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A Message from Dan Clifton:

"Merry Christmas and Happy Holidays....."

Marketplace Lenders - the Future or a Flash-in-the-Pan?

Freddie Mac's Office of the Chief Economist takes an **intensive look at marketplace lending** in the December issue of its *Insights and Outlook*. A marketplace lender (ML) is a non-bank intermediary that provides one or more types of consumer loans, usually on line. Some but not all rely on peer to peer lending (shorthanded as P2P lending by Freddie Mac) and some concentrate on niches such as debt consolidation loans or small business lending. Some of the more well-known examples are Prosper, a peer to peer lender, and Lending Club, the first ML to announce an initial public stock offering.

The borrowers served by MLs often have **limited credit histories** that make it difficult to tap into traditional lending sources and most loans are unsecured. However some MLs are now doing auto loans and some mortgage lending and others have announced their intention to enter the mortgage market.

Freddie Mac says it is **difficult to determine** the direction of marketplace lending. They could be offering a technical advance through underwriting methods to reach market segments not served by traditional lenders or merely attempting to circumvent regulation. Is peer-to-peer lending a new form of "financial intermediation" or just a temporary stepping stone to a traditional lending structure? "Will marketplace lenders become an Uber-like disruptive force in consumer lending, or are they simply old-fashioned consumer lending dressed up for the Internet?" Finally Freddie asks if MLs can move beyond unsecured consumer lending and become mortgage lenders.

While ML is a new phenomenon it is **growing rapidly** and the different business models mean there is no typical one. Freddie Mac looked at some of their notable characteristics.

MLs can function somewhat similarly to a typical bank, taking money from investors and lending it to consumers. Others, probably most at this point, act as matchmakers, allowing investors to choose individuals and business to which they want to lend.

National Average Mortgage Rates

30 Year Fixed Rate Mortgage National Average: 6.43%

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	6.43%	+0.02	0.00
15 Yr. Fixed	5.95%	0.00	0.00
30 Yr. FHA	5.82%	+0.02	0.00
30 Yr. Jumbo	6.62%	0.00	0.00
5/1 ARM	6.28%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.35%	-0.51	0.00
15 Yr. Fixed	5.51%	-0.65	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	6.44%	-0.06	0.54
15 Yr. Fixed	5.88%	-0.16	0.68
30 Yr. FHA	6.36%	-0.06	0.85
30 Yr. Jumbo	6.75%	+0.07	0.39
5/1 ARM	5.98%	-0.27	0.65

Rates as of: 8/30

Recent Housing Data

		Value	Change
Mortgage Apps	Aug 28	226.9	+0.49%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%

	Value	Change
Builder Confidence	Mar 51	+6.25%

P2P lending first appeared in the United Kingdom in 2005 and in the U.S. the next year. Morgan Stanley estimates that this lending, while still small, was on track to make originations totaling around $15 billion this year and volume is growing rapidly.

Unlike in traditional bank operations, P2P **doesn't have depositors** but instead utilizes the money of investors. Also unlike a traditional bank where depositors' money is protected by bank insurance and those depositors don't have to be concerned about credit worthiness and often have no idea of the types of loans the bank is making, in P2P lending the risk goes to the investor.

The ML matches investors to individual loans and investors can buy into them in small amounts - as little as $25 - and thus can diversify their risk. Some MLs are set up so investors and borrowers have common ties - for example being alumni of the same school. In addition to serving as matchmaker between investor and borrower the ML underwrites the loan and services it, collecting a transaction and servicing fees from both sides of the transaction. This business model allows MLs to operate with small balance sheets and low capital ratios. Freddie Mac points out that other types of institutions share some of the P2P characteristics such as providing opportunities for individuals to invest in **second mortgages** and small business loans through brokers or the common ties held by members of mutual or cooperative institutions such as credit unions.

