

## Hed: Marketplace Lenders Are a Systemic Risk

Dek: While marketplace lenders have introduced valuable innovation into financial services, they carry a fundamental flaw that threatens to undermine their business, destabilize financial markets and cause real economic hardship.

By Todd Baker

Once again the markets have fallen in love with a group of young, aggressive and not very regulated lenders.

Online “peer to peer” marketplace lenders like Lending Club, Prosper and Funding Circle are originating loans at a torrid pace and sporting eye-popping public and private market valuations. The growth predictions for this new class of technology-enabled lender are impressive—Morgan Stanley estimates that U.S. MPL originations will increase to more than 8% of total consumer unsecured lending and 16% of small business lending by 2020, with much of the loan volume taken from traditional retail banks.

MPLs combine an easy-to-use online loan application with a virtual marketplace to package and sell loans to investors. MPLs generally don’t keep any of the credit risk on the loans they sell and don’t issue the loans themselves either—they rely on a couple of specialty banks for that chore to avoid regulatory costs. And they don’t have a lot of assets or capital.

Unlike lenders that hold loans on their balance sheet and use cash from principal and interest payments to reimburse their funders and make a profit, an MPL has no loans of its own. Virtually all of its revenue comes from transaction fees paid to it when a new loan is issued and sold to an investor. As a result, it can operate at levels of financial leverage unheard of in the banking industry.

It’s an attractive story that plays well in the press, on Wall Street and with the general public—Silicon Valley techies in t-shirts and sneakers creating a financial Uber to “disrupt” traditional banking while putting up tech company-worthy growth numbers. No wonder scores of new venture-backed “me too” MPLs are rushing to cash in on the expected bonanza.

Not so fast.

The hard truth is this: while MPLs have introduced valuable innovation into financial services, they carry a fundamental flaw that threatens to undermine their business, destabilize financial markets and cause real economic hardship. The bigger the MPLs get before the inevitable squeeze, the worse the consequences will be for all of us.

But history offers us a solution—by bringing the MPLs into the regulated banking system now we can ensure that the flow of credit isn't disrupted when rates rise and the credit cycle turns.

If you peel back the skin of an MPL, what you find underneath is a finance company—which is simply a nonbank lender that gets all of its funding from the capital markets. Leading finance company names from the past like Household, GE Capital, CIT, MBNA, Countrywide, Money Store and GMAC all relied on the same liquidity model: borrow in the capital markets and lend that money to customers. In good times, this model works well. But when funding in the capital markets is unavailable or prohibitively expensive, a finance company quickly hits the wall.

The lifeblood of a lender is access to funding—a lesson society relearns every time a lender without adequate liquidity needs a government bailout or goes bankrupt. That's why the finance companies of the past all ultimately were forced or went voluntarily into the banking system to get access to the stable deposit funding they needed to survive and prosper—either by becoming banks themselves or being acquired by banks—or they failed. If there is any clear lesson from U.S. financial history, it's that the only truly reliable source of liquidity for lenders is insured bank deposits. A lender with deposit funding has cash to lend out in every environment, not just when the capital markets are feeling flush.

While MPLs share all the liquidity risks of traditional finance companies, they have an added characteristic that magnifies the instability of their business model. If an MPL can't issue new loans – which will happen any time investors refuse to buy loans in the MPL marketplace – the transaction fees that are the MPLs' main source of revenue and cash will instantly disappear, while expenses continue to mount. An MPL has to keep issuing loans to survive. It can't slow down lending and slash operating costs to stay afloat while collecting cash from existing loans, like a traditional finance company, because it doesn't own any loans. Unless the MPL can raise enough emergency capital to either hold loans itself or put enough “skin in the game” to satisfy funders, the MPL will go out of business in short order, with loan investors left to rely on whatever legal protections their contracts provide. It's an amplified version of the “hamster wheel” problem that has made the mortgage banking business so hard to manage over the years. The resulting mess will bring an avalanche of enforcement actions and lawsuits. Financial crises have been started by less spectacular problems.

It's worth noting that some of lenders that call themselves MPLs—On Deck and SoFi for example— are hybrids which hold more capital and have business models that fall somewhere between that of a true marketplace lender and a traditional finance company. Their capital and balance sheet will provide them with a bit more flexibility in an MPL liquidity squeeze but they still won't have enough stable funding to avoid infection.

