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VOLUME 5, ISSUE 3
SEPTEMBER 30, 2016

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P2P or Not P2P?—What the Future Holds for Peer-to-Peer Lending

by Preston Ash

Peer-to-peer (P2P) lending is a fast-growing online market that matches potential lenders with borrowers who need access to capital. P2P is a part of the emerging "fintech" space. Contrary to what the name suggests, P2P lending does not solely comprise retail investors, though on many platforms, retail investors have the highest share of investment funds. Lending Club, Corp., one of the major lenders in the P2P space, recently announced that individual investors comprised 54 percent of $8.4 billion intermediated on their platform in 2015. Banks and finance companies funded 25 percent and other institutional investors provided the remaining share. In February 2016, Lending Club announced that 68 percent of borrowers reported using their loans to pay off credit card debt or refinance an existing loan. So, the primary users of this platform are people who already have a history of accumulating debt. By law, retail investors have restrictions on funding commercial loans. Therefore, most loans that are funded via traditional P2P platforms are unsecured consumer loans. These loans are typically capped at a particular balance (e.g., $45,000). However, consumer loans can be funded by retail investors and then be used for business purposes. In the U.S. market, the two biggest P2P platforms are Lending Club and Prosper.

P2P lending is projected to grow over the next few years, both domestically and abroad. Domestically, in 2014, the U.S. market financed $5.5 billion in loans.[1] In 2015 alone, Lending Club facilitated approximately $8.4 billion in loans, thus financing far more than the entire U.S. P2P market in 2014, although, Lending Club's performance in 2016 has been poor relative to years past. Morgan Stanley estimates that U.S. marketplace lending will reach $122.1 billion by just 2020.[2] The global market also paints an interesting picture. In 2012, the global P2P market facilitated $4.9 billion in loans; however, in three years, that amount increased 15 times to approximately $76.9 billion in loans for 2015. According to Morgan Stanley, global marketplace lending grew at a 123 percent compound annual growth rate (CAGR) from 2010 to 2014, and the global lending marketplace will reach $290 billion by 2020 with an expected CAGR of 51 percent from 2014 to 2020.[3]

Notwithstanding this impressive growth in marketplace lending over the past few years, P2P lending only accounts for a small fraction of total U.S. consumer debt outstanding, which grew to $3.5 trillion by end of 2015. Despite this fact, if P2P lending reaches $150 billion or more by 2025, these lenders will facilitate half the amount of consumer debt outstanding held by all U.S. credit unions in 2015. P2P lending structures and developments have already raised red flags from domestic and foreign regulators. Rightly so, for many know that if P2P lending meets or exceeds growth projections in the next few years, its amplified size may magnify potential risks.

How Does P2P Lending Work?

The structure of P2P lending reveals interesting insights about the industry (*Chart 1*). One particular area that could pose potential risks to P2P investors is loan underwriting. This is the step where the P2P platform evaluates how risky the borrower is based on the loan application and then formulates an interest rate based on this information. While in many underwriting models, relevant information such as credit scores is used to calculate borrower risk, some platforms use factors such as debt-to-income (DTI) ratios from self-reported borrower data, and the platform has no obligation to verify income or employment. However, even though there is no formal obligation to verify income, some marketplace lenders still do so. Other platforms use traditionally unconventional pieces of information in their underwriting models, such as Scholastic Aptitude

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Oct. 3–4
Banking On the Leaders of Tomorrow (BOLT) Emerging Leaders Program
New Orleans, Louisiana

Oct. 5
Regional Bank Council (RBC) Meeting
San Antonio, Texas

Oct. 20
Dialogue with the Fed
Fort Worth, Texas

Nov. 3–4
Banking On the Leaders of Tomorrow (BOLT) Emerging Leaders Program
Houston, Texas

Nov. 7
Community Depository Institution Advisory Council (CDIAC) Meeting
Dallas, Texas

