Expert Q&A on Marketplace Lending

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An expert Q&A with Jeffrey Stern of Winston & Strawn LLP discussing the rapidly expanding field of marketplace lending and its impact on the loan market.

MARKET WATCHERS REPORT THAT FINANCIAL INSTITUTIONS AND COMPANIES ARE SHOWING GREATER INTEREST IN MARKETPLACE LENDING. WHAT EXACTLY IS MARKETPLACE LENDING AND IN WHAT WAYS DO THESE TYPES OF LOANS DIFFER FROM TRADITIONAL BANK LOANS?

Much ink has been spilled of late on the topic of marketplace lending. The cause of this outpouring is not difficult to discern. Marketplace lending is a field that has demonstrated an astonishing level of creativity and innovation that seems to sprout a new branch or offshoot almost weekly. In the face of shifting challenges and opportunities, marketplace lending continues to transform itself. The industry and its tantalizing potential has attracted the attention of virtually every category of financial institution and investor, from banks to insurance companies to family offices to funds to high net worth individuals. Inevitably, it has likewise drawn a wealth of market commentary.

At the risk of adding to this deluge, let us take a moment to review the brief history of this form of finance. Marketplace lending has in fact existed for over a decade, both in the US and in the UK. China has also become a significant base for marketplace lenders in recent years. Its rise has mirrored that of social media, mobile phone applications and, most notably, the use of "big data" as a crucial business tool. The last five years (or thereabouts), in particular have been transformational. During that time, the industry, the number of marketplace lenders, and the statute of the field have all experienced dynamic growth.

At the start of this period of rapid development, the industry was commonly referred to as peer-to-peer (p2p) lending. That moniker arose from the fact that marketplace arrangers established web platforms with the goal of using these platforms not only as a user-friendly and efficient method for providing loans to customers, but also as a means of funding these loans directly by investors, which are enabled by the platform to select specific loans (or fractional interests in those loans) for investment and funding. The industry at this stage envisioned technology as a fulcrum between individual investors and loan customers, bypassing dealers and other distribution channels and creating a new, transparent, and liquid market for consumer loans.

This vision of p2p lending, connecting investors to borrowers through a web platform, has been realized in large measure. However, it has also gradually been supplanted as a result of the powerful influx of capital from institutional investors, which today purchase or fund sizable pools of marketplace loans, often via flow purchase agreements that include an undertaking by the institutional investor to acquire a specified portion of the platform's future loan originations. These "chunkier" institutional-scale investments have permitted lenders to amass substantial funding resources rapidly and with relatively little transactional friction, making the investment by numerous smaller, individual investors less attractive and less practical in many cases, particularly as the overall scale of marketplace lending has steadily increased. Consequently, the name "p2p " has generally given way to newer terms, such as "marketplace lending" and "fintech" (a combination of "finance " and "technology") or occasionally to the statutory term (often incorrectly applied) of "crowdfunding " although the p2p model and name continues to be used.

With that background, let us turn to the more pressing question: What is marketplace lending? The term "marketplace lending" refers to a broad class of lending, one that is conducted or arranged, generally through web portals, by non-bank "alternative" finance companies. That is an important starting place. This field represents an alternative to traditional bank lending, and possibly a necessary one, given the regulatory burden and capital constraints that many banks face.

The differences in style and substance, between marketplace lenders and bank lenders, are many and marked. These "non-bank" lenders are typically operating in a manner that is (or that they believe is) exempt from several aspects of regulatory oversight to which bank lenders are subject. A significant portion of marketplace lenders relies on exemptions from state licensure requirements. Only time will tell whether and in what manner this variance in regulatory oversight between bank lenders (particularly federally guaranteed deposit-taking institutions) and non-bank lenders is sustained into the far future. For now and the medium term those differences appear to be quite significant, both in terms of business costs and generally with regard to the capacity to engage in risk-taking activities. The December 2016 proposal recently published by the Office of the Comptroller of the Currency captioned "Exploring Special Purpose National Bank Charters for Fintech Companies" adds another wrinkle to that discussion.

Many fintech companies often lend on terms on which or to customers to which banks refuse to or cannot lend, due to (among other things) risk-based capital limitations and regulatory guidelines. This new class of fintech lenders is also willing in many cases to use underwriting techniques that are more innovative and flexible than traditional bank credit procedures (including social-media based indicators of payment capability or likelihood, "selfies" as identity validators and so on). As a result, many of these platforms are lending into markets (or targeting populations) that banks no longer fully serve, such as small business secured and unsecured, merchant cash advance, inventory finance, and receivables finance.

The fintech industry is also distinguished from the traditional banking industry by its heavy reliance on technology and non-traditional data sources. Marketplace lenders typically use web-based or app-based interfaces as a primary tool to connect and interact with existing borrower customers and prospective customers (rather than, for example, brick-and-mortar branches), creating significant efficiencies and cost savings. Marketplace lenders also generally employ robust data analysis techniques to accelerate the credit decision process and offer rapid (often near-instantaneous) price quotes, improving dramatically the borrowing customer's experience. While there may be some debate on whether a particular marketplace lender has a "secret sauce" that actually enhances and fortifies its underwriting process and credit determinations, it cannot be denied that marketplace lenders generally draw on a far greater range of data points and use more sophisticated technological tools to assess and monitor credit than most traditional consumer lenders, providing some protection against losses and macroeconomic shifts, and offering a new level of portfolio data transparency to investors in this sector.

