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INSIGHT

VIEWPOINT

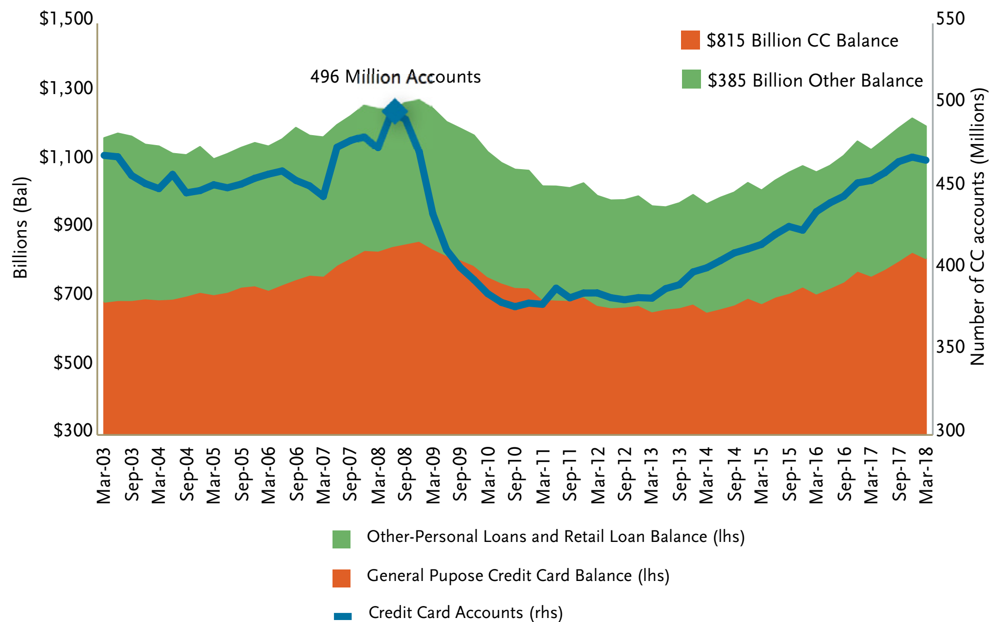
Marketplace Lending

TONY LEE | JULY 18, 2018

Modern American consumer credit can be traced back over a century to a time when merchants and manufacturers started to more readily facilitate consumers financing their purchases. While Henry Ford is widely credited for bringing his Model T automobile to the masses, the price of a vehicle was still too high for many Americans until GM introduced an installment plan to finance purchases. Although some of today's branch-based unsecured consumer lenders can trace their roots back nearly 100 years, the first big step in consumer lending evolution didn't arrive until the late 1950s when general purpose credit cards with a revolving balance feature were introduced to America. This fundamentally changed the way consumers borrowed and spent money.

Fast forward to recent history and credit card balances totaled $866 billion in 2008 (see chart) before falling nearly $207 billion to $659 billion in 2014 post global financial crisis (GFC). Today, outstanding credit card balances total $815 billion. Additional unsecured consumer credit, what the Federal Reserve categorizes as "other," includes personal loans, sales financing and retail loans and along with credit cards totals nearly $1.2 trillion.[1]

