Apr 20th, 12:30 PM - 1:45 PM

Disruption within Alternative Lending

James Chiavaro
Sacred Heart University

Chris Saunderson
Sacred Heart University

DISRUPTION WITHIN ALTERNATIVE LENDING

Global Financial Markets and Institutions

Group 6

James Chiavaro, Nicole Esposito, Chris Saunderson, Mario Macera, and Tom Ketchum

Table of Contents

I. Abstract

II. Introduction

III. Business Models

IV. Examples of Platforms

   a. Lending Club

   b. Avant and OnDeck

V. Investment Banks

VI. Risks

VII. Conclusion

VIII. Works Cited

I. Abstract

Since the 2008 financial crisis, there has been significant disruption within the financial services industry. We will pinpoint companies within the financial technology industry, particularly those that conduct lending and various products to consumers and businesses. In addition, we will discuss the benefits that are associated with this disruption and the reasoning why financial institutions like banks and hedge funds are attracted to these companies. With alternative lending becoming increasingly popular, there will be an in-depth examination concerning the risks that correlate with this newfound popularity among borrowers and investors. We will touch upon the sustainability of these alternative lenders while weighing the risks involved in recent years. There will also be a focus on the business model of these companies to see if the industry in its entirety is sustainable once the consolidation that took place in the second quarter of 2016 and risks that include event, leverage, and credit. Thus, the measured sustainability will weigh in the effects on both the market as well as those directly involved in the transactions.

II. Introduction

The implementation of regulations that include Dodd-Frank after the 2008 financial crisis propelled banks to restrict the amount of loans they were creating for small and medium sized businesses. This created an opportunity for alternative lenders to fill a void within the market. An alternative lender is a company who can originate and distribute capital in the form of various structured products to consumers and businesses. Disruption in the market occurred with the creation of financial technology companies, otherwise known as Fintech companies. These are platforms that utilize proprietary algorithms and software to provide consumers and businesses access to capital in a quicker, more transparent, and efficient way in comparison to traditional lenders and banks. As concentration within the market occurred, lenders have found ways to differentiate themselves through their business model, niche, underwriting, strategy, and data that they use. Banks and other financial institutions have welcomed this disruption by working with these platforms through strategic partnerships and securitizations or even creating their own in-house platform. In addition, there have been multiple events and risks that have limited the flow of capital to platforms in recent time, which has created a mini consolidation within the industry. This paper will explore why Fintech alternative lending is sustainable.

III. Business Models

Alternative lenders must abide by certain regulations. An example of this is that lenders must have either a license to originate within specific states or use an FDIC charter bank to originate for them. Most lenders utilize a charter bank on the basis that it is cost efficient and not as complex in comparison to obtaining state lending licenses. In addition, lenders need to register their securities with the SEC and in every state they would want to sell them in. Financial technology platforms disrupted alternative lending with the introduction of three types of business models that include marketplace, balance sheet, and hybrid.

The marketplace lending model is unconventional in comparison to the traditional banking model that takes deposits and lends to consumers and businesses. This model enables a borrower to apply and be approved for loan on their platform in a matter of days. These loans are then originated by a FDIC partner bank and held on their books for three days. The platform purchases the loan from the partner bank and underwrites it. The rate on the loan ranges from 7%

to 26% and is dependent on the borrowers' credit score, income, and other metrics. This allows a platform to be transparent, where the investor has an idea of what he is investing in and the risks that are associated with it. In addition, the platform generates revenue through origination fees and servicing fees on the loans that investors buy. The one downside that occurs with using a charter bank is that they require compensation in the form of 10 to 30 basis points. One of the unique aspects of this model is that it acts as a securitization, where the loans are divided into mini tranches obtaining their own rating from the platform. Also, an investor can diversify themselves by investing as little as $25 in each loan. Depending on the platform, these loans can be unsecured, which means there is no lien attached if the consumer or business defaults. Therefore, one can lose their investment within a loan, but since one can diversify their portfolio with these microloans, they would not endure a large loss.

The balance sheet model provides the same structure as marketplace, but with one large difference, which is there is no investor or secondary market. This means that the platform holds the loans on their balance sheet, where they retain risk. Institutional investors are attracted to this model because it shows transparency and the performance of the platform's portfolio. Therefore, platforms who incorporate this model must be more conservative with their underwriting in comparison to marketplace, even though this market is considered high yield. The one concern is that this model is capital intensive due to the need to fund loans via their balance sheet. This is why balance sheet lenders obtain a credit facility or construct a securitization.

