OK, Marketplace Lenders, I'll Say It: Told You So

By **Todd H. Baker**
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Dear alternative lenders: It's not like I didn't try to warnyou — more than once, in fact. I doubted you wanted to listen to me — an old, stodgy banker, not very forward-thinking. To you, I was probably just someone who didn't "get it" and couldn't see that everything was different this time.

The people you did listen to reinforced the false notion that marketplace and other alternative lenders were invincible young giants redefining the technology landscape, raising billions, taming unicorns and bringing cleansing disruption to yet another part of the American economy. Things were going great, for a time. The old rules of financial history? What did they matter to tech gurus like you?

Well, quite a lot, as it turns out.

Yesterday was an important marker in the short history of the online alternative lending industry. OnDeck Capital, the leading small business alternative lender, announced a much larger than expected loss due to flat loan volumes, narrow gain on sale margins and rising expenses. OnDeck's already battered stock dropped by another one-third. The core reason? Institutional investors and the securitization market aren't interested in its loans, at least at prices that work for OnDeck. And the loans it puts on its expensively-funded balance sheet take a while to generate income. OnDeck's much-vaunted "hybrid" funding model couldn't ride out the turbulence.

Prosper, the granddaddy of the true marketplace lenders, laid off more than a quarter of its staff due to reduced growth expectations. The reason? Institutional investors again. This when the horizon is looking stormy for other players. SoFi is giving strange signals about its funding, announcing steps such as in-house hedge funds and giving precious equity to institutional funders who will commit to long-term funding. Avant's first quarter loan volume dropped 27%. The industry is also waiting with trepidation for Lending Club, the best-known alternative lender, to announce results on Monday. Its stock dropped by more than 10% Tuesday in anticipation of bad news. The ecosystem of alternative lending bloggers, newsletters and conference organizers descended into a frenzy of self-doubt. How had it all gone so wrong so fast?

The answer is simple. Alternative lenders ignored the lessons that generations of nonbank finance companies learned (usually too late) in the past: liquidity is everything, institutional money can't be relied on, expenses are harder to cut than add, high rates of loan growth aren't sustainable and a business model based on volatile gain on sale margins is inherently unstable. This is where I get to say I told you so.

And I'll let you in on a little secret that makes things even scarier. The "disruptions" in the capital markets that caused all these problems for alternative lenders and call the very future of the industry into question were just the kind of minor market blip that happens every year or so in the hard world of institutional money — nothing big, nothing to write home about, par for the course. That leads to the critical point: the funding market for alternative lenders fell apart even though actual credit performance is still very good. Low rates and the strong job market have delivered the best credit performance in a generation. If a normal capital markets hiccup is enough to cause chaos in alternative lending even with excellent credit performance, what will happen if credit really starts to slide?

Before we all start stocking up on canned goods and shotgun shells, let's consider the positives for the industry. Consumer and small business acceptance of online lending has continued to grow, although satisfaction levels decline as interest rates increase. The industry is working hard to create borrower- and regulator-friendly standards and curb the "wild west" outliers. Brand value is being created. The front-end and back-end technology (in the case of the true marketplace lenders) works well. So far, individual marketplace investors have stayed loyal (stay tuned on that front when losses start to show up). Bank partnerships, which leverage banks' stable funding sources, are on the upswing. That means there's still time to right the ship.

But, alternative lenders, it's time to face reality. Without a serious course correction, your business models — particularly related to funding — are unsustainable, even in good credit times, although your core business of online lending is doing very well.

As hard as it may be to admit it, you know what the solution is as well as I do. It's with the banks. They have the thing you need most: stable, low-cost retail deposit funding. You can access those deposits in a number of ways. You can become a bank, buy a bank or be acquired by a bank. Alternatively, you can sell loans to a bank buyer. In OnDeck's case, its long-term future may actually be brighter as a technology provider through deals like its comprehensive partnership with JPMorgan Chase. Other lenders could follow that model. Sure, joining up with banks won't be as much fun, will force you to change how you do things, and will preclude you from becoming billionaires this year.

But keep in mind that you have more leverage in this situation than you may think. The banks need you just as much as you need them. It's no secret that they are terrible at one of the things you are best at — developing and deploying nimble, customer-friendly, easy-to-use technology solutions. And they see you as the gateway to the millennial customers they are so worried about keeping. It smells like a win-win situation to me.

Yours truly, Todd

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