



TRENDS IN MARKETPLACE LENDING: AN OVERVIEW

INTRODUCTION

Marketplace Lending is a thriving, innovative, and rapidly evolving segment of the financial industry. Driven by increasing demand from institutional investors for Marketplace Loans, and from venture capitalists seeking to invest in the next successful moon-shot sector, the Marketplace Lending industry is growing and evolving at an almost exponential rate.

In less than a decade, the industry has grown from nothing to an estimated \$12 billion in total loan originations, in the U.S. alone, as of year-end 2014. Marketplace Lending industry experts expect China, the U.K., and Australia to play a significant role in future growth and project that the industry has the potential to reach \$150-490 billion globally by 2020.¹

However, as with any successful emerging technology or asset class, it can be difficult to sort through the hype. Whether attempting to determine if an allocation to Marketplace Lending is appropriate given an investor's risk tolerance level or how best to participate in the market as an investor, finding reliable information is key.

In this paper, the first in our Trends in Marketplace Lending series, we pause to look at the brief history of Marketplace Lending and the current state of this rapidly evolving market before offering an overview of some key industry trends and topics. Our goal is to give those who are new to the industry a point of reference and a place to begin researching. Subsequent papers will delve deeper and present the insights and opinions of industry leaders about these important issues, the direction of the industry, and their vision for its future.

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A BRIEF HISTORY

The timing was fortuitous. Economic challenges that began in 2007 and 2008—including the financial crisis, ensuing credit crunch, and subsequent Great Recession—created a perfect storm of opportunity for the rise of an entirely new industry.

Peer-to-peer (P2P) lending emerged a few years before the 2007-2008 financial and economic crises. Zopa, which has the distinction of being the first online lending service, was launched in 2005 in the United Kingdom (U.K.). In the United States (U.S.), Prosper was founded in early 2006 and Lending Club, which began as a Facebook application, launched mid-2007. These new companies used technology to combine a simplified, online application and near instant loan decision, with a straightforward way for individual investors to vet and fund loans on an easy-to-use, cloud-based platform. If traditional lenders were unable to provide the credit that consumers needed after the financial crisis, the ‘crowd’ and Fintech firms were primed to step in.

From P2P Lending...

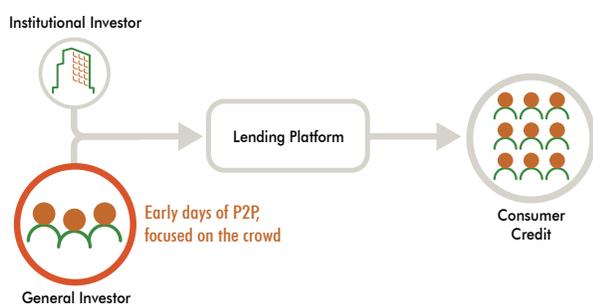
In the early years, P2P Lending was truly a peer-to-peer market. Most borrowers were simply looking to refinance existing, high-interest debt, such as credit card debt, for a loan with a lower interest rate. On the other side of the transaction, as interest rates for savers hit rock-bottom at banks and volatility in the equity markets rattled investors, individual investors began to look for alternate sources of less volatile and potentially higher returns. The P2P route seemed to be a win-win. Borrowers typically received a lower interest rate loan from online lenders than they were paying on their credit card debt. Individual lenders received a higher return than they were receiving from other types of investments—and without the extreme volatility of the equity markets.

...to Marketplace Lending

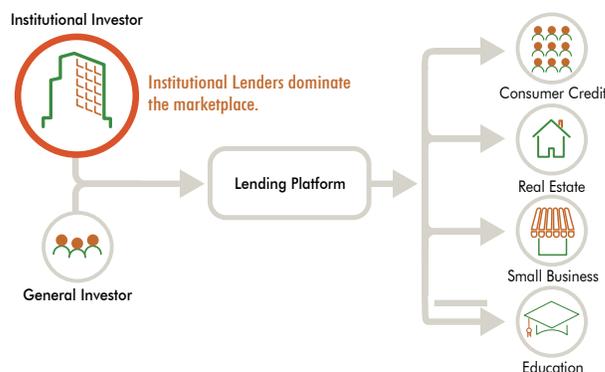
Since the early years, the character of the P2P Lending industry has changed dramatically (particularly in the U.S.) The returns generated by individual investors have attracted the attention of Wall Street. Now, the industry’s growth is being driven primarily by a surge in demand from hedge funds and other large institutional investors. As a result, there is a proliferation of lending platforms, increasing the types of loans that are available from sector to sector as they position themselves to square off against the traditional banking industry for customers.

