Expanding Access to Marketplace Loans

CUSTODY SERVICES

Is it possible that by diversifying loan products, as well as the sources of loan capital, marketplace lenders can build platforms that improve the industry's ability to weather the next downturn in the credit cycle?

Introduction

The Marketplace Lending Industry grew at a 123% Compound Annual Growth Rate from 2010-2014. Global loan originations nearly doubled year-over-year, and firms like Morgan Stanley enthusiastically described the industry as being "… in liftoff", while their researchers provided a widely cited estimate of originations reaching $290 billion globally by 2020.[1]

All eyes remain on marketplace lending—and the wider Financial Technology industry (Fintech). Banks continue to size up marketplace lenders as competitors, potential partners, or acquisitions. Investors are searching for yield and exploring a host of ways to participate in the industry (via both debt and equity). Borrowers are looking for the cheapest source of credit and the most painless method of applying for it. And more recently, regulators have stepped up their inquiries—particularly in the United States where, until now, they had mostly taken a 'wait-and-see' approach.

In our first paper, we provided a brief history of marketplace lending and a snapshot of the state of the industry at the end of 2015, before highlighting some of the core trends and themes the industry would be addressing in the coming years. In this paper, we take a closer look at the available methods for both individual and institutional investors to gain exposure to marketplace loans. And we briefly discuss the possible benefits to the industry of focusing on diversification—in a broader sense. Is it possible that by diversifying loan products, as well as the sources of loan capital, marketplace lenders can build platforms that improve the industry's ability to weather the next downturn in the credit cycle?

Expanding Capital for Borrowers

Credit is an essential piece of the economy. It is a way for individuals and businesses to purchase goods or services today, based on an agreement that they will pay for them at a date in the future.

To understand its importance, imagine an economy without credit. Imagine an individual needing to save $27,000 for an automobile or $100,000 for a home before they can make the purchase. Or a commercial printer that needs to save the entire cost of a new printing press or building before they can purchase it. Likely, there would be fewer people who owned their own cars or homes, and slower economic growth in general.

The idea is that you use credit to purchase something now, and the item purchased will help improve your ability to repay the lender later. You might borrow money to buy a car that helps you travel to a new, and hopefully higher-paying, job. Or, businesses might borrow money to purchase a new piece of equipment intended to improve and grow their business.

FIGURE 1

The early days of Marketplace Lending were focused on the crowd and largely peer-to-peer driven, with limited participation from institutional investors.

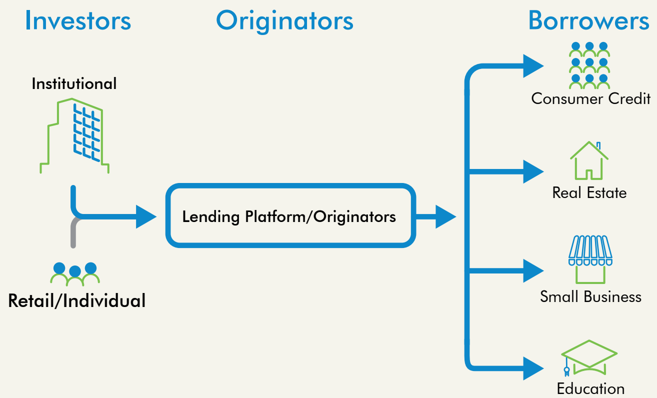
During the recent financial crisis, the credit markets froze, traditional lenders essentially stopped lending, and credit card companies increased interest rates. Credit was often either impossible to find or too expensive. Early marketplace lenders—who were self-admittedly not much more than a novel experiment at the time—turned out to be well-positioned to benefit from the situation.

While consumer credit is still a very large portion of overall loan originations, lending platforms have steadily begun facilitating a variety of credit products. And, in recent years, large institutional investors have been pouring billions of dollars into the industry, helping to drive growth, making credit available to an even wider range of borrowers.

Today, marketplace lenders provide easy, online applications and a fast approval process for an ever-expanding range of credit needs. Students can refinance expensive student loans. Small businesses can use loans to bridge short-term needs for cash—for payroll or other reoccurring expenses, or to expand operations through equipment and real estate purchases. And consumers can still apply for loans for home improvements, debt refinancing, or other personal needs.

FIGURE 2

Institutional investors begin to dominate the marketplace and platforms continue to expand lending into new markets.



Expanding Access for Investors

(Non-Accredited Individual Investors, Accredited Individual Investors, and Institutional Investors)

Investors are not limited to making direct investments through individual lending platforms. Not only are there firms that specialize in professionally managing loan portfolios for institutional investors or Separately Managed Accounts for individual investors, but investment managers are beginning to offer more complex investment strategies and structures across credit types, credit quality, lending platforms, and regions for more sophisticated individual and institutional investors.

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 accredited individuals.

PUBLIC FUNDS ('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 publicly offered registered investment companies under the Investment Company Act of 1940. Types of 40 Act Funds include mutual funds, business development companies (BDCs) and unit investment trusts (UITs). Several mutual funds that invest in marketplace loans are now available, and multiple firms have begun the process of creating new mutual funds, as well.

