The Rapid Ascent of Peer-to-Peer and Online Direct Lending Models: The Impact on Banking

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Yvan De Munck – Managing Director iFinTech at R.W. Pressprich and Co

Abstract
The Great Recession, increased regulation, regulatory backlash, and the decrease in consumer confidence in the banks have led to major disruptive developments in the way people and small businesses access credit, an important element to the growth of the U.S. economy. Given that more than 70% of U.S. GDP is related to consumption, access to credit is required for continued growth. As a result of the aforementioned events over the past five years, peer-to-peer and online direct lending have rapidly emerged as a solid alternative to mainstream banking and lending. It is poised for very strong growth and is likely to change the landscape fundamentally in a relatively short time. The banking sector continues to be one of the few remaining sectors where fundamental disruption can still occur as banks find themselves in a unique environment where government related institutions implement new changes, leaving banks paralyzed and unsure how to move forward. As these recent competitive forces are unlikely to reverse (barring any legislative action) the banks and other intermediaries really only have three options: join them, innovate, or die. Given that the latter is not an option (though the banking sector has gone through a phase of massive consolidation since the early eighties with less than half the number of banks left), banks and credit card companies are having difficulty determining how they will be able to beat the continuing onslaught. Joining the party and splitting the spoils to the benefit of all involved is the preferred, if not the only, realistic option for most. The concept of “collaborative consumption” is increasingly pervasive in our culture and peer-to-peer and online direct lending, it can be argued, is an expression of this new movement in which trust is the “new currency.” To win that “currency” back, traditional financial services companies will have to think outside the box, to regain their place at the top. The issue is timely, urgent, and not going away any time soon.

The views expressed here are Yvan De Munck’s personal views, and in no way reflect those of R.W. Pressprich & Co. The author would like to thank John Donovan, Peter Renton, and Charles Oliver for their contribution.

1 Rachel Botsman is a global thought leader on the power of collaboration and sharing through digital technologies that transform the way we live, work, and consume. She has inspired a new consumer economy with her influential book “What’s Mine is Yours: How Collaborative Consumption Is Changing The Way We Live.” TIME Magazine named Collaborative Consumption one of the “10 Ideas That Will Change The World.”
Introduction

“First, small businesses have insufficient access to credit, and that situation is worsening. Second, their credit performance as a group suggests that they should be getting more credit” (Renaud Laplanche)

“Bank 3.0 – Why Banking is no longer somewhere you go, but something you do” (Brett King)

As markets are hitting new highs, the Federal Reserve is reluctant to aggressively taper its stimulus package and the economic outlook is murky at best. The Fed must continue to accommodate multiple constituencies, even under new leadership. While the Fed continues to see its actions as “data-dependent,” risks are ever increasing: inflating financial assets, nervous market participants who could respond aggressively upon any hint of further tapering, low long rates that could be at a turning point, and subpar economic growth rates and unemployment levels close to all-time record high of 2.3 trillion. What are the banks doing with that enormous liquidity? The answer is: nothing. Banks simply put that money back where it came from: at the Federal Reserve (Fed). They chose the Fed deposits paying 0.25 percent, instead of earning 4.5 percent on new car loans, or 10 percent on two-year personal loans.6

The funds U.S. banks had available for lending to businesses and households increased last month (October 2013) by $95.8 billion to an "all-time record high of $2.3 trillion. What are the banks doing with that enormous liquidity? The answer is: nothing. Banks simply put that money back where it came from: at the Federal Reserve (Fed). They chose the Fed deposits paying 0.25 percent, instead of earning 4.5 percent on new car loans, or 10 percent on two-year personal loans."

Weak bank lending continues to be one of the main culprits for the current situation, with loan growth rates far below where they should be at this point in the cycle. At the same time however, non-bank lending is growing at close to 10% per year, driven by alternative finance companies, credit unions, and, increasingly, peer-to-peer (P2P) and other online direct lenders. This is where it gets interesting. This is where we need to pay attention.

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At the same time, we continue to see that both consumers and small businesses have increasing difficulty accessing credit, which seems to be one of the reasons this economy is nowhere near its ideal growth rate. This is especially odd given that the main banks in the U.S. are once again bigger and more flush than ever. So what is happening and why?

