risk can be used to structure and price other financial

Exhibit 18: Low Losses have Increased Willingness to Lend



Produced by Goldman Sachs

Low Interest Rates have Increased Loan Demand



Developing derivatives

Synthetic Lending Marketplace (SLMX) plans to launch a new marketplace loan derivatives product – which will be structured like a credit-linked note – in the coming months. Initially, hedge funds, marketplace loan funds and credit funds are expected to be the main users of the instrument.

SLMX is developing its derivatives product with the broker-dealer AK Capital. According to Mike Edman, founder of SLMX, perhaps the greatest hurdle facing the marketplace loan derivatives market is the fact that the asset class itself is fairly cheap right now.

“There are not many investors out there who want to put on an outright short,” he says.

For Ram Ahluwalia, ceo and co-founder of PeerIQ, the biggest challenge to launching a derivatives market currently is that the size of the cash market and structured products market is still relatively small – albeit growing at a rapid rate – and that the default rate environment is very favourable for investors. “Derivatives thrive when you have a demand for underlying cash assets that cannot be filled [and this condition is true], uncertainty in the rate environment and demand for hedging consumer credit risk,” he notes.

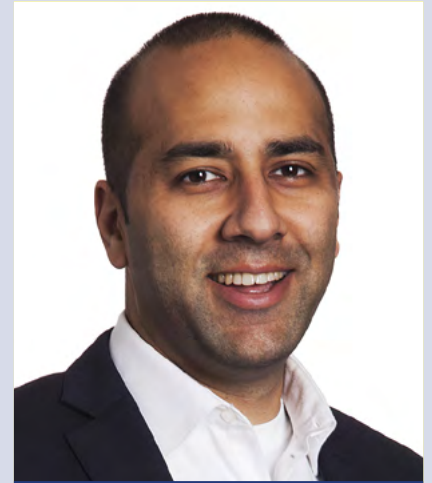
Additionally, some players active in the US marketplace lending space simply do not want to be associated with the same synthetic risk instruments that exacerbated the problems encountered during the 2008

market collapse. The worry here is that the arrival of a derivatives market on this asset might nudge the marketplace lending industry towards becoming a modernised version of the pre-crisis residential mortgage industry.

Like the pre-crisis residential mortgage industry, the interests of platforms active in the marketplace lending sector are not aligned with those of investors because marketplace lenders do not have a financial interest in loans on their platforms. The concern is that marketplace lenders might relax their underwriting standards to pump up origination volumes – just as residential mortgage lenders did before the crisis.

“I think it’s short-sighted. Derivatives would bring more transparency to the market, which everyone in the market – including the platforms – seems to favour. They’d also bring more liquidity and ultimately more investors, which is good for everyone. In the short term, it is a fair concern that derivatives will divert capital from marketplace loans, but the market is so small relative to the amount of capital out there, it would hardly make a dent,” Edman observes.

Meanwhile, the case for developing liquidity via the securitisation market follows that securitisation provides standardisation for investors and this enables bigger tickets and more deals, which in turn should attract more investors. Some market participants argue that these factors need to be in place before derivative products should even be considered.



Ram Ahluwalia, PeerIQ

“I think securitisation is great for this market and, apart from being a pretty short-duration asset, marketplace loans are very well suited for it. As far as I’m concerned, every marketplace loan that is created should either be in a securitisation or a publicly traded closed-end fund. I don’t see the great benefit to owning the loans individually,” Edman notes.

He adds: “As far as how securitisation relates to SLMX’s efforts in the derivatives market, it’s a good development. And I agree it should be a higher priority than derivatives, but that doesn’t mean they shouldn’t develop concurrently.”

products, such as insurance-wrapped P2P loans,” says Ahluwalia.

He adds: “Our clients see a lot of value from securitisation and structured products when they’re developed responsibly, with simplicity



Mike Edman, SLMX

and transparency as core principles.” Institutions and banks are more willing to fund P2P – potentially through a credit cycle – when they know they can manage their risk responsibly, he suggests.

According to Mike Edman, founder of SLMX, a lot of platforms and originators are receptive to the idea (see *box on derivatives, above*). “They understand that the ability to hedge and have liquidity is a big positive for the market,” he says.