Aggregate Unsecured Consumer Loan Balances vs CC Accounts



Source: Federal Reserve

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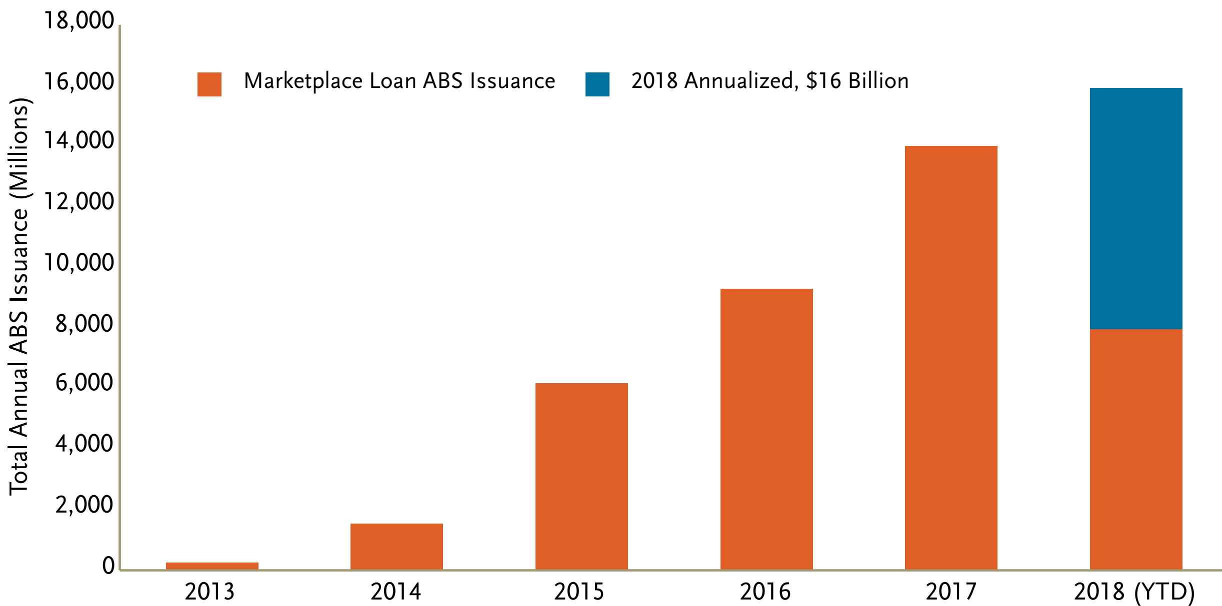
Mr. Lee joined TCW in 2010 as an analyst in the Fixed Income group. Prior to joining TCW, Mr. Lee was a Manager in the Structured Finance / Financial Risk Management Advisory practice at KPMG, where he focused on valuations and reverse engineering a broad variety of RMBS and ABS. Mr. Lee has also held positions as a Senior Analyst for Ameriquest Home Loans and Encore Credit Corp in their Capital Markets Group. He holds a BA in Economics with a minor in Management from the University of California, Irvine. He is a CFA charterholder.

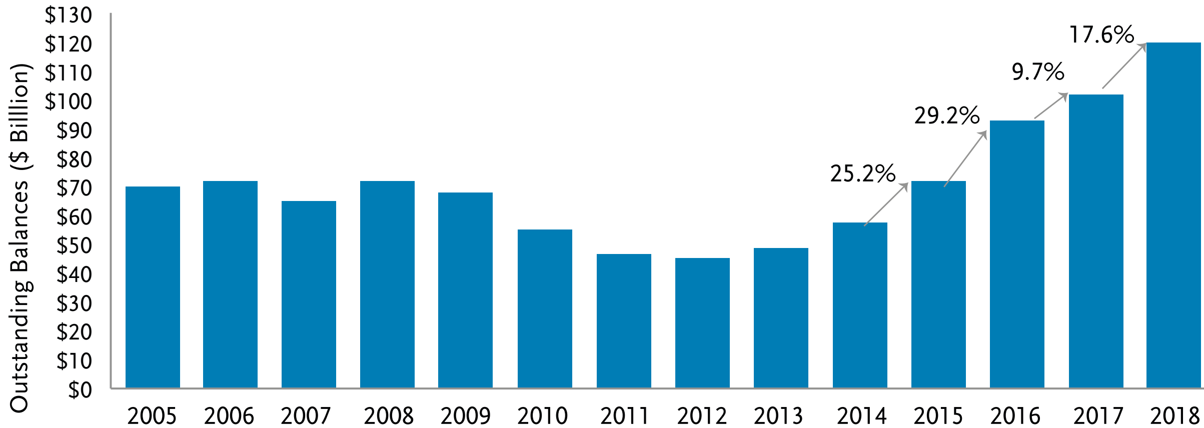
Coming out of the global financial crisis, banks and traditional lenders were reticent to dip their toes back into unsecured consumer lending to nonprime borrowers. New regulations like the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 ("CARD Act") eliminated a lot of practices credit card lenders had used to mitigate or manage their risk. Among the changes: lenders could no longer retroactively raise interest rates on existing balances, they must give 45 days' notice to increase interest rates, and limits were set on certain fees they could charge. In this more heavily regulated credit card lending environment, an opportunity for new non-traditional lending platforms was born: peer-to-peer (P2P) and marketplace lending.