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Since 2007, U.S. companies such as Lending Club and Prosper Marketplace have been slowly but steadily building solid alternatives for creditworthy consumers (and small businesses) to deal with the issues mentioned, and are now coming to the forefront, with rapid growth and massive opportunity all but guaranteed, as we are still at ground zero. Considering the following8,9 (see Figure 2).

Lending Club generates over $250m of unsecured consumer loans every month, and is more than doubling its loan volume each year. With $2.2 billion in outstanding debt, Lending Club already can be considered a massive opportunity all but guaranteed, as we are still at ground zero. Considering the following8,9 (see Figure 2).

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Prosper, the number two player in the market, and under new management, is growing even more rapidly, but from a much lower base. Other peer-to-peer and online direct lending platforms are emerging, anticipating continued growth in the market and benefitting from a favorable financing environment. This new generation of finance companies is being complemented by dedicated service providers that are helping to scale the industry: consultancy firms (Orchard, NoteX360, LendingRobot), law firms (a considerable number of with dedicated in-house expertise), secondary market platforms (FolioFN), lobbying and industry groups (Crowdnetic/NowStreetWire, CFIRA, Crowdfund Capital Advisors), blogs (LendAcademy; LendingMemo), and asset managers (Eaglewood, Emerald, Lending Club Advisors, Direct Lending Investments, Colchis Capital, etc.), both private and soon to be publicly listed vehicles in the U.S. and in Europe.

Outside the U.S. we see similar developments, but on a smaller scale. The U.K. is the most developed marketplace, with Zopa, the first peer-to-peer lending company, having developed the concept in 2005, closely followed by companies like RateSetter and FundingCircle (small business loans). All of these companies are performing well and growing rapidly. Even more telling, FundingCircle has been on the international acquisition path, announcing its U.S. entry via a merger with Endurance Lending Network in October 2013.

NESTA, a U.K. “innovation charity” has published a comprehensive overview of the current situation in the U.K.\(^\text{12}\), including details regarding market size, market growth, SME finance, and future projections. The conclusions are most interesting:

The U.K. alternative finance market:
- Grew by 91% from GBP 492 million in 2012 to GBP 939 million in 2013, with an average growth rate of 75.1% over the last three years.
- Contributed GBP 1.74 billion in personal, business and charitable financing to the U.K. economy.

Peer-to-peer lending generated GBP 287 million, peer-to-business takes GBP 193 million, and the balance was generated by invoice financing/trading platforms, equity crowd funding, and rewards/donation based crowd funding.

Collectively, with high growth rates year on year, the U.K. alternative finance market provided GBP 463 million of early stage growth and working capital to over 5,000 start-ups and SMEs between 2011 and 2013. It is predicted this will grow to GBP 1.6 billion in 2014 and provide GBP 840 million of business finance for start-ups and SMEs (see Figure 3).

We also have emerging players in Germany, Sweden, France, Australia, Mexico, China, and many other places, following in the footsteps of Lending Club, a clear leader in the industry.

In the meantime, institutional money is steadily finding its way into this newly investable asset class, with good reason. Given the increased financial repression caused by extended ZIRP\(^\text{13}\) and other policies, many yield hungry investors are discovering that there is a place where yield can be generated: peer-to-peer and online direct lending. A brief overview of the most recent news flow will illustrate the point:

- “Prosper Raises $25 Million in New Round, Adding BlackRock as a Backer”\(^\text{14}\) (9/24/2013)

13 Zero Interest Rate Policies
What is peer-to-peer and online direct lending and who are the actors?

Peer-to-peer lending, as it is more commonly known, can be considered a subset of a wider phenomenon, known as online direct lending. Online direct lending is less well-known than peer-to-peer lending, but potentially much more important to the development of this new finance industry segment, for reasons described below (see Figure 4).

We should first refer to another rather new development called “crowdfunding.” With companies like Kickstarter and Indiegogo, people have become familiar with the concept: raise large amounts of money in small increments to fund upstarts, ideas, causes, etc. by going directly to the “crowd” instead of banks or other classic financial intermediaries. This involves asking for little amounts from a large number of people, rather than one big amount from one big institution. Because borrowing from traditional financing sources works relatively well for large companies, but not as well for consumers and small businesses, the crowd funding idea has taken off and has resulted in many examples of successful campaigns:

1. Pebble Watch, in May 2012, raised $10.2 million on the Kickstarter platform. The Pebble is an e-Paper watch for iPhone and Android.20
2. Star Citizen, a video game development company, in November 2012, raised over $2 million via Kickstarter17, and has continued to raise additional funds outside of that platform as well.
3. Oculus Rift, a VR accessory company, finished its raise in September 2012 on Kickstarter for $2.5 million.22
4. Scanadu Scout, the first medical tricorder, in July 2013, successfully raised $1.7 million through the IndieGogo platform.23

Crowdfunding, while still relatively new and in full development, can be seen as having three distinct subcategories (see chart above – we note that there has not yet been a real consensus developed with regards to this classification):

1. Donation-based crowdfunding
2. Reward-based crowdfunding
3. Equity-based crowdfunding

In the past two years, a relatively marginal development in the alternative finance space has developed into the current situation in which both retail and institutional interest is enabling the alternative lending business to grow at an exponential rate.

So what is the buzz all about, and why is it important?
Crowdfunding

- Donation based and rewards based (at times considered two separate categories),
- Equity based crowd funding,
- Debt based (peer-to-peer and online direct lending) crowd funding.

In the past, it has been donation and rewards based platforms such as Indiegogo and Kickstarter that were covered most by the media. More recently, however, as the JOBS Act24 came into effect in April 2012, the focus has turned to equity crowdfunding. In addition, new regulations on the subject are starting to change the landscape radically and fundamentally, giving companies a potential new way to access (growth) capital in a less onerous and more practical way.

However, it’s been the debt based vertical (peer-to-peer and online direct lending) that has silently been the poster child for this radical new way of accessing funds for both individuals and businesses. And in the U.S., two companies make up more than 95% of the consumer (peer-to-peer) lending market: Lending Club and Prosper Marketplace.

Lending Club, the major player in the space, was started in 2006 by Renaud Laplanche, based on the idea that there must be a better way of giving creditworthy borrowers a better deal on interest rates than bank offerings to customers at the time. While Zopa in the U.K. had already pioneered the idea of matching creditworthy borrowers directly with individual lenders and investors in 2005, Lending Club (and Prosper Marketplace, which actually started in the U.S. before Lending Club) understood quickly that there was a big opportunity to become a leading player in the further disruption and disintermediation of a particular segment of consumer finance, matching borrowers and lenders directly through an online marketplace. It’s no coincidence that Lending Club at times refers to its model as the “Ebay” of finance. To show how a transaction works, we refer to the illustrations above25,26 (see Figure 5).

What started as a small, simple idea has now evolved to a rapidly growing industry, with many potential up and coming companies27 getting financing. Also, while the initial focus has been the consumer credit space, more recently the model has been adapted for other asset classes. Mortgages, student loans, small business loans, car loans, and other asset classes are all increasingly being offered through online direct lending platforms, taking out the middleman (the bank) and giving back that margin to both the borrower (in the form of a lower rate) and the lender or investor (in the form of a higher yield). The following are examples for each category:

26 LaPlanche, R., 2013, Keynote speech, presented at Lendit 2013, a conference held at the Convene Innovation Center in New York City on June 20th. Available at: http://www.youtube.com/watch?v=DxGLMSYODsk
27 According to some, more than 50 debt based platforms are active on a global scale, with more than 177 peer-to-peer and/or online direct lending platforms currently active: http://www.thecrowdcafe.com/crowdfunding-platforms/database/
Consumer loans:
- Lending Club, Prosper, Zopa, RateSetter, Auxmoney, Lendico, TrustBuddy, Pret-d’Union, Freedom Financial Network

Small business loans:
- FundingCircle, IOU Central, On Deck Capital, DealStruck, Kabbage, Lending Club, Fundation

Student Loans:
- SoFi, CommonBond

Mortgages:
- RealtyMogul, LendInvest

The operating expense ratio for banks servicing a loan portfolio (including items such as rent, salaries, marketing, and legal), is between 5% and 7%, while it is below 2% for companies such as Lending Club, and declining as the business continues to scale. Needless to say, this is a massive difference that is very difficult for traditional banks to easily overcome. Importantly, even with the current expense ratio, the traditional banking model continues to be a very profitable business, mainly because considerable revenues are generated by various types of fees, effectively rewarding transactional “friction.” With Lending Club, on the other hand, the interest with the customer and consumer is clearly aligned, eliminating much of the friction from the transaction, which leads to a much lower cost model.