However, among some market participants, the appetite for addressing current and prospective institutional investors’ liquidity concerns by developing the securitisation market outstrips the desire to develop a derivatives product. On a practical level, these players say that there is limited capacity in the market to think about the next stage of development because the market is in the throes of a major growth spurt. For now, the focus has to be on generating greater liquidity via securitisations because there is more comfort among investors in a tradable security.

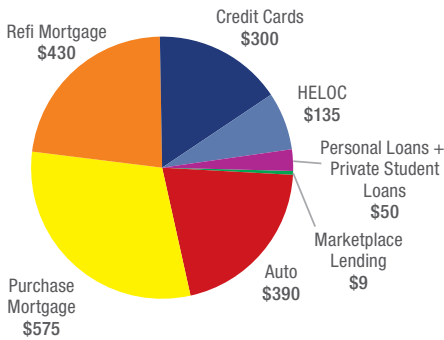
Market evolution

Even though the marketplace lending industry has been growing quickly since its inception less than a decade ago, marketplace loans still only represent a 1.1% sliver of total 2014 US consumer loan originations and a 2.1% portion of US SME loan issuance (see *exhibit 19*). But the evolution of the global marketplace lending industry is fast becoming a story about cross-fertilisation of ideas and adaption.

“There are many aspects of Chinese marketplace lending from which other countries around the world can learn, including the use of mobile apps, secondary markets and the offering of additional services,” Jeremy Todd, director of West Coast sales at Orchard Platform wrote in an Orchard blogpost after the LendIt China conference this summer. “Likewise, the Chinese marketplace lending industry believes they can learn from other countries’ regulatory and underwriting practices.”

The desire to learn and replicate is felt elsewhere, perhaps most notably in the US, where many market participants believe

Exhibit 19: 2014 Consumer Lending Originations (\$bn)



Source: DBRS

that much can be adopted from the UK marketplace lending experience. From a regulatory and organisational point of view, the UK market is ahead of the pack.

The UK

Since April 2014, the UK marketplace lending industry has operated with a single regulator – the Financial Conduct Authority – and under a set of rules crafted from scratch and specifically for marketplace lenders. The UK’s regulatory framework, which was fostered in an environment supportive of the industry’s growth and existence, requires marketplace lenders to have minimum operating capital requirements, meet client money requirements and adhere to a disclosure-based regime.

Additionally, in 2011 UK marketplace lenders Zopa, Funding Circle and Ratesetter banded together to found the Peer-to-Peer Finance Association (P2PFA) as a self-regulatory body (see also box on *bill of rights, opposite*). Since its inception, the P2PFA has set out to: secure public policy, regulatory and fiscal conditions that enable the UK-based marketplace lending sector to compete fairly and grow responsibly; to ensure that members demonstrate high standards of business conduct; and to raise awareness and understanding of the benefits and risks of marketplace lending.

A big part of the reason why the UK marketplace lender industry’s organisational and regulatory structure is so comprehensive is because the UK marketplace lender space was initially dominated by retail investors. The world’s first online marketplace lending company, Zopa, launched in 2005 as an online lender for individuals and small businesses in the UK. Retail investor involvement meant that certain consumer/investor protection issues had to be addressed head-on.

“The UK’s regulatory framework ... requires marketplace lenders to have minimum operating capital requirements, meet client money requirements and adhere to a disclosure-based regime”

One area where the UK market has not blazed new trails is in securitisation. Many market participants expect the UK’s first rated deal to arrive later this year or soon after the start of the next year.

Some market participants watching this space question whether the existence of closed-ended marketplace loan-investing funds has slowed down the arrival of securitisation in the UK. But others maintain that Marshall Wace’s closed-end fund launch, for instance, has indirectly helped facilitate the UK’s marketplace loan industry (see box on *retail investment, page 17*).

According to Morgan Stanley, the UK is the most compelling marketplace lending opportunity in Europe, with small business and consumer lending together representing a total addressable market of about £100bn. Last year, the UK alone represented about 80% of European marketplace loan origination in Europe and institutional flows and supportive policies could lift the UK from about £1.3bn annual origination in 2014 to about £15bn by 2020, the firm notes.