The hybrid model incorporates a mixture of both marketplace and balance sheet models. This enables a firm to scale in various types of environments that are created by risk. For example, if the industry has a shortage of capital, they can focus on building their balance sheet and retain a larger spread. In addition, they have the ability to offer a premium for the loans on marketplace on the basis that they are funding these loans via balance sheet and recycling through marketplace. The one problem associated with this model is the cost of technology to integrate or create an additional platform for this model.

IV. Example of Platforms

a. Lending Club

Lending Club is considered one of the largest marketplace lenders in the world. They initially launched as an application through the social media giant Facebook in 2007. The company positioned itself as a social networking service and set up opportunities for members to identify group affinities. This was based on a theory that borrowers would be less likely to default to lenders with whom they had affinities and social relationships. It developed an algorithm called Lending Match for identifying common relationship factors such as geographic location, educational and professional background, and connectedness within a given social network. The use of data mining in this respect helped Lending Club in terms of financial planning and further expansion into the market.

In August of 2007, Lending Club received an astonishing $10.26 million in Series A funding from venture capitalist Norwest Venture Partners and Canaan Partners. Series A is the first round of preferred stock offered during the early stages of a company. The investors intended to transform the application into a full-fledged marketplace lending company planning on it being the first of its kind. By June 20th 2008, they sought to be registered with the U.S. Securities and Exchange Commission. Lending Club filed what is called an S-1 statement with the SEC trying to register the $600 million in "Member Payment Dependent Notes" to be issued on the official website. The company needed this approval to start effectively doing business. On

August 1st, 2008 Lending Club filed an amendment to their initial statement clarifying the interest rates algorithm and their “online resale trading system.” The following October announced its completion of the SEC registration process and posted the filed prospectus on its website, and resumed new lender registration. Notes issued on or after October 14, 2008 represent Lending Club securities rather than direct obligations of the ultimate borrower and are tradable (can be bought and sold) on the FOLIOFn trading platform ("Better Rates. Together.").

After registering with the SEC, Lending Club underwent a dramatic transformation in business planning. It stopped presenting itself as a social network while maintaining that social affinity will necessarily reduce the default risk. This is instead of using the algorithm just as a search tool for investors to find notes they would like to purchase. Based on the criteria on borrowers such as the length of a loan term, target weighted average interest rate, borrower credit score, employment tenure, and home ownership status. To reduce default risk, Lending Club initially focused on high-credit-worthy borrowers, declining approximately 90% of the loan applications it received as of 2009. Lending Club assigned higher interest rates to riskier borrowers within its credit criteria and only approved borrowers with FICO score of 660 or higher for loans ("Better Rates. Together.").

In April 2010, the company raised $24.5 million in a Series C funding led by Foundation Capital and joined by existing investors including Morgenthaler Ventures, Norwest Venture Partners, and Canaan Partners. In following August of 2011, Lending Club raised an additional $25 million in venture capital from Union Square Ventures and Thomvest. In total Lending Club earned a $275 million post-money valuation and an increase of $80 million in valuation from the preceding year. In 2012, the company employed only about 80 people, with Renaud Laplanche acting as the company CEO and Chairman of the Board of Directors. Lending Club averaged about $1.5 million in loan originations daily, with a total of $600 million since its founding in 2008. In April 2012, Lending Club's SEC registration from 2008 was renewed for $1 billion in "Member Payment Dependent Notes" and became effective as of April 10th, 2012 ("Better Rates. Together.").

In June 2012, the company received $15 million in new funding from Kleiner Perkins Caufield & Byers and $2.5 million of personal investments from John J. Mack. Mary Meeker, a partner of Perkins, joined Mack on Lending Club's board of directors. This led to a $570 million valuation of the entire company. By November 2012, Lending Club surpassed $1 billion in loans issued since inception, and they announced that the cashflows were finally positive ("Better Rates. Together.").

In May of 2013, Google purchased a large stake in Lending Club. Just as Lending Club started to partner with smaller banks in order to help streamline their small loans operations. In June 2013, the company partnered with Titan Bank out of Texas and Congressional Bank out of Maryland to help them facilitate loans that would have been otherwise unprofitable for them. These larger banks allowed them to finance much larger loans and expand their operations overall.