Nov. 14
Dialogue with the Fed
Wichita Falls, Texas

Nov. 29
Banking Roundtable
Livingston, Texas

Dec. 1
Dialogue with the Fed
San Antonio, Texas

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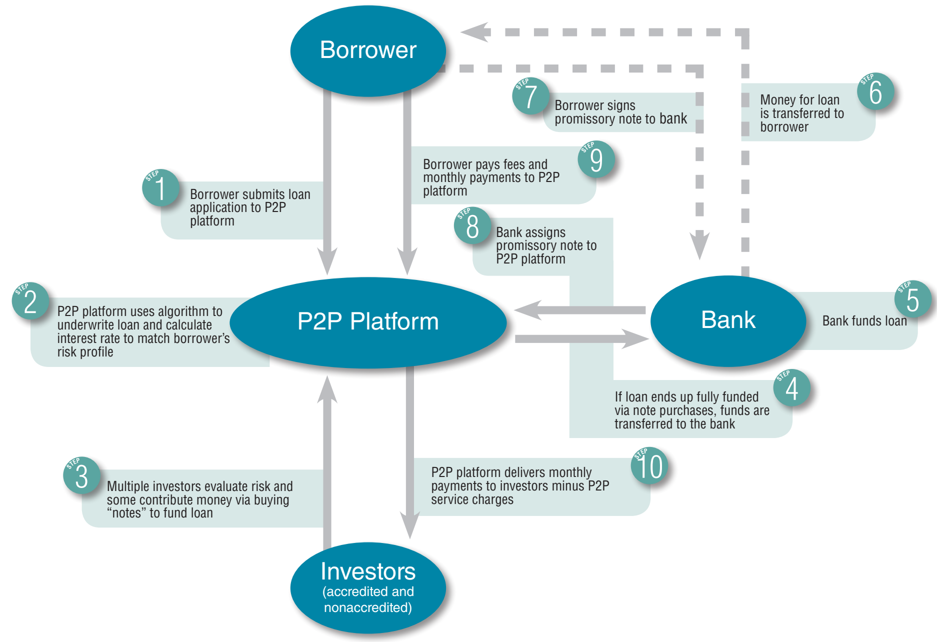
Test scores, education levels and work experience to assess a borrower's risk. Once the P2P platform evaluates the riskiness of the loan, it is assigned a risk grade and then investors decide whether to fund the loan.

Chart 1 Peer-to-Peer Lending Structure



In practice, single investors can fund entire loans, but oftentimes pools of funds are merged together from multiple investors to fully fund a loan. In the latter scenario, investors buy parts of the loan called "notes" for, in some cases, as little as $25. Most P2P platforms recommend that investors buy multiple notes from loans of various risk profiles to properly diversify their note portfolio.

Most P2P platforms complete loans through a funding bank instead of obtaining a bank charter or consumer lending license. If the loan has enough backing from investors, the funds are then transferred to a third-party bank. Indeed, one of the most common misconceptions of P2P lending is that the P2P platform actually funds the loan. In reality, a third-party bank funds the loan and then delivers the money to the borrower's bank account in exchange for a promissory note. The note is then assigned to the P2P platform. The promissory note constitutes a "promise to pay" agreement between the P2P platform and the original borrower.[4] Also, if a borrower ends up not repaying the loan, the P2P platform is not obligated to pay investors for their losses. Because the borrowers are buying legally binding "pieces" of loans in the form of notes, the P2P platform is the creator of a very unique financial security and is thus obligated to register with the Securities and Exchange Commission (SEC). The borrower, however, upon receiving funds, must pay the P2P platform servicing and loan origination fees up front in many cases.

Banks and some large shadow banks also buy loans from P2P platforms. In fact, in late 2014, Eaglewood Capital, an investment management firm, announced the completion of a $75 million securitization of various P2P loans.[5] This is not the first time this has happened. Not long after Eaglewood announced its securitization, Social Finance (SoFi), a marketplace platform for student loans, announced a $303 million securitization of peer-funded student loans with the help of Morgan Stanley and Goldman Sachs. This was one of the first examples of an investment-grade security backed by marketplace loans, and it was rated by Moody's, Standard and Poor's and DBRS.[6]

P2P lending is attractive to both borrowers and investors for various reasons. One major factor is the increased costs of traditional banking methods. Since the Great Recession, there has been an increased regulatory burden on banks throughout the United States and increased costs associated with servicing traditional loans. Traditional banking also relies heavily on paper