SEPERATELY MANAGED ACCOUNTS

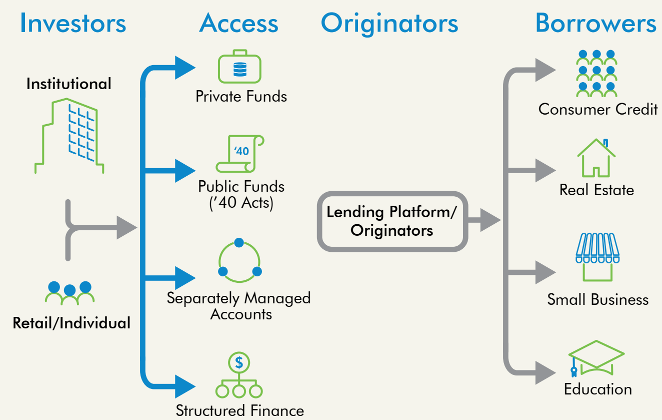
These are accounts managed by a professional advisor on the behalf of an individual investor. For example, an individual investor may set up a self-directed IRA (a type of tax-advantaged retirement account). The investor may then hire an investment advisor to manage the account on their behalf.

STRUCTURED FINANCE/SECURITIZATIONS

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.

FIGURE 3

Institutional investors and registered investment advisors begin adopting more traditional methods of investing to marketplace loans.



Expanding Sources of Loan Capital for Platforms

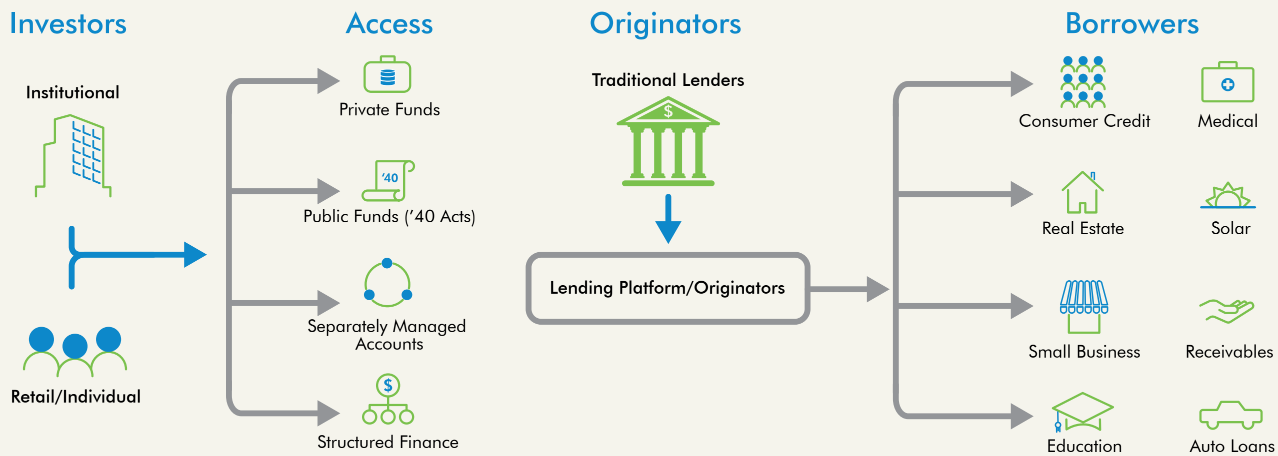
(Non-Accredited Individuals, Accredited Individuals, Institutional Investors, and Bank Partnerships)

Unlike banks that hold deposits which are insured by the federal government and used to lend in their communities (one of the traditional roles of banks), marketplace lenders are not depository institutions. A handful of platforms lend capital from their own balance sheet—typically holding loans only long enough to repackage and sell them off as securities—but most limit their risk by focusing on loan origination and servicing. Institutional and Individual investors—and more recently traditional lenders who have formed partnerships with lending platforms—form the source of capital for loans, instead of deposits.

In an interview in Bloomberg Business, JP Morgan CEO Jamie Dimon explained, "One of the issues with some of these lenders is going to be, where will their provider of credit be when there's a crisis? That's why some of these smarter services, to support their operations, are courting more permanent capital. They want a source of longer-term funding that can survive a crisis."[2]

FIGURE 4

Institutional investors and partnerships with traditional lenders will continue to drive industry growth, while improved access will attract more individual investors, helping platforms diversify and expand their sources of loan capital.



Lending platforms are working hard to expand and diversify the sources of loan capital by partnering with banks and other traditional lenders, as well as by creating initiatives to reengage with individual investors and their advisors. Additionally, some platforms have even begun launching their own private funds.

The convergence of traditional banking and FinTech appears to be a two-way street. Not only are FinTech companies looking to traditional banks for new sources of loan capital, but banks are looking to FinTech to help expand digital lending offerings. As Orchard Platform, a technology and infrastructure provider for marketplace lending, recently pointed out, larger traditional institutions often take longer to adapt to new technology and trends, and some are choosing to explore partnership , while others are developing their own technologies.

According to Bill Ullman, Orchard's Chief Commercial Officer, "We're excited to be a part of an industry that is evolving so rapidly and believe a little healthy competition and collaboration only serve to drive innovation and ultimately benefit our industry, consumers, as well as the greater economy."

Conclusion

The result of this activity is that:

- Borrowers can access the capital they need which is good for the global economy and local communities.
- Investors have multiple ways to access a non-correlated, and, to-date, fairly stable, source of yield.
- Platforms diversify/stabilize their sources of loan capital to strengthen their business models, potentially improving their ability to perform in a credit downturn.

The actual test of the marketplace lending is just beginning.

As signs point to an approaching downturn in the credit cycle[3], how marketplace lenders fair when loan defaults peak will define the industry's future. Have marketplace lenders built a resilient industry that can survive the full credit cycle? How will the default rates of marketplace loans stack up against those of traditional lenders? Will investors remain as defaults rise? Will borrower-demand for loans persist through an environment of rising interest rates? Time will tell.

References

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