MARKETPLACE LENDING FOR INSTITUTIONAL INVESTORS AND WEALTH MANAGERS

An Overview 2017

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Since 2014 when we published "P2P Lending for Institutional Investors and Wealth Managers: An Overview" about investing in peer-to-peer lending, the industry has continued to grow and evolve, so the timing seemed appropriate to provide an updated overview of the industry.

Not only has the lending volume increased, but the types of loans have expanded to include consumer loans, small business loans, student loans, auto loans and real estate loans.

Contrary to popular belief the peer-to-peer phrase was not derived from individuals lending directly to a borrower. But instead, it came from the technology term of peer-to-peer networks where computers were connected directly to each other via the internet. Therefore, a central server was not needed because both computers played an equal role in their function. Hence peer-to-peer.[1]

Alternative lending offers borrowers more opportunities to borrow and potentially at a lower cost. Investors are finding the potential for consistent risk-adjusted returns that complements their portfolio. The investor base (lenders) has shifted from primarily individual investors to mostly institutional investors. The shift from numerous small suppliers to a smaller number of large suppliers is not exclusive to MPL as other online markets are also experiencing this shift. In 2014 the name of the industry began to change from P2P lending to Marketplace lending (MPL), at least in the US, as the industry shifts from startup to growth phase.

In his article "The Evolving Nature of P2P Lending Marketplaces", Matt Heiman notes "on eBay, power sellers control a disproportionate percentage of transaction volume" and "Airbnb in New York City, the 6 percent of hosts with more than three rooms (i.e., commercial users) accounted for almost 40 percent of transaction volume."[2]

WHAT IS MARKETPLACE LENDING?

Marketplace lending may be a new concept for many investors, however the industry began over a decade ago. In 2005 Zopa began in the UK. In the US, Prosper took root in 2006, followed by Lending Club in 2007.[3]

At its core MPL is simply the centuries-old traditional transaction of lending funds. Historically a bank/ financial intermediary loaned funds directly to an individual or entity. The borrower physically went from one bank to another to find a loan, filling out an application at each bank. MPL differs from the traditional lending for three specific reasons:

1) The lender could be one or many individuals/ entities lending funds to one borrower. Single lender loans are called whole loans. Multi-lender loans are fractional loans where several lenders will fund a specific percentage of a given loan. The borrower applies once on a MPL platform. If accepted, the borrower has the opportunity for numerous investors to view their request to potentially fund their loan.

2) The transactions are completed on an online platform. One may think of a platform as a location (in this case a virtual location). The platform resembles the function of an exchange where market borrowers and lenders may find each other to complete a transaction. Marketplace lending is an example of the growing disruption in finance due to improving technology -- also known as "fintech". The technology allows for economies of scale to grow.

3) MPL decisions tend to occur faster than those of a traditional intermediary. The lending decisions are often made within 72 hours.[4] Technology is an important factor for data analysis and underwriting assessments.

The evolution from the term "P2P" to "marketplace lending" is a logical progression as online platforms are markets for lending transactions. The spectrum of funding sources includes individual investors, hedge funds, institutional investors, and banks.[5] An estimated 80% of the lenders on the platforms are now institutions.[6]

The Federal Reserve Bank of San Francisco noted the lending of funds via P2P does not go directly from the lender to the borrower. The mechanics of the online platforms include: "Platforms either: (1) broker loan reimbursements through interest-free investments; (2) broker the sale of securities backed by their issuers; or (3) facilitate the origination of loans which are sold as securities to P2P investors who behave like lenders (and who may not even realize the nuance)."[7]

Once the loan is originated, the platform services the loan and distributes funds to investors. The platforms usually have in-house collection teams to handle recent delinquencies and contract third party collection agencies for payments more than 30 days late.[8]