In continental Europe, Germany, Spain, France and Italy are generally seen as

Borrowers’ bill of rights

Until recently, industry-led efforts aimed at corraling marketplace lenders operating in the US into a trade group – similar to the UK marketplace lender trade group the Peer-to-Peer Finance Association – have gone nowhere, largely because the industry’s growth has been accelerating at a remarkable clip and competition between marketplace lenders has been fierce. The industry’s resistance to banding together is starting to show some signs of fading, however, since the US Treasury issued a request for information on the sector.

In the small business loan space, for example, a cross-section of marketplace loan industry players – including Lending Club, Funding Circle, Fundera, Accion and others – launched the Small Business Borrowers’ Bill of Rights in August. The Bill of Rights represents both a way to potentially ward off increased regulation and to uphold the integrity of the sector.

“We are increasingly concerned that the promise of ‘fast and easy’ is replacing the need for credit products to be ‘thoughtful and appropriate’ for the business. Too many of those small businesses we are working with today have chosen products that seemed right, but have proven damaging to their businesses,” notes Gina Harman, ceo of Accion, a non-profit micro and small business lending network.

The Small Business Borrowers’ Bill of Rights – which aims to enhance borrower

protections by fostering greater transparency and accountability across the small business lending sector – outlines six key rights the Responsible Business Lending Coalition believes all small business borrowers deserve. These rights include: the right to transparent pricing and terms (including a right to see an annualised interest rate and all fees); the right to non-abusive products (so that borrowers don’t become trapped in a vicious cycle of expensive re-borrowing); the right to responsible underwriting (so that borrowers are not placed in loans they are unable to repay); the right to fair treatment from brokers (so that borrowers are not steered into the most expensive loans); the right to inclusive credit access (without discrimination); and the right to fair collection practices (to prevent harassment and unfair treatment).

“Setting consistent rights and principles for the benefit of small business owners is necessary and important. We hope the entire small business financing community will join us in upholding these rights,” adds Renaud Laplanche, ceo of Lending Club.

Any small business lender, broker or marketplace can attest that they abide by all aspects of the Small Business Borrowers’ Bill of Rights on a form signed by their ceo.

Currently, no other efforts aimed at forming US marketplace loan industry trade groups are underway.

the markets to watch. Further afield, the Australian market is said to be promising for marketplace lenders, albeit the industry is still in its early days there.

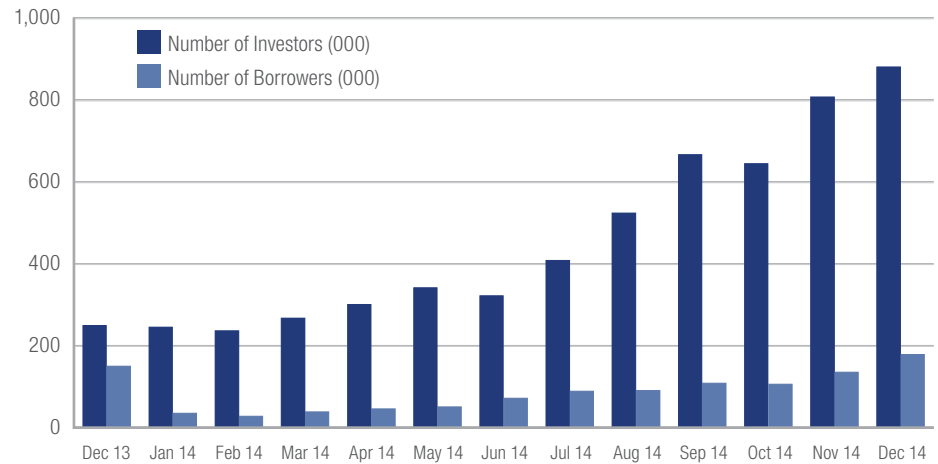
But Morgan Stanley notes that the country's high internet usage, its concentrated banking industry, comprehensive credit reporting regime and the current wide spreads between rates on personal loans and credit cards versus cash rates all help make Australia an attractive market. The country's lack of innovation and generic pricing in the personal loan space and its lack of alternative sources of funding and high borrowing costs for small businesses could also work in marketplace lenders' favour.

China

China is also widely viewed as fertile territory for marketplace lending, not least because of the sheer size of the potential lending market. By some estimates, loan originations in China stood at US\$9bn in 2014. The number of marketplace loan borrowers and investors increased by more than four-fold during the same year (see exhibit 20).