Today, only investors in 39 of the 50 U.S. states are eligible to purchase notes on the Lending Club Platform. Eligibility differs when purchasing notes on the secondary market and borrowers from all but two U.S. states are eligible to apply for a loan. As of 2016, a high proportion of funds for Lending Club-facilitated loans came from hedge funds. During May of this year, Lending Club was seeking to sell hundreds of millions worth of loans as bonds as part of a strategy to overcome difficulties in accessing sufficient funding. The problem has become that the company just simply cannot keep up with the amount of users due to a lack of funds. According to statistics provided on Lending Club's website, as of 31 December 2015, 68.5 percent of borrowers reported using their loans to refinance other loans or pay off credit card debt. The average Lending Club borrower has a FICO score of 699, 17.7% debt-to-income ratio (excluding mortgage), 16.2 years of credit history, $73,945 of personal income and takes out an average loan of $14,553. The average loan is used for debt consolidation or for paying off credit card debts. The investors have funded $11,217,348,156 in loans, with $1,911,759,192 coming from Q3 2016. The nominal average interest rate is 14.08%, default rate 3.39%, and an average net annualized return (net of defaults and service fees) of 8.93%. The average returns of investment for Lending Club lenders are between 5.47% and 10.22%, with 23 straight quarters of positive returns ("Better Rates. Together.").

b. Avant and OnDeck

There have been other platforms that have caused even more disruption within the market that include OnDeck and Avant. OnDeck was the first player that introduced this hybrid model to offer originations and access to capital for small businesses that had prime credit. They surpassed over 5 billion originations since their inception in 2007. Avant brings a similar concept, but differentiates themselves with their algorithms and metrics they use. For example, they originate personal loans, but only do so for individuals who have sub-prime credit.

V. Investment Banks

Investment banks have decided to work with financial technology companies to not only upgrade themselves but also to prevent themselves from falling behind in the future. Working with these Fintech companies expands investment banks' reach to new consumers and provide new features for current consumers, however not working with them drags them behind as these start-ups get larger or are bought by other banks. The scenario is that these start-ups are getting larger, but the banks that have acquired or partnered with them now have the upper hand. An example of this is how Goldman acquired General Electric's depository institution in 2013 for 16 billion dollars. This enabled them to create their very own online lending platform called Marcus. Marcus pinpoints consumers that have a credit score above 660, otherwise known as prime borrowers. Goldman developed this product in response to needs from potential clients. Another example is the partnership of J.P. Morgan and OnDeck. This investment bank benefits on the basis that they can provide access to capital for small businesses in an efficient and cost effective way. The advantage that the platform has is that they receive the adequate capital to perform these actions and have the ability to create a securitization if they want to.

Securitization is the process of taking an illiquid asset or group of assets and transforming them into a security through financial engineering. These pools are then separated into tranches, which are based upon the securities' credit. Investors that include financial institutions like hedge funds and pension funds find this attractive due to the safety and steady income these securities generate. An example of securitization is Avant's deal with Credit Suisse. "CHICAGO, Aug. 15, 2016 /PRNewswire/ -- Online lending platform Avant announced today two closed transactions, including a $255 million 144A asset-backed securitization deal and the renewal of its $392 million warehouse facility held by J.P. Morgan and Credit Suisse." "The three tranches AVNT 2016-C securitization transaction include Class A, B and C fixed-rate notes that were rated A-, BBB- and BB by Kroll Bond Rating Agency (KBRA)." Credit Suisse was one of the leaders with J.P. Morgan and Morgan Stanley. The ABS deal was strongly received by investors and was significantly oversubscribed. The transaction provided debt financing for Avant's core U.S. installment loan business.