P2P lending is actually **more complicated** than the above description implies. Sometimes the MLs need funding to cover a loan between its close and sale to investors and may obtain warehouse funding from banks to cover the gap. Others may not fund a loan until it is fully committed to by investors.

Not all MLs are P2P lenders, some partner with banks or other institutional investors and operate in a fashion similar to mortgage brokers. Some of the larger MLs have begun to securitize loans, tapping the private placement or capital markets for funds. It may be that more-successful MLs will **outgrow** the P2P method of funding loans over time.

Not unlike traditional banks MLs make **heavy use of the Internet** but their use is distinguished from that of traditional banks by two characteristics - they tend to emphasize social media elements and advertise online underwriting models that incorporate nontraditional criteria. Freddie Mac points to the ML SoFi, its very name a contraction of social and financial. Its website refers to its borrowers as "members," offers a "Partner" program for firms that employ or have business relationship with current or potential SoFi members and its pages provide links to others describing "member stories", career planning and job search assistance services, an Entrepreneur program (mentorship, access to investors, loan deferrals), a referral program, and events like happy hours, community dinners, and career seminars.

In the second instance, while underwriting models are proprietary some MLs that **specialize in student loan consolidation** target borrowers who have short credit histories but instead take into account factors like SAT scores, schools attended, and current jobs. Some MLs specialize in lending to a narrowly defined group of borrowers such as graduates of a particular school or type of school, others concentrate on types of loans such as debt consolidation.

Freddie Mac says while it is hard to document it appears the **Millennials are the dominant ML borrowers** and some survey evidence that they have high awareness of it and are comfortable with the on-line application process. The types of loans offered, such as student loan refinances and the relatively small loan sizes may appeal to younger consumers as well.

While ML are **not** subject to banking regulation or examination they must conform to some state and federal consumer and licensing laws and examination by the Consumer Financial Protection Bureau (CFPB). After sanctioning Prosper for violations of the Securities Act in 2008 the Securities and Exchange Commission now treats all P2P lending transactions as sales of securities and requires all platforms to register with it.

With respect to the growth of this market, PricewaterhouseCoopers LLP estimates the market **could reach $150 billion** by 2025 while others put a much higher number on it. ML could present a disruptive innovation that threatens traditional lenders but others question these forecasts as the industry is still comprised of relatively small firms with limited capital.

This industry has not yet been through a shake out, leaving **questions about its resilience**. Larger banks could always adopt some of the industries more appealing features or simply buy out the most successful firms. "It's too soon to tell whether marketplace lending is the next Uber or just another flash in the pan," Freddie Mac says, and suggestions some of the factors that could decide the issue.

- Cost reduction. By operating as nonbanks and avoiding balance sheet lending, MLs have gained a significant cost advantage and traditional lenders may be pushed to adopt some aspects of the ML model to reduce costs.
- Niche lending. By virtue of their small size and lower costs, MLs can target niche markets which larger lenders may not find profitable or attractive.
- Nontraditional underwriting. MLs advertise proprietary algorithms that outperform industry-standard credit scores, especially for borrowers with limited credit histories. These have yet to be tested in a "challenging economic environment." They may fail or they may make a significant technical breakthrough.
- Mortgage lending. MLs have focused largely on unsecured consumer lending followed by small business loans and student debt refinances with only small ventures into secured lending to date. One barrier to change is the complexity of mortgage lending compared to unsecured lending
- Regulatory evolution. Regulators may increase oversight of MLs, particularly if it continues such a high growth rate. Its underwriting algorithms may raise questions about both prudential and fair lending and the practice of funneling loans through banks - the so-called "rent-a-charter" relationships, may raise questions about attempts to evade regulation.

Freddie Mac concludes by saying that the current crop of MLs **could fail in the next downturn**, regulators could take a stronger interest, or the cost advantages of ML may not extend to mortgage lending, but innovation is difficult to stop. New companies will find new ways to improve business models, large banks may adopt ML innovations but no matter what, "expect change."