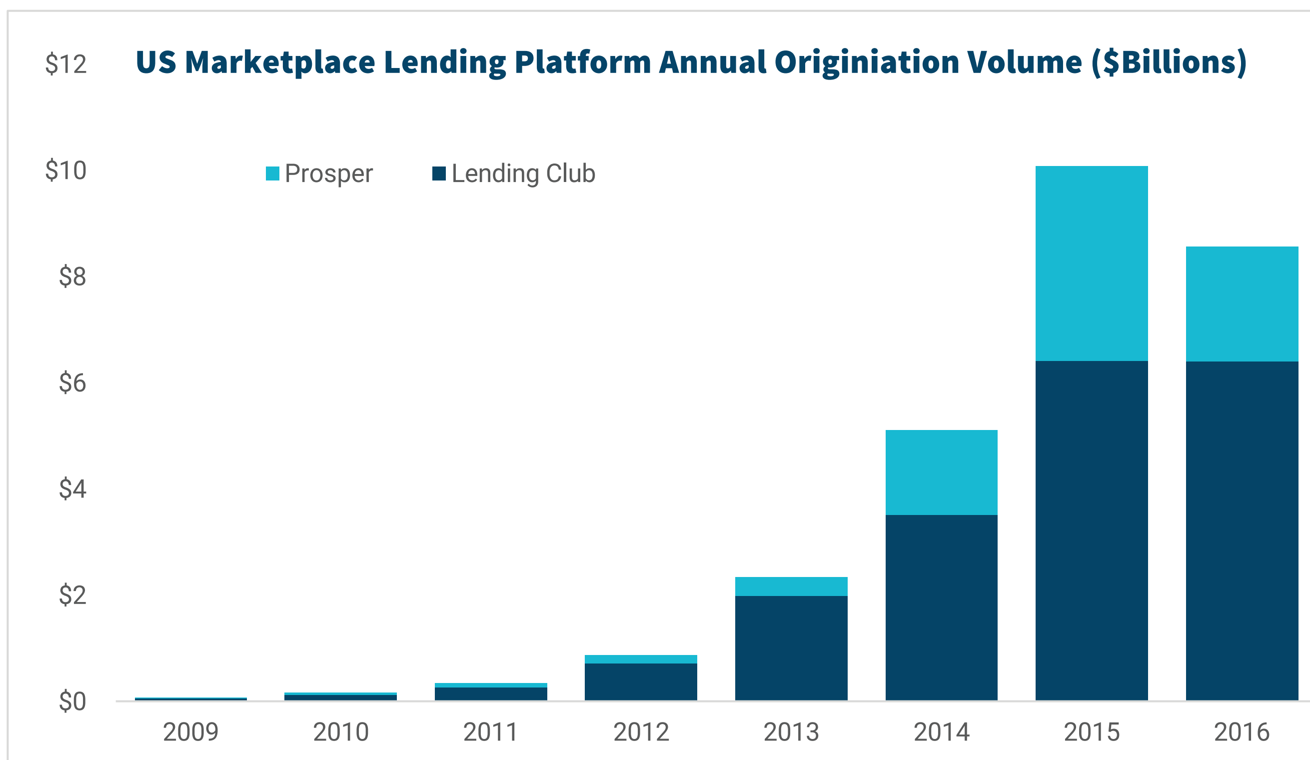
GROWTH OF LOAN ORIGINATION

The UK originated £3.20 billion in loans in 2016, an increase of 39% from £2.3 billion in 2015 and £1.9 billion in 2014.[9]

Prosper and Lending Club are two of the largest marketplace lending platforms in the US. As noted in Chart 1, the industry continues to grow as Prosper and Lending Club's annual origination volume (in dollars) grew by 97% in 2015 to $10.08 billion from $5.1 billion in 2014. To put this in perspective, Chart 2 demonstrates how consumer credit has expanded since 1969. The deleveraging of credit in the post-financial crisis now appears as a correction of a multi-decade credit trend. The Federal Reserve Board estimated total outstanding consumer credit (seasonally adjusted) as of December 2016, at $3.7 trillion giving MPL room to grow.[10]

Chart 1: Marketplace Lending Annual Origination Volume ($Billions)

