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Risks of Marketplace Lending Are More Pronounced Than in Traditional Lending

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Securitization is a viable source of financing for the nascent marketplace (or peer-to-peer) lending sector, but these transactions have several risks that are harder to quantify or more pronounced relative to securitizations from traditional lenders. We divide these risks into four categories: performance history, operational plumbing, alignment of interests and regulatory resilience. On the other hand, marketplace lenders provide investors with superior data transparency concerning their asset characteristics relative to many of the more established consumer lenders.

Moody's Managing Director William Black recently spoke with Structured Finance News regarding marketplace lending (a.k.a. peer-to-peer) platforms and securitization. Click here to view segments of the interview.

Marketplace lenders have captured about 0.1% of the $3.3 trillion non-mortgage consumer debt market to date.[3] However, marketplace lenders have their sights on new frontiers, including loans to small businesses and mortgages.

Marketplace lenders have limited performance history

Performance history, or track record, is one area in which virtually all marketplace lenders fall short of traditional lenders. Many companies have only been around for two or three years, if that. And some more established companies previously existed in several incarnations and have only recently scaled up their businesses. As a result, their business models have not been "battle" tested. Some companies address their lack of experience by back-testing their lending algorithms to the historical performance of consumer assets with similar characteristics (e.g., credit cards). Although backward-looking analysis is informative, it is also limited. First, the analysis sometimes draws comparisons between two different asset types (e.g., credit cards vs. installment loans), which may have very different performance profiles in an economic downturn. Second, the next recession or credit crisis will invariably be different than the last, so there remains a large degree of performance uncertainty. Furthermore, the credit environment post credit crisis has been notably benign, making it more difficult to differentiate between lending platforms.

Marketplace lenders' operational plumbing is less developed than traditional lenders'

Operational plumbing refers to important back office services, including: collections, loan servicing, customer service and cash management. The importance of operational plumbing is not unique to marketplace lending, but it may be more amplified given that most of these companies are more focused on developing and expanding their asset originations while acquiring the capital to fuel growth. As these companies grow and seek to access broader sources of capital, including securitization, operational plumbing becomes increasingly important.

Securitization, in turn, requires yet another layer of operational discipline. Given that one of the main objectives of securitization is to separate the credit risk of the securities from that of the originator or seller, it is important that the operational infrastructure permits, to the extent possible, uninterrupted and

[3] The non-mortgage consumer debt market size according to Federal Reserve data is available here. We derived marketplace lenders' share by examining the lenders' public filings.

unmitigated securitized cash flow payments to investors, even if the originator fails. In short, the integrity of the operations backing a securitization should be built to survive the failure of the originator.[4]

However, practically all borrowers on marketplace lending platforms make payments through the Automated Clearing House (ACH) payment service, which automatically withdraws monthly payments from borrowers' bank accounts, simplifying servicing and mitigating operational risks.

Alignment of interests for marketplace lenders is not as strong

The implicit alignment of interest that marketplace lenders share with investors is weaker than that of the direct economic interest that traditional lenders/sponsors have in their securitizations. Traditional lenders that sponsor their own securitizations typically retain a direct economic interest in the performance of their sponsored securitizations by, for example, retaining subordinate notes or a residual equity interest. In contrast, some of the most prominent marketplace lenders to date have not sponsored securitizations of the assets originated through their partner banks, and thus do not directly have "skin in the game" with respect to the performance of the securitization. However, marketplace lenders interests are aligned implicitly with securitization investors because the ongoing viability of their business is predicated on the performance of loans originated through their platforms, which, in turn, serves as the collateral underlying the securitizations.

In addition, the sponsor of a securitization, which is typically the originator of the assets being securitized, makes representations and warranties concerning the assets in the securitization. However, for marketplace loan securitizations, the representations securitization investors rely on are made by an originator that is not directly involved in the securitization. Consequently, the representations in the securitization are dependent on what a particular sponsor negotiates with the loan platform operator, which may not be as fulsome as the representations typically made by a sponsor that has also originated the loans.

Marketplace lenders could face increased regulatory scrutiny

So far, perhaps because they are relatively small and new on the scene, marketplace lenders appear to have avoided the same degree of regulatory scrutiny as some of the large, traditional lenders. But that will likely change as marketplace lenders gain scale. For example, as non-bank entities, some of the most prominent marketplace lenders rely on third-party bank relationships to originate loans, which the bank typically sells to the marketplace lender two or three days after origination. In this way, the marketplace lender, through the bank partner, can take advantage of "rate exportation" laws, and obviate certain state licenses and other state-specific lending restrictions. This arrangement calls into question whether the bank or the marketplace lender is the "true lender" of the loans, a possible weak link in the transactions.

If courts determine that the marketplace lender, and not the bank, is the true lender, some of the loans originated to date would, in the worst case, be unenforceable. The uncertainty regarding the true lender status of the loans is a prominent risk factor in the prospectus and public documents of some marketplace lenders. Indeed, recent litigation has focused on the true lender status of programs of non-bank entities that use third-party banks to originate the loans.[5]

Another regulatory risk is statistical bias, which can be incrementally higher for marketplace lenders that use nontraditional and untested underwriting criteria. Lenders cannot take any action that discriminates against members of a protected class.[6] Therefore, marketplace lenders that use an underwriting model with nontraditional criteria must ensure that the model does not have a disparate impact on protected classes

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[4] See Global Structured Finance Operational Risk Guidelines, 16 March 2015
[5] See *CashCall v. Morrisey, Sawyer v. Bill Me Later* and *Ubaldi v. SLM Corp.*
[6] Categories of protected classes include race, color, national origin, religion, gender, age (40 or older) and disability.

(i.e., a discriminatory effect due to its disproportionately negative impact, even though there is no intent to discriminate).

Clearly, if the fundamental legality is questioned, even if deemed a remote risk, the marketplace lending business model falls short of traditional lending.

Data transparency is better for marketplace lenders

Marketplace lender securitizations have a notable advantage over those of traditional lenders in the transparency with which they provide their data to investors. Marketplace lenders are generally good at amassing, organizing and sharing large amounts of data, a foundational element to any securitization. In many cases, both retail and institutional investors have the access to the same (or very similar) data, including very granular (e.g., loan by loan) loan origination characteristics and loan performance statistics. This data access differentiates marketplace lenders from their traditional counterparts, who have been more guarded with their asset data.