China also has seen a robust adoption of online/mobile banking, coupled with unmet demand for consumer and business lending. "There are an estimated

Exhibit 20: China: The Number of P2P Borrowers and Investors Increased by More than Four-fold in 2014



Produced by Morgan Stanley

500 million consumers in China, who are economically active but never have had access to bank credit," Zane Wang, founder and ceo of China Rapid Finance said in July, when his firm raised US\$35m in its Series C round of financing.

Certain marketplace lenders could also tap into China's underserved consumer

and SME credit markets and certain mezzanine financing opportunities that are currently serviced by other high-yield financing channels, Morgan Stanley analysts note. Overall, consumer loans probably represent a more sustainable long-term opportunity in the country, especially if the People's Bank of China decides to allow marketplace lenders access to its credit reference database.

According to Todd, China offers diversification opportunities for investors interested in purchasing Chinese loans and for Chinese investors interested in purchasing other countries' loans.

Nevertheless, marketplace lending has grown rapidly in China since 2010 and the fact that the industry has been largely unregulated is a point of concern for many. The Chinese government's efforts to monitor the marketplace lending industry are just now taking shape.

This summer the Chinese regulatory agencies issued new guidelines that usher in a monitoring structure for marketplace lenders and create clearer boundaries between P2P lenders and banks. The new guidelines are expected to reduce the number of marketplace lenders, which at last count in 2014 included 1,575 platforms.

China's first marketplace lender PPDAI – which lends to small businesses – went live in 2007. PPDAI has since been joined by CreditEase, China Rapid Finance, MY089, Lufax, Dianrong, RenRenDai, Yooli and many others, particularly since 2010. However, last year alone, nearly 370 marketplace lending platforms operating in the country failed. [sci](#)

Retail investment opportunities

The UK government's planned introduction of lending individual savings accounts (ISAs) is slated to be a pivotal moment for the country's marketplace loan industry. According to Funding Circle data, 41% of investors said that they would invest more in marketplaces (like Funding Circle) if the opportunity was provided for within ISAs, while one in 10 people said that they would transfer their existing stocks and shares into a lending ISA.

The UK's Tax Incentivised Savings Association, a not-for-profit membership association, estimates that more than £50bn is invested in ISAs every year. "If just 3% of this money was channeled through [marketplace lenders like Funding Circle], it would create more than £1.5bn of new lending to businesses annually, leading to approximately 75,000 new jobs," a Funding Circle spokesperson comments.

She adds that previous independent research by UK innovation think tank Nesta revealed that businesses that receive a loan through Funding Circle employ, on average, 11 people and see an average increase in employment of 27% after receiving finance.

The UK's new lending ISA will sit between the existing cash and stocks and shares ISAs in terms of risk and reward.

Elsewhere in the retail investment space, Marshall Wace launched the UK's first closed-ended fund – called Peer-to-Peer Global Investments (P2PGI) – that invests in marketplace loans in May 2014. P2PGI recently raised another £400m from investors, bringing the fund's total market capitalisation to almost £900m and making it one of the UK's biggest 30 investment companies – little more than a year after its debut.

At this stage, two other closed-ended marketplace loan investing funds exist in the UK – Victory Park Capital (which launched this spring and has a market capitalisation of £205m) and the £143m Ranger Direct Lending fund – and others are reportedly in the pipeline.

Across the Atlantic, the US market is waiting for the US Securities and Exchange Commission to move on RiverNorth Marketplace Lending and Van Eck Overland Online Finance Trust's separate filings for closed-ended funds that invest in marketplace loans.