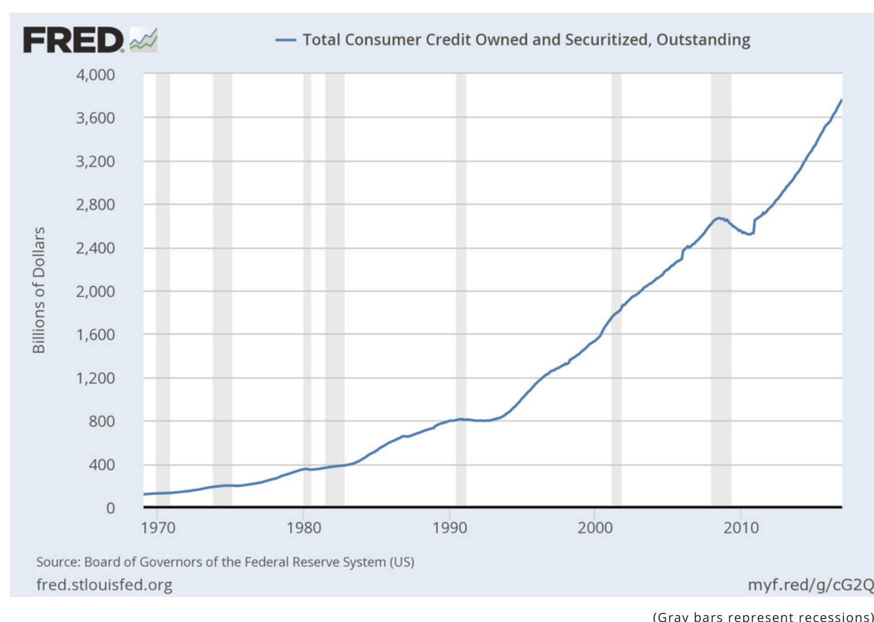
An estimated 24% of US personal loans in 2015 were originated on MPL platforms, thus indicating another metric of growth.[11]



SOURCE: www.nsrplatform.com, www.lendingclub.com, MonJa

After a reduction in loan origination growth in early 2016, it began to move higher again in Q4. Lending Club's loan origination in Q4 2016 experienced a low single digit increase from the previous quarter. However, per MonJa, Prosper's Q4 increased by an estimated 45% from Q3. Transparency Market Research notes small businesses and students (student loans) are growing demographic sectors of borrowers on these platforms due to an easier application process and potentially lower loan rates versus traditional lenders. Both sectors should assist the long-run growth of the industry.[11] Global P2P lending was estimated at $26.6 billion in 2015 with the potential to reach between $150 billion and $400 billion by 2020 and over $890 billion by 2024.[12]

Chart 2: Seasonally Adjusted Total Consumer Credit Jan. 1969 to Dec 2016



(Gray bars represent recessions)

INDUSTRY INFRASTRUCTURE EVOLVES

The nature of any industry's growth cycle moves from start-up phase to growth phase (increased competition and institutionalizing the infrastructure). With innovation spurred on by an increase in competition, the marketplace lending industry, as a whole, is in the growth stage and is visibly working to strengthen infrastructure. Characteristics of the growth phase include: regulatory clarity, continued product innovation, technology improvements, outreach within industry associations for best practices and an increase in the development of strategic partnerships.

PWC states that MPL platforms are forming alliances with traditional banks to:

- **"Fund loans**
- **Provide customer referrals**
- **Partner to create products for both companies' customers"**[13]

MARKETPLACE LENDING: FIXED INCOME OR AN ALTERNATIVE INVESTMENT?

High net worth investors and institutional investors may allocate a percentage of their portfolio to private credit investments. Private credit is often funding debt of middle market firms or for infrastructure projects for millions of dollars. Marketplace lending could be a considered a subset of private credit as the transaction is directly from the lender to the borrower without utilizing an intermediary such as a financial institution.

Loans usually range from $1,000 to $35,000. In 2016, the average Lending Club funded loan was about $14,700.[14] Think of MPL as large scale micro investing. The loans are short-term duration of 36 or 60 months mostly to individuals and to small firms. A 2015 survey showed 46% of investors were planning to increase their allocation to private credit in 2016.[15]

ACCESSING THE ASSET CLASS:

There are three ways to allocate to marketplace lending loans:

1) Self Directed investor researches loans, yields and duration, then determines their risk tolerance and invests in whole loans or partial loans and decides how many loans they want to invest in.