To understand the difficulty of the task at hand for banks consider the following:
- According to a recent McKinsey study in which consultants analyzed how Lending Club is driving costs out of the system, they concluded that the company has a 425 basis point advantage over traditional banks, primarily driven by operating leverage. It is the main reason why Lending Club can offer better rates to both investors and borrowers.

A second issue is cultural, in that large financial institutions (actually now larger than before the Great Recession) cannot react easily, if at all, to the change coming from the ground up, driven by lean and mean and legacy free upstarts, who redefine how many of their core services are being offered. There is the physical branch network to manage and support, although the number of transactions that require branches have continued to decrease over the years.

Related to that is the fact that most of the classic players have to work with complex legacy systems that are increasingly difficult to manage, support, and change to accommodate an increasingly mobile population, looking for instant gratification and a “wow” factor, including in their financial transactions. This development has also given birth to some great new bank franchises like Moven and Simple, redefining what a bank is and does in today’s market.

Brett King, a visionary thought leader on banking disruption and CEO/Founder of Moven, a mobile only digital bank, will tell you that “banking is not where you are going, but it’s something you do.” I have had the pleasure of speaking with Brett about his vision for the future of banking, and have been both shocked and impressed. Shocked, as he puts into very clear focus the major issues traditional banks have to solve. And impressed as it relates to his vision of the future of banking, which I now share. One does not need much imagination to appreciate the potential impact of the changes ahead.

A final point on the issue of culture is the people factor. Both the users of the capital (the borrowers) and the providers (the lenders), are increasingly going “direct” in everything they do. As a result, both are having a very difficult time understanding the value proposition of classic intermediaries. Current leadership and employees at the classic players are being bogged down by legacy issues, technological and psychological, and are not able to absorb what’s happening in the real world, with a younger generation that seeks instant gratification at all times, and will not hesitate to switch providers.

Lending Club’s Renaud Laplanche, in a recent interview, when talking about the banking culture and why it’s going to be difficult for these big banks to make the necessary changes, lists three factors:

1. Physical infrastructure (branches): with this big cost factor, it is difficult to see how they are going to get leaner quickly,
2. Systems: expensive legacy systems versus lean, state-of-the art, purpose built platforms,
3. Culture: the kind of people that work for a bank are very different in mindset compared to people that work for the new platforms, ready to change the world.

How big is the opportunity and what drives its growth?

Most, if not all, of the bigger platforms have been backed by large and well known VCs:
- Lending Club: Kleiner Perkins Caulfield & Byers, Google, Foundation Capital, Canaan Partners, Norwest Venture, Morgenthaler Ventures
- Prosper Marketplace: BlackRock, Sequoia Partners
- Orchard: Spark Capital, Canaan Partners, Brooklyn Bridge Ventures, Conversion Capital, Vikram Pandit

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28 LaPlanche, R., 2013, Keynote speech, presented at LendIt 2013, a conference held at the Convene Innovation Center in New York City on June 20th. Available at: http://www.youtube.com/watch?v=DxGLMSvDk
29 “With a 4% average annual decline in branch traffic over the past 16 years, banking is the next natural domain to fail … the competition among online banks, particularly from names like Ally Bank and ING and Everbank, is likely to cut into margins (…) Chris Steiner – Digital Bank, 2013 – p. 41.
The Capco Institute Journal of Financial Transformation

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P2P and online direct lending represents only a very small fraction of a very large base. In the first phase, these platforms are focusing exclusively on prime and super prime consumers (only a fraction of the total), so one could argue that there will be an impressive growth opportunity for years to come. The opportunity therefore continues to be nothing short of sizable, with 100% plus growth per annum anticipated, in a very large market which continues to grow as well. Another major reason for these numbers is the fact that consumer lending in the U.S. is an oligopoly in which four banks represent 80% of all unsecured consumer debt, so with very little incentive to change an existing and very profitable business model.

On the small business side, the numbers are equally compelling and large\(^3\), as discussed by Renaud Laplanche\(^2\) in his most recent testimony. In a survey released by the Federal Reserve Bank of New York in August 2013, a grim picture regarding the situation for small business lending was illustrated as follows. Out of every 100 small businesses, 70 desired financing. Of those 70, 29 were too discouraged to apply. Of the 41 that applied for credit, only 5 received the amount they wanted. 93% of these businesses were looking for $1 million or less in capital.

