

An Asset Securitization Report Executive Roundtable

Marketplace Lending: A Growing Opportunity for Institutional Lenders

Our panel of capital market executives explores what this new lending platform will mean for the credit industry.



MODERATOR

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Marketplace lending, also sometimes referred to as digital lending or peer-to-peer lending, is poised to enter prime time as major banks and leading lenders look to partner with the thousands of fintech startups that have entered the market. Yet even as interest in these online lending platforms surges, questions about their role in growing the credit markets and the extent to which they should be regulated are causing many of the markets' key players to proceed with caution.

On October 11th, in New York City, the Asset Securitization Report hosted an executive roundtable to consider which business models and strategies are best suited to the marketplace paradigm. Moderated by ASR Editor-at-Large, Elliot Kass, five industry executives participated in the event: Rick D'Emilia, Managing Director for asset- and mortgage-backed securities at Wilmington Trust; Matt Joseph, a partner at Morgan Lewis; Karan Mehta, head of capital markets at Marlette Funding; Steve O'Neal, Vice President for global capital markets at Wilmington Trust and Andreas Wilgen, co-head of North American asset-backed securities at Fitch Ratings.

What follows is an edited version of the lively and informative discussion that took place.

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Elliot Kass: How did we arrive at the term ‘marketplace lending’? How do you define it?

Steve O’Neal: It began with the peer-to-peer platforms—online platforms that pair borrowers with lenders. As people started to see the viability of those platforms and the kind of returns they could generate, you had hedge funds, investment banks and others wanting to take advantage of those opportunities. So the platform players began to partner with financial institutions. There are many different reasons for platform providers to partner with financial institutions, one of which is availing themselves of the

national banks’ exemption to the state usury laws. This strategy has been challenged by the Madden case and is seeing opposition in other states as well. That was followed by other opportunities to match up institutional investors with loans, and aggregators entered the arena and started securitizing the loans. So the whole category kind of morphed.

Andreas Wilgen: When it started out it was called peer-to-peer lending, which refers more to the funding side than the origination side. Nowadays, the term ‘marketplace lending’ covers various asset classes, such as student loans, unsecured consumer installment loans

and mortgages, and it really refers to a means of loan origination. Seen in this way, marketplace lending is really online loan origination.

Elliot Kass: It’s fair to say that marketplace lending is a hit, and there’s obviously huge and growing interest in this area. But why? What makes this form of loan origination so appealing?

Karan Mehta: There are two reasons. One is that the technology and the access to information—most notably credit information and fraud detection measures—has changed dramatically



in the last five-to-ten years. So fintech companies now have the ability to disrupt the banks' traditional business model and assess risk in a very professional manner, ensure legal compliance and take all the other steps that you need to take to make a loan. This can be done by a much smaller scale organization than it could in the past.

The second thing that's changed is that traditionally, if you were making these loans, you were a loan owner and you captured all the economics from that ownership. But the whole marketplace movement is based on the sale of assets. Equity that would have accrued

back to an owner, like the old GE Capital or a CIT, is now being sold. So you now have the opportunity to invest in the asset, which offers a mixture of a bond-like return and an equity-like upside. Previously, you could only do this with mortgages, but the availability of these kinds of assets has become widespread, and you've got billions and billions of dollars being sold in a very professional manner through these marketplaces. That's what has attracted attention to this sector.

Matt Joseph: Loans made by marketplace lenders offer a desirable combination of yield and credit. Many

investors, as a result, have found this asset class to be one in which they very much want to invest.

Rick D'Emilia: The yield on auto ABS [asset-backed securities—editor] has been so low, and there are so many short-term investors that are looking for more yield, and now you have this other asset class that offers short duration assets with much higher yield. There are other issues that people are dealing with to get comfortable with this space, but the yield is a lot higher and the loans are short-term, so there are a lot of money funds and others that are very interested in it.





Andreas Wilgen: That's on the investor side. There's also interest from the consumer side, and a lot of it comes down to convenience and price. It really depends on which players you're looking at and what portion of the market they cater to. There are those marketplace lenders who serve people at the lowest end of the credit spectrum and compete with payday lenders and the like. Then you will find others who compete with traditional lenders. If you've got a 28 percent APR on your credit card, and you can get a loan consolidation for eight or 10 percent, that sounds like a no-brainer. And you can easily take advantage of it with an app on your phone or through the computer.

Elliot Kass: On the borrowers' side, what are the advantages of marketplace lending and what kind of borrowers are drawn to this approach?