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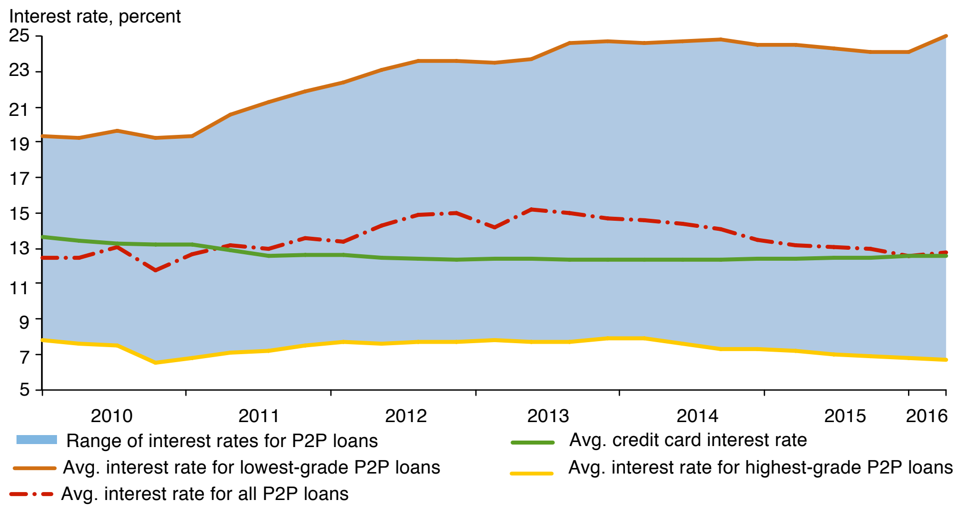
FIRM was organized in 2007 by the Federal Reserve Bank of Dallas as an outreach function to maintain mutually beneficial relationships with all financial institutions throughout the Eleventh Federal Reserve District. FIRM's primary purpose is to improve information sharing with district financial institutions so that the Dallas Fed is better able to accomplish its mission. FIRM also maintains the Dallas Fed's institutional knowledge of payments, engaging with the industry to understand market dynamics and advances in payment processing.

FIRM outreach includes hosting economic roundtable briefings, moderating CEO forums hosted by Dallas Fed senior management, leading the Dallas Fed's Community Depository Institutions Advisory Council and Corporate Payments Council, as well as creating relevant webcast presentations and this publication. In addition, the group supports its constituents by remaining active with financial trade associations and through individual meetings with financial institutions.

processing and real estate, the costs of which add up. P2P platforms solely operate online and are outside the majority of regulatory requirements. Thus, P2P lenders can service loans at a lower cost relative to other traditional lenders and can pass on more competitive rates to borrowers. P2P lending also does not face the classic challenge that traditional brick-and-mortar banks face of having short-term deposits but making long-term loans. P2P platforms keep their investors for the full length of the loan. However, if the loan is facing problems, the investor can sell his notes on a secondary market at a discount, or some platforms offer buy-back options to help investors recover some of their losses. Additionally, P2P lending may offer high returns for investors. Indeed, Lending Club provides historical data on returns to investors on its website. For all loans issued in 2015, adjusted net annualized returns were 6.90 percent, and the average interest rate on loans was 12.94 percent. From the borrower's perspective, the interest rate on P2P loans can also be much lower than the average credit card rate depending on the borrower's risk classification from the P2P platform's underwriting model (*Chart 2*). Of course, this also raises concerns that P2P borrowers are often customers with poor credit, though these same borrowers can be turned down by more experienced lenders and receive a lower rate on a P2P platform.

Chart 2 Range of Interest Rates for P2P Loans



SOURCES: Federal Reserve Board of Governors; Lending Club.

Many news reports have predicted that P2P lending will eventually eliminate the need for traditional banking with brick-and-mortar institutions, though these pundits often ignore the abundance of services offered by traditional banks. It is true that P2P platforms operate on a different cost structure for servicing loans, but that is also somewhat due to the fact that the platform does not have to get a banking license and, instead, must partner with a traditional funding bank. In other words, part of the reason why the P2P model works is because it exists outside of the stringent rules and regulations traditional banking partners take on.

Banks, on the other hand, have options they can pursue to gain from the comparative advantage of the marketplace platforms. One option is to buy loans on a P2P platform as an institutional investor to diversify the bank's portfolio. Also, the bank could partner with the platform and refer customers who do not match the bank's lending criteria with the bank-to-P2P lenders using a co-branded platform. Finally, banks could develop online lending platforms on their own as a way to compete with existing lenders or even purchase existing platforms.

Potential Challenges and Recent Developments

As marketplace lenders are increasingly interacting with banks, risks posed to these traditional banks need to be evaluated. The Federal Deposit Insurance Corp. (FDIC) published a report at the end of 2015 highlighting these risks, which include third-party risks, compliance risks and liquidity risks.[7] The main takeaway is that the FDIC is strongly encouraging banks to evaluate

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the business model, solvency and risk profiles of marketplace lenders and to set up the proper agreements between the parties involved to protect the bank from these risks. Also, the bank needs to ensure that the marketplace lender is properly complying with state and federal laws and is aware of the limited market available if it would like to resell loans facilitated by marketplace lenders.[8]