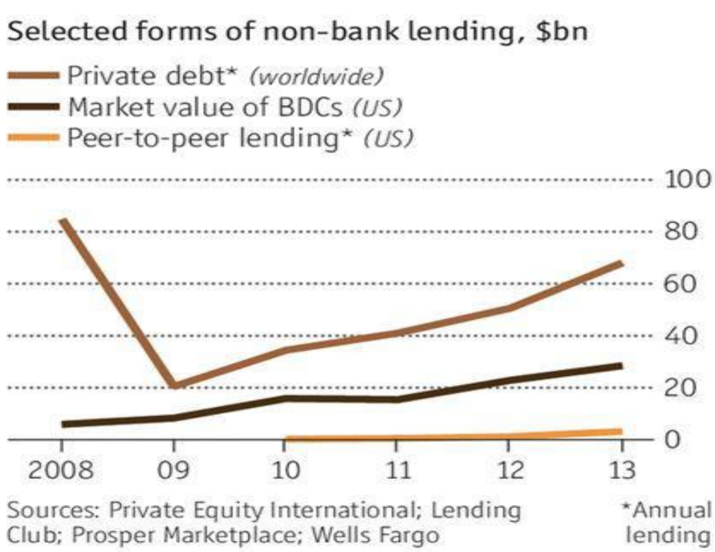
VI. Risks

Although incredibly enticing at first glance, alternative lending poses certain risks that one should take into consideration. The growing popularity of alternative lending poses a concentrated market risk, as many of the firms lack differentiation from one another. Some alternative lenders copy structures of other lenders, making the decision process confusing for the individual/business receiving a loan. For example, Prosper, an online marketplace attempts to differentiate themselves in terms of new technology and focusing on customer satisfaction. Aaron Vermut, CEO of Prosper stated in an interview with an associate from Fintech that “customer satisfaction as measured by NPS (net promoter score) is very high and we’re seeing a lot of repeat borrowers and investors. We also offer the most comprehensive automated investing program on the market in order to streamline the investing process for our customers” (2015). This differentiation has kept a steady stream of customers investing in Prosper, however, with increased popularity, other lenders, like Lending Club and smaller lenders, are keeping up with similar technology and copying such innovations. This makes it difficult for the consumer to decide which lender to choose. Thus, although alternative lenders are differentiated from banks, with such a concentrated market, it is more difficult to differentiate themselves from other non-bank entities.

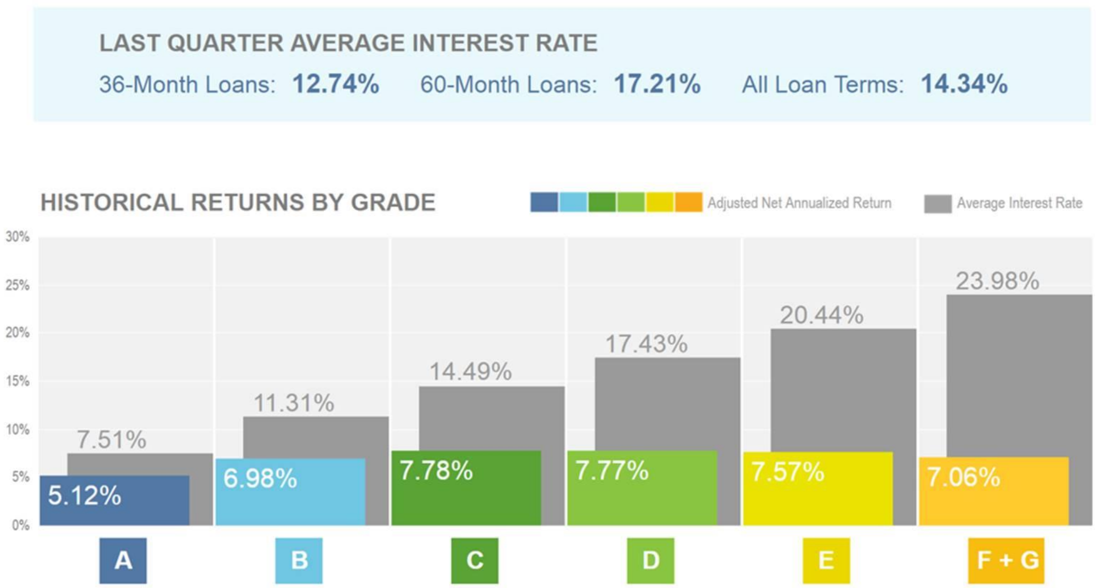
Alternative lenders also face interest rate risk as rates set by the Federal Reserve can affect their overall model. Normally, when rates rise, for example, the lender would raise borrowing costs in hopes of a strong economy and unemployment. This preparation from future trends has causes some skepticism revolving around Lending Club earlier this year. Their platform of underwriting data is under scrutiny as it has over-priced and under-priced the values of loans, but the data located on Lending Club's website has no concrete number to support these claims. In response to the discrepancies, "LC Advisors noted the December and January rate changes and said that Lending Club had made two "risk adjustments." The higher rates were meant to prepare for a potential slowdown in the U.S. economy, according to the presentation" (Buhayar). However, Buhayar then points out how other slides show the opposite- that the economy is strong with low unemployment. Such inconsistencies occur because alternative lenders must constantly tweak their algorithms as interest rates fluctuate. With such intensive monitoring, alternative lenders are faced with interest rate risk, and must align their rates with overall interest rate movements.