He continues by pointing out that the situation has deteriorated further, with the overall volume of loans of more than $1 million having risen slightly since 2008, loans less than $1 million having fallen by 19%, and the number of small businesses with a business loan falling by 33% from 2008 to 2011. The problem is also worst for the smallest businesses, with the smallest of them all (businesses with two to four employees) down 33% from 2008 to 2011.

However, alternative financing options are increasingly available. From the same survey we find that “online lenders and merchant cash advance providers are the fastest growing segment of the SMB loan market – recording a 64% growth in originations in the last four years.” As many of these companies charge fees and rates resulting in APRs north of 40%, it is clearly an unsustainable and unhealthy situation for companies in both the short and long term. Once again, peer-to-peer and online direct lending are coming to the rescue. As an asset class, charge-off rates on (secured) small business loans have been below 1% since March 2012 (compared to a peak above 10% for consumer credit cards during the financial crisis)\(^3\).

Therefore, the quality of the asset class cannot possibly be the reason why classic banks are not lending the way they should. The reason is more structural. Incumbents have a legacy cost structure that needs large ticket items to be properly amortized which cannot possibly be achieved by actively engaging in small business loan sourcing, underwriting and servicing. Banks still go out of their way to write large loans to large businesses, but have lost interest in doing anything else because it’s no longer profitable. And don’t managers have regulators and shareholders to please?

Again, peer-to-peer and online direct lending come to the rescue.

So what we’re witnessing is exactly the same as what we’ve seen in so many other markets that have already been disintermediated by the internet: travel agencies (now Expedia, Travelocity), book stores (from Borders to Amazon), record/music stores (Spotify, iTunes), video rental market (from Blockbuster to NetFlix), hotels (Airbnb).

In a keynote speech earlier in the year, the following slide was used to illustrate exactly how other technologies have been transformational, at first being rejected and ignored flat out by incumbents, only to be widely adopted at maturity. We return to this concept later in the text\(^3\) (see Figure 6).

Where are the banks?

Many businesses and consumers have lost trust in the banks, but they are now bigger than ever, and focused on larger transactions with large companies. There are many reasons for this trend: increased regulation (Dodd-Frank, Basel 3, Card Act, etc.), risk aversion, and large bank consolidation that began in the early 80s, to name a few.

“Banks have been exiting the small business loan market for over a decade. This realignment has led to a steady decline in the share of small business loans in banks’ portfolios (the fraction of nonfarm, nonresidential

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1. Regulatory issues make it such that most of that market is actually non-bank lending, at least on the unsecured side, driven by alternative lenders such as Capital Access Network, Kabbage, On Deck, together with numerous merchant cash advance and factoring companies.


loans of less than $1 million – a common proxy for small business lending since 1998, dropping from 51% to 29%. The 15-year-long consolidation of the banking industry has reduced the number of small banks, which are more likely to lend to small businesses. Moreover, increased competition in the banking sector has led bankers to move toward bigger, more profitable loans. That has meant a decline in small business loans, which are less profitable (because they are banker-time intensive, more difficult to automate, have higher costs to underwrite and service, and are more difficult to securitize).35

We have shown that traditional lenders are increasingly less present and supportive of unsecured consumer credit and secured small business lending, two key drivers of the economy. This helps to, at least partially, explain why the growth rate of this economy has been below the historical trend since the latest recession began in 2008, with substantial long term consequences in terms of lost productivity and diminished wealth and opportunity.

We have also shown the effects of alternative players entering the market, rapidly taking the place of established players, and once consumers and small businesses are introduced to this new financing, they are unlikely to go back to traditional financing. And while it still very early in the process and we’re starting from a very low base, there is still time for traditional lenders to adjust, and actively engage in developing the business, in close collaboration with the new market entrants.

Let’s first analyze more in detail what has ailed the banks and other traditional lenders over the last few years.

Brett King, referred to earlier, is a recognized thought leader on the subject of retail banking disruption and evolution. In his most recent book, he states the following: “By this new measure, a customer’s assessment of a service provider in the retail banking or financial services space will not be capital adequacy, branch network, products or rates. It will be how simply and easily customers can access banking when they need it, and how much they trust the partner or service provider to execute.”36 With traditional NPS scores in the tank, it appears banks and other traditional financial services providers have a long road ahead just to gain back that critical element that is lacking: trust. Those providers continue to value large businesses over small businesses and consumers.