WHAT TYPES OF CREDITS ARE TYPICALLY INVOLVED IN MARKETPLACE LENDING? HOW IS THIS CHANGING AS THE MARKET EVOLVES?

As marketplace lending began its recent period of exponential growth, the clear driver of the growth and still the largest segment of the fintech industry has been unsecured consumer lending. Lending Club and Prosper are two of the largest participants in that category. A subset of this segment, student loans, has been another important component of marketplace lending that has a significant presence within the marketplace lending field and has been an outsize contributor to the nascent securitization market for marketplace loans.

However, several forms of "alternate lending" have become important areas of growth in the marketplace lending field in recent years. These include some more complex consumer categories, such as mortgage lending. They also include several types of corporate lending, including commercial and residential real estate finance and both secured and unsecured small business loans.

In the real estate area, several firms function (wholly or in part) on a p2p model, with investors selecting from an array of particular real estate investment opportunities. Among these companies are Realty Mogul, Realty Shares, iFunding and Patch of Land. Given the idiosyncratic nature of real property, and the unique risk/reward profile of each investment, the p2p approach seems to be a good match for this asset class. That same quality, that is, the non-standard character of each lending opportunity, may ultimately present some impediments to achieving growth, in this lending category, on the scale of consumer marketplace lending. Still, real estate p2p lending, which coalesced as an industry just a few years ago, has grown swiftly. There are nearly a dozen serious players, with substantial deal flow, operating in the market.

Another class of alternative lending, small business lending, has emerged as one of the key growth stories of the fintech market (notwithstanding recent challenges in this sector), with a new set of business loan products that leverages this industry's marriage of finance and technology. Lenders are using technology to evaluate and monitor business credit and performance in ways that offer greater and more-rapid access to capital, and that promise earlier notice of impending hazards.

Much of this small business lending has been unsecured, although in some cases the loans are linked to a closely watched flow of trade receivables. Other small business loans are secured forms of receivables finance (including factoring and merchant cash advances). Three of the largest online small business lending platforms are OnDeck, Kabbage, and CAN Capital.

WHAT AREAS OF MARKETPLACE LENDING DO YOU BELIEVE PRESENT THE GREATEST OPPORTUNITY FOR GROWTH AND WHAT FACTORS MAY BE DRIVING THAT?

Although lawyers may sometimes be poor prognosticators of business trends, there are a few developments we can certainly identify in the marketplace lending field. We can start by confirming that unsecured consumer lending is likely to remain the core product of this field. However, to answer the specific question raised above, it is unclear what level of growth is available in this particular category of marketplace-originated loans.

The prospect of rapid growth in unsecured consumer marketplace lending may well depend on several factors, including whether significant, disruptive technologies or applications, or both, (some of my clients are working on just these technologies and apps) emerge that fundamentally change the process by which fintech companies acquire borrower customers and through which consumers take on and refinance debt. Another similar variable is the recent entry into the industry of several major companies with considerable balance sheet strength or massive existing customer bases, or both. These new entrants may well alter the growth trajectory of this sector.

At the same time, marketplace consumer lending is facing headwinds from several sources, including heightened regulatory scrutiny, adverse (and potentially disruptive) judicial decisions, increasing customer acquisition costs, liquidity and funding diversity concern, and possible macroeconomic challenges. On balance, the market appears to expect that the next couple of years are likely to bring steady, but not explosive, growth, along with a winnowing of the significant number of lending platforms and a reallocation of the market among the more robust lenders that remain.

On the other hand, we may see more rapid growth in the still developing alternative lending areas, such as small business lending, real estate lending, and other niche products (including specialty finance). Small business lending and real estate lending, in particular, are huge segments of finance in which marketplace lending still represents only a small fraction of the overall activity, which provide for enormous opportunity.

At the same time, the scaling of real estate marketplace lending may be constrained by its idiosyncratic assets and its reliance on a p2p model. Small business lending has its own set of challenges, including cost-of-funds issues and some overcrowding in a segment in which fintech lenders are still working to achieve significant market share. While fintech companies have made strides in these loan categories, there are both hurdles to overcome and room for accelerated growth.

Another potential growth story is in the area of mortgage lending. Marketplace lenders have just recently begun to make serious forays into this loan category. One of the challenges for marketplace lenders is that the existing mortgage market is well established and is financed rather efficiently, with the benefit of government support.

Consequently, there is likely to be a narrower opportunity for marketplace lenders to displace existing lenders and add value to the mortgage origination process. That being said, this remains a new, exceptionally broad, and largely unexplored territory for the fintech industry. Given the industry's ties to a growing customer base, a significant expansion of marketplace mortgage lending appears likely.

We should also anticipate a fairly rapid growth of marketplace lending, consumer lending in particular, in a number of jurisdictions outside the existing centers of marketplace lending (that is, the US, UK, and China). Many of these markets, including parts of Europe, Asia (outside of China), and Latin America, are now starting to explore marketplace lending. New platforms and fintech firms have been announced in a number of jurisdictions. That process is likely to quicken during the coming years, bolstered in many cases by inefficiencies in local banking models.

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