Online lenders have taken to referring to the industry as Marketplace Lending rather than P2P Lending. A change that reflects the shift in investor base, as well as the growing ambitions of industry leaders.

P2P Lending



Marketplace Lending



THE STATE OF THE INDUSTRY

Marketplace Lending is driven by technology and encompasses a diverse ecosystem of companies that include lending platforms, investment products, consultants, and financial service providers. As the industry matures and attracts more and more capital globally, platform offerings, investor access, competition, and the regulatory landscape will be in flux. During the next few years, the marketplace's structure will be informed by the ways in which these pieces interact and eventually settle into place.

Key Trends And Topics

Because there are so many moving parts and the pace of industry growth and evolution is quick, it's difficult to predict what the industry will look like ten or even five years from now. However, there are many key trends and overarching themes that may allude to the general size and shape of things to come.

Key Trend 1: Loan Types and Business Models

The size and number of lending platforms are growing rapidly. New and existing platforms are expanding the breadth of financing products available online. Building on the initial success of consumer lending, platforms now provide capital for such diverse needs as small business growth, student loan financing and refinancing, real estate, and franchise financing, among others. Credit is also available in a variety of formats, from longer-term loans and lines of credit to short-term accounts receivable financing (borrowing against future invoices) and merchant cash advances.

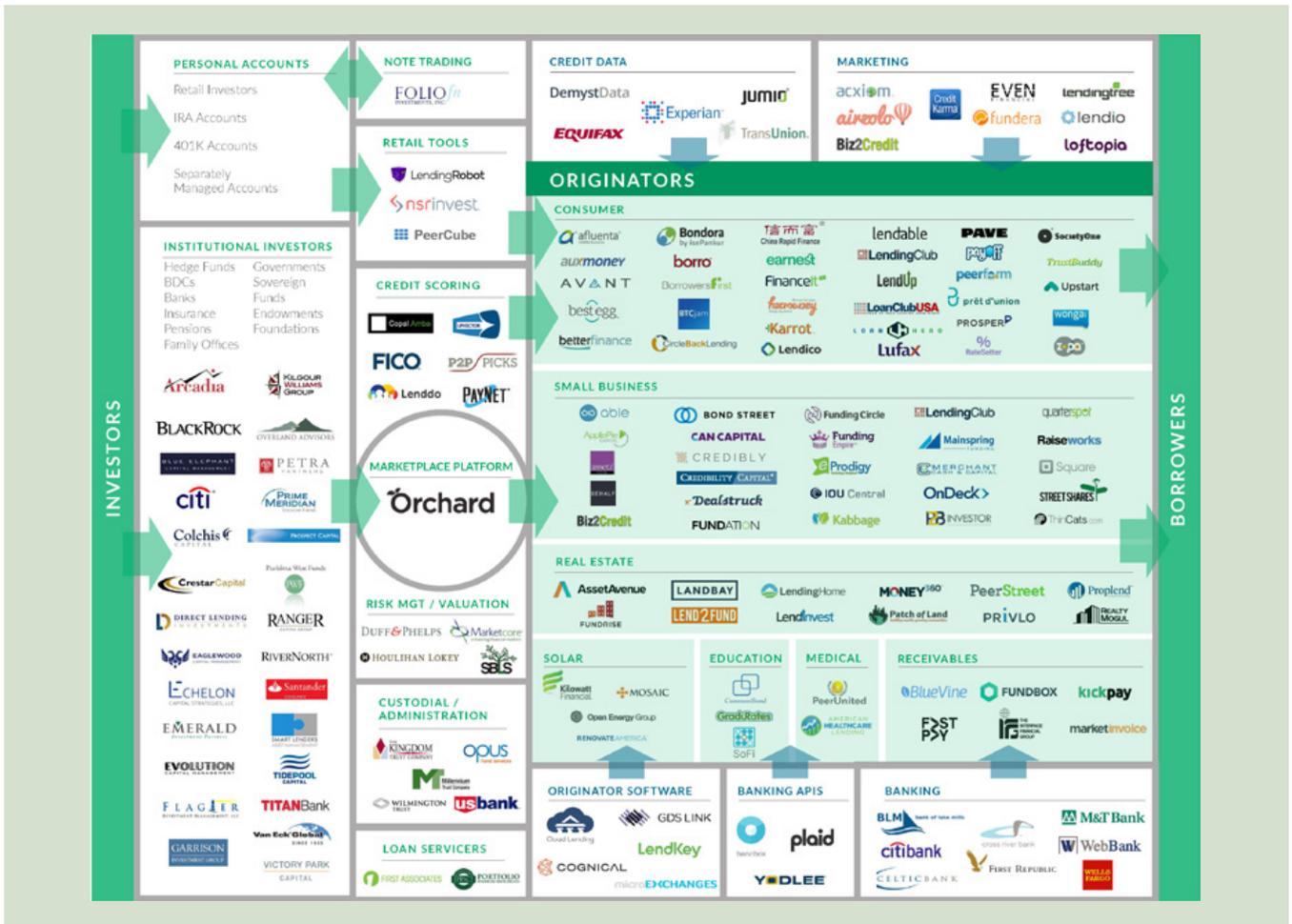
In addition to using technology to improve the overall lending process, technology-based companies are nimble enough to evolve and explore diverse business models. The two most common models are marketplace-based platforms and direct (or balance sheet) lending. The original lending platforms like Lending Club and Prosper began by facilitating loans, connecting borrowers and lenders online, originating and servicing the loans, and collecting