The original premise of P2P lending was to match individuals who wanted to borrow money to individuals who were looking to lend one loan at a time through a technological platform. The original business model for the technology platforms was to match the borrower and the lender and thus have no risk on the platform all while making an origination fee and servicing fee. As the market grew, P2P became a subset of the larger and more institutionalized Marketplace Lending market, which is an expanded version of P2P. Marketplace Lending still serves the same individual borrowers, but simply institutionalizes the funding from a variety of sources including bank conduit lines, whole loan sales to institutional investors, and the ABS market. Over $39bn in marketplace loan ABS has been issued to date since 2013[2]. Marketplace Lending has also expanded to include refinancing existing student loans (SoFi and DRB) and lending to small and medium businesses (OnDeck and Kabbage). Transunion reported nearly 17 million people had a personal loan at the end of 2017. Marketplace lenders have come to capture about 36% of the total personal loan market in 2017 from roughly only a 4% share in 2012[3]. The typical marketplace borrower is either near prime or prime with loan terms ranging from less than a year to seven years.

Marketplace Loan ABS Issuance



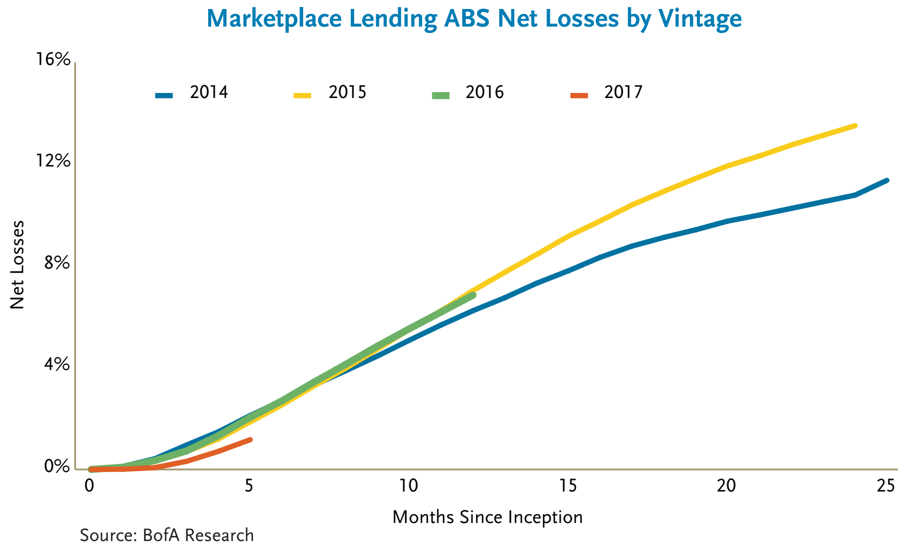
Source: Morgan Stanley Research, TCW

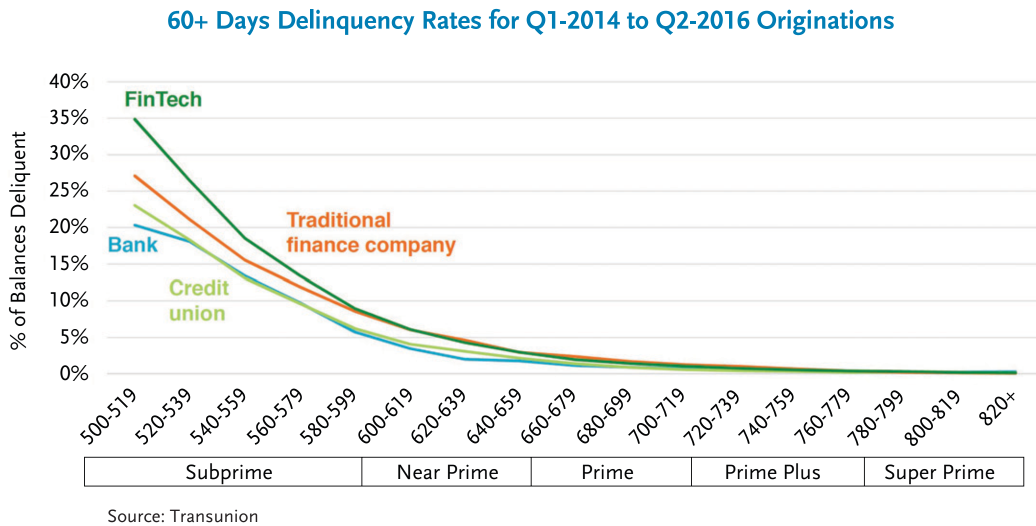


Source: Transunion

Marketplace lending serves three main constituents: 1) the underserved customer, 2) the disintermediated borrower (Fintech), and 3) the marginal borrower who otherwise wouldn't have access to credit. The underserved borrower is credit worthy by traditional underwriting standards but doesn't have access to unsecured credit or is being charged an above market interest rate. The disintermediated borrower is looking for an easier, faster, more efficient technology-based solution to access credit. Finally, the marginal borrower can access credit through new underwriting methods marketplace lenders deploy. Employing proprietary algorithms, artificial intelligence, and/or machine learning, these new platforms attempt to underwrite credit not only better and more accurately but cheaper and faster than traditional lenders. Marketplace lenders have access to massive amounts of financial data and alternative data sources previously unavailable or underutilized by traditional lenders. Some examples of alternative data used to underwrite credit include insurance claims, utility payments, education/degree, and mobile phone data.[4] They are able to provide a materially quicker, easier, and more efficient application, credit decision, and funding process through technology. These advantages will help them to penetrate the market and take share. While marketplace lenders have the ability to scale via technology it is ironic that many rely on traditional methods such as direct mail to find and acquire customers.

Of the many risks facing the nascent sector, lack of performance history through a full credit cycle appears to be at the forefront. It remains to be seen if newer credit underwriting methods utilizing artificial intelligence and machine learning will actually prove to be superior in predicting defaults and losses over a long time horizon and through multiple credit cycles. It seems reasonable that over time, with more and better data through various cycles, the ability to predict the probability of default will improve not just for marketplace lenders, but all lenders who utilize the data thoughtfully.