Chris Skinner is another highly regarded visionary with regards to the future of companies who serve the financial markets (he is Chairman of The Financial Services Club, U.K.). In his most recent book, he goes even further stating: “This is the new augmented reality of customer intimacy through Big Data analysis, and bank retailing will be based upon the competitive differentiation of analyzing mass data to deliver mass personalization.”37 In other words, with banks being just bits and bytes38, the future lies in the hands of those who understand this radically changed landscape. The incumbents must adapt if they want to stay relevant.

It is worth revisiting a transaction earlier this year involving both Lending Club and Google. In May 2013, it was announced that Google was the lead investor in a $125m secondary funding round, taking around a 7% stake in Lending Club. Importantly the investment was made by Google directly, and not through its VC arm, Google Ventures. Google Ventures provides seed, venture, and growth-stage funding to companies that are not strategic investments for Google. Therefore, their investment in Lending Club is strategic in nature. And when one of the most admired and powerful companies gets involved with a category killer like Lending Club, one can imagine many exciting possibilities. At the time of the deal, and even in recent conversations, the CEO of Lending Club indicated they were talking about all kinds of “cool stuff” that could be developed in a joint effort, without any further detail. He did point out, however, that they were intrigued by the kind of disruption Lending Club is causing in the banking industry, not dissimilar to what Google has done to disrupt advertising by making it more efficient, more transparent and more consumer friendly.39

36 King, B., 2012, Bank 3.0: Why banking is no longer somewhere you go, but something you do, New York: John Wiley & Sons
38 “Banking is just bits and bytes.” A quote from then Citibank CEO John Reed, as reported by Chris Skinner in Digital Bank (see note 32)
Imagine the following scenario:

You are in the market for a new car, but haven’t explicitly expressed this desire to the outside world yet. Actually, you may have done so unintentionally. As you have first researched the market online, the system (most likely Google) already knows you are in the market for a car. Next, you are planning to go to a local dealer, the address of which has already been suggested by Google as it knows where you live and where you travel (location based services). When you enter the dealer, you’ll be prompted on your smartphone, through a dedicated app, with the latest information regarding the car you are considering. This puts the consumer on equal footing with the sales person. We have moved on from caveat emptor to caveat venditor, with important implications for the whole sales process. You will know how to ask the right questions and how to negotiate because you’ll be coached and armed with relevant data, including the dealer’s profit margin. Then, when it’s time to talk about price, your smartphone will ping you and tell you that you are pre-approved, no questions asked, for a $15,000 car loan right there, just by pressing the green dot in the middle of your screen.

The whole process is fluid, frictionless, and eerily efficient. In fact, you don’t even realize that in the background, it’s effectively a Lending Club or Prosper loan that’s being offered to you at the most competitive rate. When accepted, the loan is immediately funded by hundreds of peer-lenders who are dying to get a piece of your high yielding, secured car loan. It all happens in minutes, perhaps even seconds, without friction, at the lowest possible cost. No paper, no phone, no desktop nor laptop – just a smart phone. That is the kind of experience, or a variation of it, that we’ll be having in the very near future, courtesy of a Lending Club/Google or other inspired combination. Some will argue this is “creepy,” I would argue that, when well executed, it’s the best of all outcomes. The right offer at the right time and location, at the best possible terms, designed around you and only you, and the Holy Grail for direct marketers who now see one to one marketing redefined.

Another most recent and radical example is the announcement that Lending Club is talking to large banks and corporations about opening up its platform to offer loans to employees of large companies as part of a human resource benefit and a potential recruiting tool. Indeed, what would be better than to have companies offer this novel service as a perk to employees who qualify, thereby increasing employee loyalty? Employees could use the loans to refinance credit card debt and student loans, or otherwise finance discretionary expenses, with payments being automatically deducted from paychecks. The companies could finally put their large cash balances to work in a more productive way by funding these loans, and could price them even more competitively by funding the origination fee as well, for example. Lending Club (and others) would handle the processing, underwrite, and service the loans, add a new business opportunity to their growth story, and continue to redefine consumer finance.

The bottom line is that traditional banks and finance companies are being disintermediated quickly, by smaller, more nimble competitors. So how should a traditional bank respond?

What can and must be done by the establishment players, if at all possible?