Steve O'Neal: The speed and convenience of obtaining a loan,

but also the fact that a lot of these borrowers don't fit a traditional bank lending profile. And not just because they may have lower credit scores, many of the borrowers in this space are prime and near-prime borrowers, but also—especially in the small business market—because they don't meet minimum loan amounts or the traditional banks just don't compete in that space. So marketplace lenders fill the void that is left by the traditional financial institutions.

Karan Mehta: The ease of transacting with a marketplace lender is well ahead of—and significantly more frictionless—than walking into a bank branch. And that's even more true for borrowers who are not sub-prime, but who would typically get turned down by a bank—especially a prime-lending bank. But they may not get turned down by a marketplace lender with finer grades of risk-based pricing. There are buckets of capital looking for that kind of risk. Banks, in particular, tend to focus on prime

customers, and they are generally averse to moving outside their box. And even if you're within their box, you still have to go walk to down the branch, shake hands with the branch manager etc. ... and then hope that you get a loan in a timely manner.

Matt Joseph: And then there are the millennials who don't want to walk into a branch at all. A lot of us are happy to go to a branch or not go to a branch. But the newest generation is against it, and they're transacting all their business online. That cohort keeps getting bigger and every single one of them is a potential customer.

Elliot Kass: You've drawn a distinction between traditional banks and the marketplace lenders. But what about the composite lenders? Aren't a lot of traditional banks getting more involved in marketplace lending? Is there a blurring of the lines?

Karan Mehta: We are definitely seeing the fintechs and the banks moving closer together. There are now hybrid business models, where marketplace lenders retain risk and fund loans themselves, and have their own sources of capital and their own warehouse lines. Marlette's plan from inception was to operate in this manner. We also see some banks moving closer to marketplace lenders and looking to partner both around asset sales but also in terms of loan origination. So there is blurring of the lines, but this is generally happening at the fringe. You're not seeing dramatic shifts in the banking industry where all the banks, or a large number of the banks, are looking to make these moves. Instead, banks are expressing their interest in the sector in other ways. One of them is partnering.

Steve O'Neal: A lot of the larger financial institutions were waiting to see these platforms prove themselves. Now that that's happened, more of the traditional financial institutions are interested in tapping this market. The other thing that's driving more partnerships is greater involvement by the regulators, who don't like to see things take place outside their sphere of influence—especially when it comes to lending to consumers. The Madden litigation started a lot of this [Madden v. Midland Funding, in which the Second Circuit U.S. Court of Appeals ruled that Midland, a collections agency, violated New York State usury laws when it attempted to collect on a high-interest debt it had purchased from a national bank--editor], and there's a big push to pull these things under the regulatory umbrella. As that happens, you're going to see more partnerships between fintechs that understand the customer experience and the technology but don't



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Karan Mehta
head of capital markets,
Marlette Funding

want to deal with onerous regulations, and financial institutions that understand how to operate in a heavily regulated environment.

Elliot Kass: Where do you want to see this market head? How would you like to see it further develop?

Karan Mehta: We want this market to grow rapidly and responsibly. So we want good quality originations; we want low headline risk; we want access to credit to be priced well and to be available to as much of the population as possible. And this does not need to be a zero-sum game. We want this market to grow the pie for everybody—on the consumer side, on the bank side, on our side—and it should work from the oversight body's perspective as well.

Rick D'Emilia: To get started, a lot of these fintech companies used smaller service providers that could help grow their business. But now they're trying to access \$500 million deals in the capital markets with big investors behind them, and these investors want to see more credit guidelines and responsible parties involved at all levels of the transaction. They want to know who you are partnering with, what banks are providing you credit and what institutions are helping you with your financing. If you're going to access the big money investors, you have to have a solid program with credit guidelines and all the right parties.

Steve O'Neal: It ups the ante for due diligence and greater transparency, when you start trying to access the capital markets.

Matt Joseph: On the capital markets side, a lot of the term securitizations have either not been rated at all, or have been rated by only one rating agency. As the market matures, I would think that all the rating agencies will be rating deals, and each deal will be rated by a couple of rating agencies. That should open the door to additional investors as some investment guidelines require investment grade ratings and ratings from two rating



agencies. Depending on where one sits that will be good or bad. As more money is available, rates on offered securities backed by these loans will come down and then presumably that will drive down the interest rates on the loans.

Andreas Wilgen: There will be a section of the market where you will probably have some form of partnership with a bank, or where the banks themselves will start to look into getting back some piece of the business. But there will also be a section of the market that hasn't been well served by the banks and that probably continues to be served by non-bank financial institutions.

Elliot Kass: Is more regulation of this market segment a given? Is it desirable?