So how do things look for MPL liquidity? So far, MPLs have been good to their liquidity providers—initially wealthy individuals and now mostly hedge funds, pension funds, family offices, banks and other institutional investors. Lending Club, for example, has delivered an adjusted annualized return of almost 8.7% on its first \$8 billion in issued loans. But any neutral observer would conclude that the easy access to capital markets funding enjoyed by MPLs is a temporary product of unusually good credit performance in the post-recession economy and repeated Federal Reserve interventions to keep interest rates low.

Investors are happy to fund MPL loans today because there are few, if any, alternative investments that provide such high yields. Self-interest matters too—hedge funds buy loans from MPLs rather than buying asset-backed securities in the market (managed by a tested issuer like Capital One) because they can justify their management fees by re-underwriting the loans they buy.

But all it will take is a credit issue or a serious legal or regulatory problem to shift investor sentiment away from MPL investments and toward other high-yield investments, and there is plenty of reason to think credit and regulatory issues are lurking in the background.

When sentiment changes, the MPL investors' rush to the exits will be no less swift than it was for traditional finance companies in 2007-08 or in the Russian and Asian debt crises of the late 1990s. There will be no rescue from the MPLs' original funders—the celebrated "peer-to-peer" individual investors—who will abandon ship the minute credit losses and passed-through collection costs begin to bite (although they will make sympathetic plaintiffs in the lawsuits that follow.) *When* this will all happen is a matter for conjecture, but history shows that it *will* happen if present trends continue.

The most likely trigger for a liquidity squeeze will be rising loan losses and declining loan spreads. There's a strong whiff of adverse credit selection in MPLs—any time borrowers scramble to take out loans carrying lower interest rates and better terms than they can get elsewhere, especially when most of the lending is for consolidation of existing debt, we should expect credit problems. In fact, MPL lending spreads are already coming under pressure from new market entrants, and MPLs are responding by increasing issuance of higher rate but lower-quality loans to keep their spread-dependent investors happy; Lending Club has already issued over \$1 billion in personal loans carrying interest rates above 20%.

And one should always be skeptical of credit analytics that haven't been battle tested. It's important to recall how unanticipated changes in customer behavior and insufficient stress-testing of newly created financial products made the "highly sophisticated" models used in the pre-2007 mortgage business useless as loss predictors.

The impact of an MPL disruption on the real economy is likely to be much more severe than is commonly recognized. Imagine the consequences a decade from now if 8% of consumers and 16% of small business borrowers can't find replacement loans quickly from traditional lenders in an MPL liquidity squeeze, especially borrowers who may not meet traditional bank credit standards. As MPLs enter more sectors of the U.S. lending market, such as commercial real estate, healthcare, student and single family lending, the impact will be even greater. The rapid withdrawal of credit to so many Main Street consumers and businesses could be devastating to the U.S. economy.

So where are the regulators in all this? They should be focused on ensuring that the MPLs' inherently fragile business model doesn't threaten the continuing flow of credit to the economy during good times and bad. Maintaining stable credit markets is (or should be) the principal goal and justification of prudential financial regulation. Instead, state authorities are occupied with narrow licensing questions, while the U.S. Treasury (which has just launched an [information gathering process](#)) and the CFPB (which has jurisdiction over consumer but not small business lending products) seem most concerned with avoiding abusive lending practices.

But all is not lost. A perfectly good solution for the problem of these "neobanks" exists—the same solution that led past generations of finance companies to find a home in the banking system when their funding became precarious. Those companies had to give up some higher-risk lending and leverage to join the banking system—and that affected their market value. But they survived—and so can the MPLs.

As for the banks that end up buying or being bought by the MPLs? They will benefit too, by getting a technological makeover which should make them more attractive to the Millennial customers they have a hard time attracting today.

So how is it possible that today's MPL managers, not to mention regulators, aren't doing everything they can to bring MPLs and their consumer and small business borrowers into the banking system before a liquidity crisis hits? The answer is depressing: There is too much money to be made before the inevitable blow-up. When MPLs begin to falter and seek shelter in the arms of the banks, the price to be paid for this lack of foresight will be steep.

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