Marketplace Lending in 2014



Source: RealtyShares

Online Lending Ecosystem



Source: Orchard Platform. The U.S Peer-to-Peer lending space has a range of players and is expanding. While not comprehensive, the above is intended to serve as a simplified illustration of what Orchard believes are typical

a modest fee, operating as a central marketplace. Others, like OnDeck, began by originating and servicing loans but also acting as the lender. These firms hold loans as assets on their balance sheet and also package them to sell to investors via loan securitization.

The industry is still maturing, and part of that process involves experimentation. Platforms are continually exploring the possibilities, testing new credit products, and tweaking business models. For example, OnDeck continues to operate as a direct lender but it also makes certain loans available for purchase by institutional investors through the OnDeckMarketplace®. Lending Club recently announced it is planning to begin providing loans to consumers for

used automobile purchases. Other platforms are exploring partnerships that make their lending technology and loans available to customers of companies like Google, Staples, UPS, and others.

Key Trend 2: Origination and Credit Analysis

An essential component—and one that currently gives marketplace lenders a significant advantage over most traditional lenders—is the use of technology to improve lending processes and credit analysis.

Lenders have long depended on human interaction, insight, and traditional credit analysis when processing loan applications. Most rely on the industry standard Fair,

Isaac and Company (FICO) score and manual processes to evaluate a potential customer’s creditworthiness. While lending platforms also incorporate FICO and other traditional metrics into their credit analyses, they are building proprietary analytical models based on alternative data sources, as well as the wealth of information gathered from loan applications and servicing. Also, most analysis is completed in near real-time via an assortment of technology-based methods.

Venture capital and private equity firm Foundation Capital described the Marketplace Lending process:

“The best loan marketplaces have developed their own data sources and algorithms to evaluate potential borrowers. New insights can be gleaned from data sources that incumbents haven’t even begun to consider – everything from business sales volume from credit cards or accounting programs for [small business] lending to the length of time a prospective borrower has used the same email address to the number of friends on Facebook, the number of followers on Twitter, the rating of a store

on Yelp, or even a heuristic like the amount of time a prospective borrower spends on the lending website deciding how much money to request...”²

Marketplace lenders’ use of technology to collect and analyze large amounts of data creates a flow of information that should reduce the cost of loan origination and promote the improvement of analytical models over time. In theory, these reduced costs and the potential for better and faster lending decisions should allow marketplace lenders to offer lower rate loans and attract more borrowers, who will supply even more data to feed into the system to improve lending decisions, reduce costs, and so on.

Key Trend 3: Regulatory Environment

The regulatory environment differs from region to region. For example, in the U.K., regulators quickly developed rules for Marketplace Lending while, in the U.S., regulators have taken a largely hands-off approach.

Investor Access

As previously mentioned, a primary driver of growth for the industry over the last two years has been the significant amount of money flowing in from institutional investors. ‘Institutional-quality’ has become an industry buzzword and new investment products and services are being created to effectively ‘institutionalize’ Marketplace Lending. The result is that individuals and institutions have more options for investing in online loans than ever before.

Private Funds

These private investment vehicles pool the capital of investors to purchase loans from online marketplaces. They are not publicly offered; relying on exemptions defined in the Investment Company Act of 1940. They are only available to qualified institutions and wealthy individuals.

‘40 Act Funds

These funds pool investor capital to purchase loans from online marketplaces, and fall into two broad categories, open-end and closed-end. They are registered as securities with the SEC and are considered to be publicly offered. Types of 40 Act Funds include mutual funds, business development companies (BDCs) and unit investment trusts (UITs).

Separately Managed Accounts

Are accounts managed by a financial advisor on the behalf of an individual investor. For example, an individual investor may set up a self-directed IRA (a type of tax-advantaged retirement account). The investor may then hire an investment advisor to manage the account on their behalf.

