Lending Club Lays Bare Marketplace Lending's Problems

By **Todd H. Baker**
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The bombshell announcement Monday that founder and Chief Executive Officer Renaud Laplanche is resigning from LendingClub due to violations of company policies is another blow to the alternative lending industry, ironically on a day that otherwise would have been pretty good for LendingClub. First quarter earnings met Wall Street expectations and growth was acceptable, although the outlook is weak. The 35% plunge in LendingClub's stock price, like the similar plunge at OnDeck and Square last week, shows that other concerns now predominate.

There are three things we should take away from this situation.

First, it's rare for the compliance and legal professionals at a company to be empowered enough to bring down a star CEO. Whatever else you may say about LendingClub, it has shown itself to be a company committed to living up to its internal standards and complying with law. That's not a small thing, particularly in a young industry. Bravo to everyone at LendingClub who took personal risks to do what was right.

Second, confidence in data transparency has been badly hurt. LendingClub built its entire business model on the idea of complete loan data transparency. As Laplanche said last year, "Transparency in the industry is very differentiated from more traditional banks. Our ability to embrace transparency of data, track records, performance as an industry is really important." By altering loan data to make a loan sale work, LendingClub has undermined investor confidence in loan data industrywide.

Based on what was said in LendingClub's earnings call, there were two problems — one involving loans sold to an investor which contravened "non-credit, non-price" criteria set by the investor and one involving deliberate alteration of application date data. The company has said that this is the only time data has been altered, and there is no reason to doubt them. But institutional investors will take a "show me" attitude in the future before buying more paper, and lending volumes and pricing will take a big hit until confidence is restored. It will be worth looking very closely at how the company's stable of individual loan buyers react to this news, as their "stickiness" as loan buyers has not been tested by adversity. LendingClub's board has taken a good first step on the confidence front by acting aggressively and demonstrating its commitment to ethical behavior, but it will take a long while for this to blow over.

Finally, if there was any doubt before, we should all understand now that pure gain-on-sale marketplace lending businesses, like LendingClub, are inherently unstable. Their dependence on perpetual topline growth and gain-on-sale margins makes their results intrinsically sensitive to macro and micro trends in investor demand and risk appetite. Small changes can have an outsized impact. The mess at LendingClub comes at a time when institutional risk appetite for marketplace loans is tightening, while the pressure to hit growth and margin numbers is likely growing inside alternative lenders. We've seen this story many times before, particularly in the mortgage banking business. Bad things happen when the goal is to hit those volume and gain-on sale numbers at all costs.

At one level, all that has really been happening to the alternative lenders is that stock prices and private market valuations are adjusting to the reality that volumes and margins will be weaker going forward. The only people harmed by that are those who bought those stocks at prices reflecting more optimistic assumptions about growth, risk and profitability. But at a deeper level, the inherent instability of the alternative lending business model, particularly around funding, is being exposed for all to see.

Todd H. Baker has been chief strategy and development officer at three of the largest U.S. banks and been a partner at two leading international law firms. He is currently the managing principal at Broadmoor Consulting LLC.