While it will be difficult for traditional banks to change their practices due to general inertia, size constraints, regulation, culture, legacy systems, etc., there are ways to participate in this big shift in the landscape. In June of this year, two community banks announced that they would team up with Lending Club to source new consumer loans, in a clear sign of “old meeting new.” Titan Bank from Texas and Congressional Bank in Washington began buying loans originated by Lending Club. Titan Bank also announced that it would start offering personal loans to its customers through the platform. In his most recent recorded testimony, Renaud Laplanche, CEO of Lending Club, indicated there are now seven such entities active on the platform which indicates that five more have joined since then. This is only the beginning, Lending Club (and other similar players) are bringing a low cost operating model to consumer lending, and for reasons mentioned earlier, classic banks do not have the ability to successfully compete with this development. What they can and do bring to the table is a combination of low cost of funds (that ultimately will need an adequate rate of return) and a captive local customer base (in the case of regional/community banks).

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40 For more compelling arguments on why these trends are unstoppable: http://www.youtube.com/watch?v=R430lKyrGbU
Another way for banks to participate is to utilize these platforms, which will in turn drive the growth of loan origination. Platforms like Lending Club and Prosper (and others pretty soon to follow) are technology companies first, interested in scaling the business as quickly and efficiently as possible, as they make money on the volumes (through origination fees and servicing fees). Highly effective matching machines, they do not take balance sheet risk, as the loans are transferred immediately to the lender upon funding in a seamless transaction. Instead of these platforms taking the entire burden of loan funding upon themselves (customer acquisition), they are increasingly turning to outside managers to help them speed up the process. At this point, we should welcome the institutional money or asset managers looking to deploy larger amounts of money, in addition to the retail investor base today.

Let’s compare it with the Apple Store with its app ecosystem. Early on, Apple understood the power of a large ecosystem (of apps and developers) to exponentially grow the business. It focused on helping “outside managers” – in this case, app developers, to develop compelling content utilizing the Apple platform. Because they were planning to take a 30% cut of every transaction, they projected this approach would lead to very large profits. This approach has made Apple one of the most highly valued companies in the world. And Apple continues to push for more developers to develop original, cutting edge, content and apps, as this is at the core of its profit model.

I believe it will be somewhat similar with online direct lending platforms. Early on, some of the players understood that in order to scale the business, they would require institutional capital. This is where outside managers come into play, helping to bring large and reliable money flows to these platforms on a consistent basis. Some of these managers are directly or indirectly backed by traditional bank assets, and are accessing this asset class through another channel. The platforms themselves are not concerned with who buys the loans – they simply desire more and larger buyers on a consistent basis so as to predictably scale the business. They care about the volumes (and the quality of the assets) first, and less about the ultimate buyer. Bigger is better, as the business is very scalable, and becomes more profitable as it grows, and can accommodate larger amounts of investment money. Over the last year, the balance has dramatically shifted from too many borrowers and not enough lenders/investors to the clear opposite.

Money managers dedicated to online direct lending will see growing commitments from institutional investors looking for efficient access, in size, to this newly investable asset class, which will drive continued dramatic industry growth for the foreseeable future.

With banks being just bits and bytes, a lot of what used to be the core functions of any banking institution can now be outsourced to third party platforms that are each much better at that particular activity, and can deliver services more quickly and at a much lower cost44. Banks and other classic intermediaries are left with cheap funding, a desperate need for return in a quasi-zero real return environment, and in case of the regionals, proximity to its core client base. And as we have seen earlier, there is a clear opportunity for these players to actively engage in the online direct lending space, not by trying to copy the business model internally but by proactively seeking out the members of the ecosystem and starting a conversation about ways they can bring value to the table. They can also go directly to the platforms, like some regional banks have done. Maybe we’ll see an opportunity for revival of smaller, regional banks to come out strong and use the opportunity to take back market share.

One could also consider setting up a new proprietary platform, as the market is big enough to accommodate more than the current two large players. However, there are some serious barriers to entry:

- High financial and opportunity costs, as it takes time, money, and effort to get a competitive platform up and running, and create/validate a model,
- Regulatory burden – state and federal,
- Cannibalizing their own core business,
- Cultural mismatch (there needs to be a buy-in from senior management, which takes time),
- Lack of “coolness” factor (see NPS scores – many people will never again trust banks the way they did before).

**So what can go wrong?**

As the market grows, a number of commentators are sharply criticizing these new companies. It is worthwhile to review some of the arguments against these new platforms.