Appendix: Marketplace Lending Securitisations

Date	Deal name	Class	Size (m)	Spread	WAL	M/S&P/F	Arranger	Originator	Type	Market
23/12/2015	MarketPlace Loan Trust series 2015-OD4	A	\$134.93	3.25%	0.48		JEFF	OnDeck Capital	Other ABS	US
		B	\$15.87	5.25%	1.27					
		Cert	\$7.94							
15/12/2015	MarketPlace Loan Trust series 2015-CB2	A	\$119.45				N/K	CircleBack Lending	Consumer/credit card ABS	US
		B	\$7.56							
		Cert	\$24.19							
11/12/2015	Citi Held For Asset Issuance 2015-PM3	A	\$161.53	190	0.78	A3/NR/A+	CITG	WebBank	Consumer/credit card ABS	US
		B	\$59.83	350	2.2	Baa3/NR/BBB+				
		C	\$43.38	600	2.98	Ba3/NR/BB-				
13/11/2015	AMPLIT TRUST 2015-A	A	\$136.11				MS	Avant	Consumer/credit card ABS	US
		B	\$19.44							
		Cert	\$19.44							
13/11/2015	MarketPlace Loan Trust series 2015-LD1	A	\$123				N/K	LoanDepot	Consumer/credit card ABS	US
		B	\$7.50							
		Cert	\$7.50							
13/11/2015	SoFi Professional Loan Program 2015-D	A1	\$154.9	1mL+150	3.86	Aa2/NR/NR	MS	Social Finance	Student loan private ABS	US
		A2	\$334.78	150	3.74	Aa2/NR/NR				
		B	\$46.69	235	4.64	Baa2/NR/NR				
04/11/2015	Insikt Prosper Primary Master 2015-3	A	\$32.02				N/K	Prosper	Consumer/credit card ABS	US
		B	\$9.11							
		R	\$4.78							
16/10/2015	Citi Held for Asset Issuance 2015-PM2	A	\$230.87	195	0.77	A3/NR/NR	CITG	WebBank	Consumer/credit card ABS	US
		B	\$86.05	350	2.19	Baa3/NR/NR				
		C	\$58.77	525	2.97	Ba3/NR/NR				
16/10/2015	MarketPlace Loan Trust series 2015-AV2	A	\$86.34				N/K	Avant	Consumer/credit card ABS	US
		B	\$12.33							
		C	\$12.33							
24/09/2015	MarketPlace Loan Trust series 2015-AV1	A	\$88.47				N/K	Avant	Consumer/credit card ABS	US
		B	\$12.64							
		C	\$12.64							
15/09/2015	MarketPlace Loan Trust series 2015-OD3	A	\$67.73				N/K	OnDeck Capital	Other ABS	US
		B	\$7.97							
		Cert	\$3.98							
12/08/2015	Avant Loans Funding Trust 2015-A	A	\$108.4				JEFF	Avant	Consumer/credit card ABS	US
		B	\$15.49							
		C	\$15.49							
29/07/2015	Citi Held For Asset Issuance 2015-PM1	A	\$227.28	140	0.71	A3/NR/NR	CITG	WebBank	Consumer/credit card ABS	US
		B	\$86.29	200	2.08	Baa3/NR/NR				
		C	\$63.13	385	2.9	Ba3/NR/NR				
29/07/2015	SoFi Professional Loan Program 2015-C	A1	\$136.5	1mL+125	3.81	Aa2/NR/NR	MS, GS, CS	Social Finance	Student loan private ABS	US
		A2	\$250.8		3.67	Aa2/NR/NR				
		B	\$30.3		5.41	Baa2/NR/NR				
08/07/2015	Insikt Prosper Primary Master 2015-2	A	\$3.62				N/K	Prosper	Consumer/credit card ABS	US
		B	\$0.78							
		R	\$0.81							
17/06/2015	CommonBond Student Loan Trust 2015-A	A	\$96.4	165	4.02	Baa2/NR/NR	MS	CommonBond, Bank of Lake Mills	Student loan private ABS	US
12/06/2015	MarketPlace Loan Trust series 2015-OD2	A	\$59				N/K	OnDeck Capital	Other ABS	US
		B	\$6.94							
		Cert	\$3.47							
05/06/2015	SoFi Professional Loan Program 2015-B	A1	\$146.68	1mL+105	3.59	Aa2/A/NR	GS, MS, CS, DB	Social Finance	Student loan private ABS	US
		A2	\$235.45	110	3.75	Aa3/A/NR				
		B	\$29.78	175	5.14	Baa3/NR/NR				
04/06/2015	MarketPlace Loan Trust series 2015-OD1	A	\$44.27				N/K	OnDeck Capital	Other ABS	US