2) Auto invest investor utilizes a platform's automatic function to invest based on the investor's investment factors.[16]

3) Investment funds the investor allocates to a professionally managed fund that lends on one or multiple online platforms. They often utilize custom algorithms executed through an online lending platform's API to find hundreds or thousands of new loans with specific investment characteristics for immediate investment. This allows for greater diversification and potential to reduce return volatility.

RISK AND RETURN OF MARKETPLACE LENDING

The loans are typically unsecured and are not covered by FDIC insurance in the event of a default. US platforms are regulated by the SEC. Under the Securities Act of 1933, the loans are registered with the SEC and include a disclosure.

Risk management and diversification are fundamental concepts of portfolio construction. Equity investors often invest in several stocks to reduce correlation risk and tail risk of the equity component of their portfolio. MPL investors may lend to hundreds or thousands of loans to potentially reduce correlation risk and tail risk of the MPL component of their portfolio.

According to Lending Club about 99% of investors will maintain positive returns by diversifying among 100 loans or more of different borrowers with no more than a 1% allocation to any single loan.[17] Thus potentially reducing the volatility and tail risk of the marketplace lending portfolio. Think of it as a portfolio allocation risk pool.

The annualized loan yields may range from about 5% to over 25% based on the risk level (grade) the platform assigned to the loan. The yields are at a premium when comparing the yields to the 5-year T-note below 2% since 2011 and the 3-year note below 1.75% since 2010. The spread differential between MPL and T-notes is a contributing factor for institutional investors to allocate into the MPL space.

The due diligence of the borrower is completed by the platform to meet certain underwriting standards in deciding if they will accept the loan application and how to value the risk. Metrics include traditional underwriting data such as a FICO score and debt-to-income. According to the Treasury, other data sources include: "real-time business accounting, payment and sales history, online small business customer reviews and other non-traditional information." Currently the US MPL market is mostly "prime and near-prime" borrowers.[18] The technology and application of big data allows for a relatively quick decision process. Platforms frequently reject the majority of loan applications.

HOW DOES P2P LENDING BEHAVE IN A RISING INTEREST RATE ENVIRONMENT?

In an environment of rising interest rates, a portfolio of marketplace lending loans would gradually experience an increasing portfolio yield over time. The higher yielding loans would occur as new lending allocations are made. Therefore, the portfolio would tend to gradually drift towards a higher average yield as the older loans mature and the newer higher yielding loans become a larger percentage of the allocation.

SUMMARY

Fintech has opened the door of a very old traditional business of lending funds to become more efficient in both time and process for both the borrower and lender in creating a more user friendly experience. Marketplace lending offers more choices for the borrower and it allows a wider range of investors to access the lending market.

Marketplace lending has disrupted the banking industry and is changing the loan origination process. As the industry grows and evolves, becomes more institutionalized and institutional investors increasingly allocate to the space; MPL may also be in the process of disrupting the investment industry as investors re-evaluate their portfolio asset allocation and how marketplace lending may add value to a portfolio.

As with any investment, the investor should always do their due diligence and understand the product and how it may add value to a portfolio. Past performance is no guarantee of future results.

Mark Shore, Chief Research Officer, Shore Capital Research LLC has over 25 years of experience in the capital markets and publishes research, consults on alternative investments and conducts educational workshops. His research can be found at www.shorecapmgmt.com. Mark is also an Adjunct Professor at DePaul University, where he teaches the only known accredited managed futures course in the country and a Board Member of the Arditti Center for Risk Management at DePaul University.

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Prime Meridian Capital Management is an investment management firrm specializing in online Peer- to-Peer (P2P) lending strategies.

Our flagship Prime Meridian Income Fund provides investors low cost access to short-duration, high yield loan portfolios by taking advantage of the efficiencies in the burgeoning Peer-to-Peer (P2P) lending space.

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