# Reality Check for Marketplace Lenders

By Todd H. Baker
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Social Finance Inc., or SoFi, the San Francisco startup “unicorn” focused on lending to high-earning graduates of elite universities, recently disclosed that it had started a hedge fund to buy the loans it originates. This effort by SoFi should set off alarm bells among online lending cheerleaders in venture capital and stock markets, but also points the way to a long-term future for best-of-breed alternative lenders.

The new hedge fund, called SoFi Credit Opportunities Fund, has “a real chance to solve the balance-sheet problems facing the industry," SoFi Chief Executive Mike Cagney told The Wall Street Journal.

“In normal environments, we wouldn’t have brought a deal into the market,” Cagney told the Journal. “But we have to lend. This is the problem with our space.”

Let’s all take a moment to recognize Cagney’s statement for the milestone it is. The CEO of a leading “marketplace” alternative lender has admitted that balance sheets and liquidity really matter, and that it is a “problem” that alternative lenders need to keep increasing lending volumes to prosper.

This marks the official end of the era where alternative lender finance companies claimed exemption from two of the core laws of financial gravity: that stable liquidity is the key to long-term survival, and that ever-accelerating loan growth is a recipe for trouble.

To his credit, Cagney is being upfront about what its most immediate problem is—concerned institutional investors are balking at funding SoFi’s loan growth and/or demanding better terms on the loans they do buy. It has been obvious for some time that reliance on wholesale funding will be the Achilles heel of online alternative lenders like SoFi, Lending Club, Prosper and OnDeck, just as it was for the paper-based finance companies that all failed, were bailed out or became banks in the period leading up to the 2008-9 financial crisis. This funding problem is actually worse in true marketplace lenders like Lending Club and Prosper (and perhaps SoFi) than traditional, balance-sheet-focused finance companies. Because marketplace lenders transfer all loans and credit risk to marketplace investors at origination, no loans are held on the lender’s balance sheet and almost all revenue is generated from “gain on sale” fees on new loan sales. That makes marketplace lender profitability exquisitely sensitive to loan performance, interest rate expectations and the fickle volume and pricing appetite of institutional investors.

You have to admit, SoFi's latest funding solution is pretty odd — if I told you I was starting a hedge fund to lend money to myself because my institutional funders don't want to anymore, you'd probably hang up the phone. I guess we can chalk it up to the financial engineering background of its founders. But SoFi is still not quite ready to admit that the other cardinal rule of the finance company business — too-fast growth is a bad thing – applies to its technology-based model.

If there's one thing financial history has taught us it's that companies that rely on excessive rates of loan growth always come to a bad end, usually because credit standards get loosened and funding strategies get riskier when management tries to compensate for slowing growth. So anyone with financial services experience is likely to find the reason SoFi gives for starting the new hedge fund — the need to keep SoFi growing at all costs — more than a bit concerning.

But it's standard operating procedure in the venture capital/tech unicorn bubble to value top-line growth above anything else. That skewed fintech investor perspective – which amounts to treating a finance company as if it's an app developer—and the growing risk it creates for the alternative lending industry and the real economy – has to change if these innovative companies are to have a long-term future.

So here's where we should all pause and ask again, why isn't SoFi a bank?

We know that access to customer deposits would largely solve SoFi's liquidity and balance sheet problems. It would not need to rely on unreliable institutional funders to keep originating loans, and it could maintain some loans on its balance sheet indefinitely rather than relying entirely on gains on sale to generate revenue.

But the advantages of bank status would go much deeper. SoFi's stated goal is to be the preferred financial services provider for the millennial class of emerging high-income knowledge workers. It provides loans and investment opportunities (as well as parties and dating services) for these future one-percenters but it can't provide a safe place for them to hold and manage their cash assets, i.e., a deposit account. Without the capacities that deposits and payment access through the banking system provide customers, SoFi will never reach its goal of a being a complete financial solution for its customers. Cagney is well aware of this problem—he has repeatedly told the press that SoFi will create some kind of privately insured deposit-equivalent product so that it can provide a full alternative to a traditional banking relationship (I'll leave the dismal history of private deposit insurance plans, only one of which— the collective credit union insurer American Share Insurance—has ever survived, for another time).

So it's pretty clear that SoFi would be better off, from a balance sheet and customer experience standpoint, if it were a bank. The same probably goes for Lending Club, Prosper and all the other pioneers in this space. But we know that SoFi doesn't want to be a bank because Cagney has told us so repeatedly, and in no uncertain terms. He blames regulatory requirements and costs and a regulatory mindset tied to an older model of retail banking out of touch with the changes technology has brought to other parts of the economy.

And for the most part he's right—the system we have today needs to find ways to adapt to the new realities of companies like SoFi rather than forcing those companies to conform their business to an outdated model of retail banking.

But those things can change, especially if entrepreneurs like Cagney used their bully PR pulpit to push for a new approach. His more important reason to avoid bank status comes from SoFi's belief that it needs continuous and high-rate loan growth to make the business model work and drive a higher and higher market valuation. And I think it's pretty clear that no amount of lobbying will shake bank regulators' core belief that excessive growth equals excessive risk.

How then to resolve the conundrum and bring innovative financial services companies like SoFi into the banking system? Two things need to happen.

First, U.S. regulatory agencies need to become innovators themselves. Much ink has been spilled on the question of why the U.S. regulatory system, unlike the system in the U.K. and other parts of Europe, isn't actively trying to attract new fintech companies into the banking fold by adapting its policies and processes to a changing landscape.

In the U.S., it all comes down to fear of doing anything controversial in a polarized political environment. But we can't wait for the politics around financial services to become benign before regulators start to act. As the banking regulation expert Jo Ann Barefoot has said, "regulation innovation" is what U.S. regulators should be focused on. There needs to be a place in the regulatory scheme for innovative, but more narrowly focused, banks that don't fit into the traditional mold of physical branches and standard commercial and consumer loan products. That's what was so encouraging about North Carolina Banking Commissioner Ray Grace's recent comments encouraging the formation of new types of innovative banks in his state, which he hopes to make a "laboratory of change." That attitude needs to spread at the state and federal levels.

Second, and more important, best-in-breed alternative lenders like SoFi, Prosper and Lending Club need to recognize that a "growth at all costs" mentality is inherently unsound for any lender, technology-enabled or not. True, accepting lower rates of growth will have negative implications for equity market valuation that may not satisfy the dreams of venture capitalists and founder-managers. But there really is no choice if long-term survival is the goal.

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