Asset-backed Securities (ABS)

These securities pool assets into a financial instrument that may be sold to investors. A security is created through a process called securitization. In this case, the security is ‘backed’ by online loans. Lending platforms or other organizations sell these securities to large institutional investors, such as pension funds.

The U.K.'s Financial Conduct Authority (FCA), developed rules specifically for marketplace lenders and industry leaders established the Peer-to-Peer Finance Association (P2PFA) in 2011. The P2PFA is a self-regulatory body that promotes high standards of conduct and consumer protection. The group's stated goals include:

- > Promoting P2P finance in the United Kingdom to the public, businesses, and policymakers
- > Producing best practice guidelines and robust operating principles for P2P finance

Member firms must adhere to the group's rules and operating principles for transparent, fair, and orderly operation.

In the U.S., marketplace lenders operate under all applicable federal and state securities, banking, and lending regulations, as well as consumer protections laws. However, these laws and regulations were not enacted specifically to address Marketplace Lending and, recently, activities by regulators and others in government may be signaling a change in approach.

On May 13, 2015, the U.S. House of Representatives Committee on Small Business held a hearing called Bridging the Small Business Capital Gap: Peer-to-Peer Lending. Industry leaders and academics were invited to present testimony.

On July 16, 2015, the U.S. Treasury Department initiated a study of Marketplace Lending. According to their press release the goal is to, "...make sure the benefits of our continuing economic recovery reach all Americans, it is important that more consumers and small businesses have broad access to safe and affordable credit."

On August 6, 2015, the Responsible Business Lending Coalition was created. The group asked that small business lenders sign a 'Borrowers' Bill of Rights' aimed at protecting small businesses from lending abuses. It

is widely viewed as an effort by industry leaders to get in front of regulators, and may be the first step towards forming a self-regulatory body for marketplace lenders in the United States.

It will be interesting to see how U.S. regulations play out over the coming months. While the Responsible Business Lending Coalition is an important step, no self-regulatory body currently exists, in the U.S., to police the entire industry. Is it possible that industry leaders will follow the example of their U.K. counterparts as regulatory scrutiny increases?

Key Trend 4: Competitive Pressures

PricewaterhouseCoopers (PwC) estimates that marketplace loans could be valued at \$150 billion or more by 2025. They reported, "To reach \$150 billion, peer-to-peer lending platforms would need to capture 10% of the \$800 billion in revolving consumer debt and 5% of the \$1.4 trillion of non-revolving consumer debt held by financial institutions."³

As analysts ponder the potential size of the market, lending platforms, traditional banks, and other non-bank lenders are contemplating strategy. How will marketplace lenders scale their businesses to capture market share? Should they collaborate or go head-to-head? Some platforms have already partnered with traditional banks to fund loans, acquire customer referrals, and create credit products. Others have accepted traditional lenders as institutional investors who purchase loans directly. As the players decide whether to compete or cooperate, they'll be evaluating issues related to:

- > Acquiring and retaining customers
- > Offering competitive interest rates
- > Preparing for a rising interest rate environment
- > Planning for long-term stability

Key Trend 5: Financial Service Providers

While Marketplace Lending platforms like Lending Club, Prosper, Funding Circle, SoFi, and others are the public face of the industry, its smooth operation and growth largely depend on firms that provide supporting financial services, such as:

- > Custodians
- > Administrators
- > Auditors
- > Attorneys

For example, attorneys are instrumental in fund structuring. Custodians and administrators assist with fund operations. Accounting firms and independent auditors ensure that fund operations are transparent and provide asset valuations. The ways in which these service providers work together is integral to the function of traditional investment operations. Technology also is driving change in these industries, helping address the particular needs of marketplace lenders and better support the electronic assets and loans being created. Most large traditional financial service firms have shied away from Marketplace Lending's 'newness', leaving a handful of nimble niche players in the alternative investment space to lead the way. How could this change, as the industry matures and becomes more institutional in nature?

CONCLUSION

Marketplace Lending is growing and evolving. The number of platforms is expanding. New business models and loan types are being introduced. Credit assessment is becoming more sophisticated. Institutional investors are playing a larger role in the market. Former competitors are forming alliances. While it is an exciting time to be involved, it is worth noting that Marketplace Lending is still in its infancy.

To better understand what the future may hold, Millennium Trust Company will publish a series of white papers focusing on critical industry issues. We plan to interview leaders at lending platforms and the companies that provide supporting services and share their thoughts about the future of the industry.

REFERENCES

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2001 Spring Road, Suite 700 | Oak Brook, IL 60523 | www.mtrustcompany.com