On July 12, 2016, the House Committee on Financial Services facilitated a hearing titled "Examining the Opportunities and Challenges with Financial Technology ('FinTech'): The Development of Online Marketplace Lending." While the benefits of P2P lending to the underserved and unbanked were noted in testimony, future regulatory enforcement was discussed. A major development in the future of marketplace lending occurred in a court decision in *Madden v. Midland Funding LLC*, the verdict of which indicated that nonbank lenders cannot export interest rates by activating a provision in the National Bank Act.[9] Many P2P lenders have relied on this provision in the past to circumvent the potentially restrictive state usury laws. In the wake of this verdict, some P2P lenders have worked with their funding bank to change their strategy to still take advantage of the fact national banks themselves can still export interest rates to borrowers in other states with stricter usury laws.[10]

Current regulations for the industry also require P2P lenders to comply with varying state laws that often differ depending on which state the P2P lender is servicing. This has caused some within the industry to advocate for a limited-purpose charter for many of these alternative lending institutions to standardize a regulatory framework for their platforms. The Office of the Comptroller of the Currency in particular has looked into this idea, but the details have not been fully developed.[11] New regulations might drive up some of the costs of originating loans by the P2P platforms but could also increase investor confidence, legitimizing the P2P lending space by making sure lenders are properly evaluating risk in their loan-origination models.

Conclusion

P2P lending has already disrupted the traditional financial services industry, and evidence suggests it is set to grow further. Yet, concerns remain. P2P lenders have little experience through adverse business cycles, have difficulties with sound business practices and have had little regulatory scrutiny. Needless to say, the P2P model will continue to be tested in the future. However, the future benefits of this model of lending cannot be ignored. Its low cost of underwriting, quick deliverability of funds, relatively low rates, opportunities to reach customers denied by traditional lending sources, platforms suited for future demographic shifts and an efficient risk management model give P2P platforms a comparative advantage against their brick-and-mortar competitors. The industry will likely continue to grow, but it will have setbacks in future years battling with regulations and a changing economic landscape. However, these setbacks could also bring strength to the industry as a whole, providing much-needed stability behind a very young movement. Lending Club's recent setback further proves the need for regulations to help legitimize the industry and revive investor confidence. P2P lending is probably not going away, but the challenges posed will test the industry's viability and business model over the next few years.

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NOTES

[1] See "Peer Pressure: How Peer-to-Peer Lending Platforms Are Transforming the Consumer Lending Industry," by PricewaterhouseCoopers, February 2015.
[2] See "Can P2P Lending Reinvent Banking?" by Morgan Stanley, June 17, 2015.
[3] See note 2.
[4] The "notes" that are purchased by investors to fund the loan are also a type of promissory note; the only difference is that the P2P platform is only obligated to pay investors the funds that it actually receives from borrowers.
[5] See "Eaglewood Completes $75 Million Securitization of P2P Loans Originated Via Lending Club," by J.D. Alois, Crowdfund Insider, Oct. 20, 2014.
[6] See "SoFi Completes $303 MM 'A' Rated Securitization of Refinanced Student Loans," by Market Wired, Nov. 10, 2014.
[7] See "Marketplace Lending," by Angela M. Herrboldt, Federal Deposit Insurance Corp., vol. 12, no. 2, *Supervisory Insights*, Winter 2015.
[8] See note 7.
[9] See the Testimony of Bimal Patel to the House Committee on Financial Services, July 12, 2016.
[10] See note 9.
[11] See "OCC's Curry: Limited-Purpose Charter for Fintech Is Possible" by Lalita Clozel, *American Banker*, June 14, 2016.

Noteworthy Items

Release of Framework for Meeting CRA Obligations on Closing Digital Divide Follows Announcement of Interagency Q&A on Community Reinvestment Act (CRA)
Access to broadband has become an essential component of economic opportunity and financial well-being, yet there is a significant digital divide in many underserved communities. This new publication is a practical guide for financial institutions that shows how digital inclusion can improve the lives of low- and moderate-income individuals who have limited access to broadband infrastructure. Broadband is included as a form of infrastructure investment in a recent publication from the Board of Governors, the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency. This publication presents best practices and information on lending, services and investments that can help close the digital divide and contribute to an inclusive and vibrant entrepreneurial economy.

Federal Reserve Releases Federal Open Market Committee Statement (Sept. 22, 2016)

Dallas Fed President Rob Kaplan Gives Remarks Before the Official Monetary and Financial Institutions Forum in Beijing, China (Aug. 2, 2016)
President Kaplan presented his views concerning the need for economic policy action to move beyond monetary policy. He believes that advanced economies around the world are at a stage where structural reforms, fiscal policy and other government actions need to join the menu of economic policy. He also commented on economic conditions within the Eleventh District and abroad.

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