With the increasing popularity of alternative lending, regulators are delving into the structure of the firms. This supervision poses a regulation risk to the alternative lenders, which may in turn affect small businesses. With little regulatory constraints, alternative lenders are able to charge high interest rates to their customers, namely small businesses that could not qualify for bank loans or other small businesses, resulting in a higher profit for the lender. The lack of regulation also allows for a more rapid process when receiving the loan. However, with regulators searching for cracks within the foundation of alternative lenders, this structure may be compromised.

In the case of *Madden v. Midland Funding*, questions were raised concerning the extent to which a State can regulate a national bank's ability to set interest rates through limitations that arise as soon as a loan is sold or assigned. The statement to the Supreme Court reads, "The question presented here is whether, after a national bank sells or otherwise assigns a loan with a permissible interest rate to another entity, the Act continues to preempt the application of state usury laws to that loan" (2). Despite the popularity of the case, the Supreme Court denied to hear the petition. Therefore, the decision stands, that a national bank cannot sell a loan to a non-bank entity with that entity free from state law. This impacted alternative lenders as any of the qualifying lenders must abide by state law interest rate caps. With the decision in place, many lenders must rearrange their model to fit state regulations. As state licenses are expensive for the alternative lenders, the entities may need to have charters instead. Although this may be attractive to the customer, it can hurt their overall profit with lower rates. Also, the lenders will be comparable to national banks, which makes the alternative lending process less differentiated. Thus, the regulation risk surrounding alternative lending may hurt their current practices and popularity among small businesses.



Last, when considering risks with alternative lending one should take into account the Lending Club scandal that took place this summer. The scandal was so severe that the company's then CEO, Renaud Laplanche resigned. Later, a recent internal investigation found an issue with $22.3 million worth of loans sold to Jefferies bank. Some of the loans did not meet the buyers' criteria but they were doctored to look like they did anyway. In light of this situation, the company's stock fell 20% in one day and the market was negatively affected within the alterative leading industry. The decrease in influx of capital to these firms was significant. This lead many alternative lending firms to default.



The bar graph above illustrates, the third quarter's average interest rates for lenders club. The increase in rates is indicative of the recent financial trouble that Lending club has gone through.

VII. Conclusion

We believe that Fintech alternative lending is sustainable for several reasons. First, consumers are attracted to these platforms due to the efficiency of the platform. The ability to receive a loan within a day is appealing, especially for consumers and businesses who need access to capital in a quick manner. Second, banks have partnered with these platforms, which symbolize a strength and a need for this type of lending within the market. Third, we believe that events that include the Lending Club scandal separate the strong from the weak, where the weak have defaulted. Lastly, the recent raise of interest rates and current economic environment show the strength of the economy and height of consumer confidence, which in theory will create a demand for loans and leverage in the future to fund projects and growth that are associated with this economic climate.

VIII. Works Cited

Avant. "Avant Secures $255 Million Asset-Backed Securitization Led by J.P. Morgan, Credit Suisse and Morgan Stanley and Renews $392 Million Warehouse Facility." *Avant Secures $255 Million Asset-Backed Securitization Led by J.P. Morgan, Credit Suisse and Morgan*. N.p., n.d. Web. 16 Dec. 2016.

"Better Rates. Together." *The Leader in Peer to Peer Lending: Loans and Investing |*

Lending Club. N.p., n.d. Web. 15 Dec. 2016.

Buhayar, Noah. " LendingClub Models Misfire as Loan Write-Offs Top Forecasts." *Www.bloomberg.com*. N.p., 5 Feb. 2016. Web. 15 Dec. 2016. <https://www.bloomberg.com/news/articles/2016-02-05/lendingclub-models-misfire-as -loan-write-offs-exceed-forecasts>.

Dobrolioubov, Sasha. "Prosper, The Importance of Data & Customer Satisfaction i P2P Lending." *Www.medium.com*. N.p., 9 Nov. 2015. Web. 15 Dec. 2016. < https://medium.com/wharton-fintech/prosper-the-importance-of-data-customer-satisfaction-in-p2p-lending-a08e97153188#.m0kpmvtvr>

Leghorn, Thomas. Etcetera. "MIDLAND FUNDING, LLC, AND MIDLAND CREDIT MANAGEMENT, INC., PETITIONERS v. SALIHA MADDEN" *Www.scotusblog.com*. N.p., 2016. < http://www.scotusblog.com/wp-content/uploads/2016/03/Madden-Midland -Cert-Petition-11-10-15.pdf>

"Personal Loans | Online Loans - Avant." Avant. N.p., n.d. Web. 15 Dec. 2016.