The first argument is that peer-to-peer and online direct lending are gimmicks and just another form of “shadow banking.” In positive sense, this is not a new business per se, but more a new iteration of an existing core activity of a bank, i.e., lending to creditworthy individuals and businesses. By taking “friction” out of the transaction, its cost is dramatically reduced, thereby achieving two goals: lowering costs for borrowers through lower rates and attracting funding capital from lenders and investors through higher rates. Lowering transaction costs while keeping the core proposition unchanged is good for all parties involved.

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44 See also Fred Wilson, managing partner at Union Square Ventures, talking about three trends for the next 10 years: transition from bureaucratic hierarchies to technology driven networks; unbundling; and nodes on a network all the time, with money one of the big sectors impacted by it [http://www.youtube.com/watch?v=Fe430kYz0uH8]
Another argument revolves around the concept of “skin in the game.” Indeed, at this time, most of the platforms act like match makers and don’t keep any of the risk on their books. Critics argue that platforms are not concerned about the performance of the loans (though longer term reputation is a key element here, which can be seen as a counter argument). While a number of players will develop models whereby the loan portfolio may (partially) be kept on the books, it’s important to appreciate the fact that trust and reputation is more important than ever in this business. It’s comforting to see that these platforms have been extremely transparent in terms of the kind of information that they disclose both on the corporate level and on the loan detail level. Also, with high visibility and scrutiny, these players have been making sure that the performance track record (in terms of the performance of their loans) is solid, over a multi-year period.

Thus far, loan performance is strong, supporting the idea that management is ensuring that they continue to be the best at what they do: sourcing, underwriting, matching, and servicing loans45. Indeed, we see some of the best players in the industry in charge of the credit and risk departments at these platforms. However, as some of the platforms go public, and gain a different set of shareholders, there is always a risk that prudent underwriting may decrease in order to achieve new growth targets. It will be necessary to follow developments in this respect carefully and be vigilant about weeding out underperformers.

From a macro perspective, we must mention the credit cycle. When the next recession hits, it will be interesting to see how well the new platform credit behaves, primarily influenced by the level of unemployment (in the case of consumer credit). It would be good to see a mature and liquid secondary market having developed by then, in order to partially hedge that risk. There is always regulatory risk as well, though so far, it has been well managed. Indeed, the main players in the space have been making great efforts over many years to work with the regulators and agree on the shape and form of the core business practices. Conceptually, the regulators should continue to be supportive of the development of the sector, as it is beneficial to both consumers and small businesses (with increased access to credit at affordable rates), and lenders or investors, in the form of a higher yielding fixed income investments.

In a recent op-ed46, Sheila Bair, former Chairman of the FDIC, weighs in as well, supporting increased regulation at the state level, specifically related to the issue of potential fraud and other dangers related to the industry. This is a clear sign that the business is maturing.

Conclusions

Peer-to-peer and online direct lending have been scaling rapidly in the last few years. They are poised to accelerate further this year, on the back of a highly anticipated Lending Club IPO (and maybe others overseas), further institutional investment interest, and a much higher awareness of the opportunity for all other market participants. Brand recognition through public awareness will draw more people in, and the concept will steadily become more mainstream. Many more interesting business models will be developed and funded in an effort to capture the momentum, with some of them failing to get traction. However, a substantial number of them will likely become very successful. An increasing number of banks (mostly small and regional banks at the start) will look to partner, at times in creative ways, with the leading platforms in the space, which will lead to some surprisingly creative business models. (For instance, imagine the impact of a Lending Club, a Google, and a Moven combined on your smartphone). Expect a slew of ancillary products and services to be developed, helpful to those who are looking to get involved and need tools. There will be more activity in different asset classes, securitizations, secondary trading, indexes, ETFs, new fund variations, mutual funds, industry publications, blogs, and websites. There will be more cross border initiatives and hybrid structures seeing the light of day, and the public will slowly but surely realize that something is afoot. Smart money has already found a way, but as the sector and the opportunity grows, more investors will get involved.

Banks and other classic financial institutions, still frozen after five years of recovery, may start to look at the opportunity set and research ways to participate. For reasons explained throughout, they will likely find it difficult to come up with in-house solutions and conclude that there are better alternative ways to get into the action. Low funding costs coupled with customer connectivity at the local level is a powerful combination, so teaming up in some shape or form (white labeled or not) with some of the platforms seems likely. In the near future, today’s children will not be on the lookout for a bank branch just as today’s teens are no longer familiar with the alien concept of “landlines”.

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