		B	\$5.21							
21/05/2015	MarketPlace Loan Trust series 2015-CB1	A	\$99.89	4%			JEFF	CircleBack Lending	Consumer/credit card ABS	US
		B	\$6.32	6%						
31/03/2015	Insikt Prosper Primary Master 2015-1	A	\$3.67				N/K	Prosper	Consumer/credit card ABS	US
17/03/2015	Blue Elephant Loan Trust 2015-1	A	\$55.03	3,149%	0.96		CITG	Blue Elephant Capital Management	Consumer/credit card ABS	US
		B	\$8.88	5,634%	2.56					
		C	\$3.55							
02/03/2015	GLC Trust series 2015-B	A	\$97.38				N/K	Prosper	Consumer/credit card ABS	US
		B	\$5.94							
02/03/2015	GLC Trust series 2015-A	A	\$154.07				N/K	Prosper	Consumer/credit card ABS	US
		B	\$9.4							
03/02/2015	Consumer Credit Origination Loan Trust 2015-1	A	\$281.32	240	1.05	Baa3/NR/NR	CITG, CS	Prosper/Blackrock	Consumer/credit card ABS	US
		B	\$45.38	425	2.86	Ba3/NR/NR				
		C	\$18.15							
23/01/2015	SoFi Professional Loan Program 2015-A	A1	\$151.5	1mL+120	3.89	A2/A/NR	MS, GS, BCG, CS	Social Finance	Student loan private ABS	US
		A2	\$162.3	125	3.47	A2/A/NR				
29/12/2014	GLC II Trust 2014-A	A	\$109.84				N/K	Prosper	Consumer/credit card ABS	US
		B	\$9.47							
22/12/2014	Insikt Prosper Primary Master 2014-2	A	\$7.11				N/K	Prosper	Consumer/credit card ABS	US
		B	\$0.64							
		R	\$0.89							
05/11/2014	SoFi Professional Loan Program 2014-B	A1	\$105.7	1mL+125	3.89	A2/A/NR	MS, GS, BCG, DB	Social Finance	Student loan private ABS	US
		A2	\$197.5	130	3.3	A2/A/NR				
17/10/2014	CAN Capital Funding series 2014-1	A	\$171				Guggenheim	CAN Capital	Other ABS	US
		B	\$20							
25/09/2014	Kabbage Funding 2014-1RT	A22	\$575.27				N/K	Kabbage	Other ABS	US
		B2A	\$168.65							
		B2B	\$168.65							
		B2C	\$21.08							
18/07/2014	GLC Trust 2013-2 series 2014-A	A	\$36.92				N/K	Prosper	Consumer/credit card ABS	US
		B	\$2.25							
09/07/2014	SoFi Professional Loan Program 2014-A	A1	\$125.5	1mL+160	3.69	NR/A/NR	MS	Social Finance	Student loan private ABS	US
		A2	\$125.5		3.72	NR/A/NR				
02/07/2014	GLC Trust 2013-1 series 2014-A	A	\$147.63				N/K	Prosper	Consumer/credit card ABS	US
		B	\$9							
28/05/2014	Insikt Prosper Primary Master 2014-1	A	\$7.11				N/K	Prosper	Consumer/credit card ABS	US
		B	\$0.64							
		R	\$0.56							
01/05/2014	Eaglewood Consumer Loan Trust 2014-1	A	\$120				N/K	Lending Club	Consumer/credit card ABS	US
		B	\$22.5							
30/04/2014	OnDeck Asset Securitization Trust 2014-1	A	\$156.68	250	2.32		DB	OnDeck Capital	Other ABS	US
		B	\$18.32		2.8					
17/12/2013	Insikt Prosper Primary Master 2013-2	A	\$2.64				N/K	Prosper	Consumer/credit card ABS	US
		B	\$0.57							
		R	\$0.56							
17/12/2013	SoFi Professional Loan Program 2013-A	A	\$151.8	3.75%	4.4		MS	Social Finance	Student loan private ABS	US
		A	\$11							
04/10/2013	Insikt Prosper Primary Master 2013-1	A	\$0.31				N/K	Prosper	Consumer/credit card ABS	US
		B	\$0.16							
		R	\$0.16							
26/09/2013	Eaglewood Consumer Loan Trust 2013-1	A	\$75				N/K	Lending Club	Consumer/credit card ABS	US
		B	\$24							
		R	\$1							

Source: bank research, rating agencies, PeerIQ