Transunion analyzed over 40 million personal loans originated between 2014 and 2016 and found that Fintech originated consumer loans had a higher 60+ delinquency level at 12 months for lower FICO borrowers.[5]

With scale and ease of use through technology also come unintended consequences. The risk that nefarious actors will look to abuse lenders with fraudulent applications and identity theft or loan stacking increases with technology. Loan stacking is when a borrower takes out multiple loans simultaneously before a credit bureau or any one lender realizes what is happening. This significantly increases the credit risk of any one loan. Given their unsecured nature, another facet of the loans is they can be used for virtually anything. The most commonly stated loan purpose is to consolidate debt. Lenders can't and/or do not verify if this is in fact the case since the funds are sent directly into a person's bank account and money is fungible, easily substituted or interchangeable for goods and services. Student loan refinancing is one exception since funds are sent directly to the servicer of the loan being refinanced. Other borrower stated reasons for marketplace lending include home improvement, medical, small business, car, and vacation.

Regulatory issues remain and could possibly hinder the industry's current business model where a bank originates the loan and quickly sells it to a marketplace lender. Currently, many marketplace unsecured loans are originated via a partner bank headquartered in a state with little to no usury laws. Then the loan is subsequently sold to the marketplace lender a few days later. This arrangement, in essence, allows the lender to use one state's lax usury laws nationally and introduces the question of who the actual lender is.

Time will tell if marketplace lending platforms will be able to disrupt how unsecured consumer credit is disseminated and fulfill its promise to tap a population that typically was underserved. There is no disputing more consumers are becoming comfortable using technology in nearly all parts of their lives. International companies like WeChat (Tencent Holdings Limited) and Ant Financial Services Group in China have already made significant inroads in disintermediating traditional banking. Along with credit performance through a full credit cycle as primary concern, what remains to be seen is how traditional banks will respond to the growth of these marketplace lending platforms. Banks currently enjoy the material advantage of access to low cost, sticky deposits but many have partnered with marketplace lenders to license their technology among many other ways. While the evolution will take time, the lenders best and most thoughtfully able to utilize data in their underwriting, whether they be marketplace lenders or traditional banks, will likely accrue value over time, though there will likely be missteps during the process. To identify which new data is meaningfully predictive in identifying the good borrowers from the bad ones inherently means identifying which data isn't meaningful and/or those that lead to defaults. By definition, the bigger and better the data and the underlying data analytics become, the more scrapes and bruises in the form of defaults and losses there will be along the way. ■

1 Federal Reserve Bank of NY: Household Debt and Credit Report (Q1 2018)

2 Morgan Stanley Research, Bloomberg

3 Transunion - *Fact or Fiction: Are FinTechs Different from Other Lenders?*

4 Federal Reserve Bank of Philadelphia*, Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information*

5 Transunion - *Fact or Fiction: Are FinTechs Different from Other Lenders?*

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