Andreas Wilgen: It depends on the type of regulation. If it's regulation to protect consumers from predatory lending, it would have to apply to everyone in a similar way. Any negative media coverage about an institution that charged horrendous rates or didn't

treat its customers fairly will result in push back. But if you look at regulation intended to maintain financial stability, then it depends on the funding model. If you're an institutional investor, and you're not taking deposits, then presumably you don't need to be regulated in the same way as a bank.

Steve O'Neal: That's where partnering with financial institutions comes in, because the nationally chartered financial institutions are effectively exempt from the state usury laws. And that's why a lot of these online lenders partnered with these institutions, because otherwise they'd have to go and get licensed in every state. But the Madden litigation challenged the way they were doing this. Having the nationally chartered financial institution issue the loan, but only keep it on its books for a few days and then sell it back to the marketplace lender, has been interpreted by some courts to imply that the financial institution was acting as a kind of store front and that the purchasers of those loans were not entitled to the benefit from the state usury law exemption. So, to negate that

argument, a lot of marketplace lenders now are re-examining those relationships and working on new deals, where the issuing financial institution keeps some skin in the game and retains some ownership of these loans.

Karan Mehta: With respect to Madden versus Midland, if there's proper alignment in the ecosystem, it's good for all stakeholders, and from a regulatory perspective, you can ensure alignment of interests by this mechanism.

Andreas Wilgen: Alignment of interests is often focused on risk retention — do you retain the loans that you have? But the fee structure of a given lending platform is important to consider as well. When fees are very skewed toward origination fees, and not to ongoing performance, the platform is incentivized to originate as many loans as it can, and what happens afterwards is only a concern in the ability to attract future investors. There is often very little risk retention and they're not as sensitive to risk. But what happens in a downturn, when investors shy away from risk and loans are cut back? Now you're looking at a scenario that would lead to a very substantial drop in income due to the reduced origination volumes.

Steve O'Neal: That's a great point. This paradigm hasn't really been tested in a down market yet.

Matt Joseph: I think that it is important to point out that while we need to consider how to comply with the Madden decision, the most senior attorney of the United States government, the Solicitor General of the United States, said in a brief to the United States Supreme Court, that the Madden case we are talking about was wrongly decided. He said

that federal preemption should have been applied. I also think it important to note that while the Madden decision is currently binding in the second circuit, two other circuits have decided the opposite way.

Elliot Kass: So we have regulatory uncertainty?

Rick D’Emilia: We don’t know what direction it’s going to take, but we’re likely to see more regulation, that’s for sure.

Karan Mehta: We realize that to successfully market bonds into the securitization market there’s a certain expectation on disclosure, and we’re very comfortable with that. We think it brings transparency to the space.

Matt Joseph: On the disclosure side, there’s a movement towards providing more ongoing loan-level performance information for certain deals. This is helpful for future trading of the bonds. It is also particularly helpful for investors in allowing them to better know what their positions really mean.

Elliot Kass: Let’s close out with this — what are your fondest hopes for this market, and what are the risks that you’re most concerned about?

Rick D’Emilia: The ABS market is one of the fastest growing markets and there’s a lot of institutional interest. The players who are going to succeed are the ones that partner with the right people and secure stable funding. The market has a lot of room to move into securitization, where large banks will be partners or investors, and there’s a lot of investor appetite. So if it’s done right and doesn’t grow too quickly,



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there will be a lot of opportunity, including a big opportunity in the structured market.

Andreas Wilgen: The two concerns that we have encountered are a lack of data and the alignment of interest. The issue with data is one of historic performance, but also having enough data for the institutions to conduct robust underwriting. People try to run before they walk, and more progress with letting the evidence present itself would be quite useful in many areas. There’s a future for marketplace lending as a technology and as a means of origination. I’m pretty sure that there will be online origination going forward and that will be a major stay in the business. But what institutions will be standing behind it, I can’t say.

Karan Mehta: Marketplace lending and financial technology in general is here to stay. It’s truly disruptive and very additive to the entire finance ecosystem. Obviously there will be bumps in the road; there already were some earlier this year and, for a relatively young industry, it weathered them fairly well. So marketplace lending certainly has a lot of potential, and it will continue to evolve.

Matt Joseph: There are a lot of folks focused on best practices in this space, which is going to serve the securitization of marketplace loans very well. I believe that marketplace lending securitizations are going to be leaders in providing data on an ongoing basis—and perhaps other assets classes will follow suit.

Steve O’Neal: I believe that Marketplace lending is the future for the consumer and the small business space, it’s going to continue to grow, and it will probably be the primary source of funding in those arenas. ■

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