HARDING LOEVNER

ONLINE MARKETPLACES FOR LOANS ARE GROWING RAPIDLY. SHOULD BANKS BE WORRIED?

Peer-to-peer lending platforms have flourished in a period of steady economic growth, but their popularity with lenders may decline during the next downturn.

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KEY TAKEAWAYS

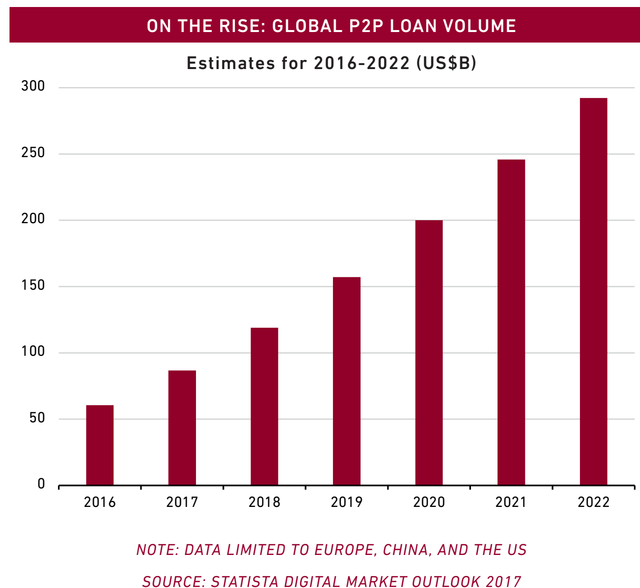
- Peer-to-peer (P2P) lending platforms—online credit marketplaces that connect individual lenders with borrowers for a fee—transfer risk to individual lenders and have no branches, lower staffing needs, and fewer regulatory requirements. These advantages allow the companies to offer better rates to lenders and borrowers alike.
- P2P platforms found their footing when banks curtailed lending after the global financial crisis and have expanded rapidly during a period marked by steady, if slow, economic growth and rising popularity of online financial services.
- However, P2P companies have not yet been tested in a downturn. A deterioration in the credit environment could cause individual lenders to abandon the platforms.
- P2P platforms are most likely to succeed in emerging market economies such as China, India, and Indonesia, where larger portions of the population do not have access to traditional bank accounts.

In the 1680s, merchants, sailors, financiers, and ship-owners frequented Lloyd's coffee house in London to trade stories and arrange shipping ventures. The haunt quickly became the city's hub for shipping news—essential information for its deal-making clientele. Here, the world's first insurance marketplace emerged as caffeinated financiers agreed to put their capital on the line and cover the losses of ship owners and trading companies in the event of disaster on the high seas. Over time, the marketplace formalized and began charging for facilitating transactions. It expanded in scope and complexity, and eventually took on the name Lloyd's of London, now the world's largest specialized insurance marketplace.

More than three centuries later, another financial marketplace developed a short distance from where Lloyd's coffee house stood. Established in 2005 as the world's first online "peer-to-peer" (P2P) marketplace for credit, Zopa redefined the twenty-first century lending industry by taking the basic Lloyd's model of providing reliable information and facilitating transactions between parties for a fee. Those with capital lend it to borrowers directly, bypassing banks. Like Lloyd's, the marketplace was catalyzed by unprecedented access to information to help parties assess the risk of their counterparties. But in the modern story, the data flows over the internet, not through a coffee house.

Zopa, which remains one of the UK's leading P2P lending platforms, sparked a wave of similar ventures such as LendingClub and Prosper in the US, Faircent in India, Lufax and Renrendai in China, and Fairplace in Brazil. Over the past decade, the P2P lending industry has grown at breakneck pace. While only originating a small percentage of the approximately US$40 trillion in outstanding consumer loans globally, online lending businesses now operate in dozens of countries around the world and in 2017 accounted for about US$85 billion in total loan volume. Growth has been particularly strong in China—by some estimates there were over 4,000 Chinese online lending platforms in operation by 2016—though government intervention after a series of fraud cases may dampen that market. Some bullish observers suggest global P2P loan volume could top US$300 billion by 2022.

Should traditional banks be worried? "While they do not threaten large commercial lending or secured consumer loans such as mortgages, peer-to-peer lending platforms have already taken some unsecured consumer lending business from banks, albeit at the margins," says Harding Loevner Financials Analyst Bryan Lloyd, CFA (not a descendent of the coffee house owner, to the best of his knowledge). "The greater threat, however, is that future loan-seekers, particularly millennials and digital natives, may turn first to mobile-friendly P2P lending platforms, denying banks lending opportunities down the road. Even if this alternative credit market doesn't expand as quickly as some predict, investors and stakeholders in the broader banking industry should certainly take note."



NOTE: DATA LIMITED TO EUROPE, CHINA, AND THE US

SOURCE: STATISTA DIGITAL MARKET OUTLOOK 2017

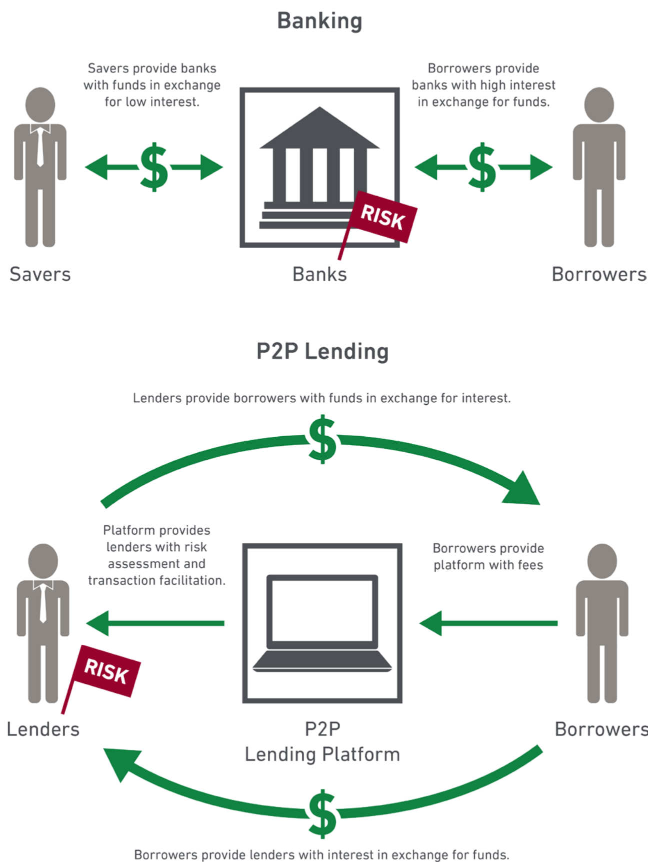
A LEANER INTERMEDIARY

The key to P2P lending's recent growth is simple: better rates. Banks incur large operating expenses—for staffing, branch facilities, information technology, regulatory compliance, and capital requirements—all of which are passed on to customers. As online-only businesses with limited staffing, no branch offices, lower compliance costs, and no capital requirements, P2P lending platforms have far fewer costs to pass on, benefiting borrowers and lenders alike.

While banks and P2P platforms both act as intermediaries, online platforms also provide individual lenders with more competitive rates because lenders take on more risk than the savers who supply their capital to traditional banks in the form of deposits. "In their most basic form, banks generate profit from the difference, or 'spread,' between the lower rates offered to savers to attract their funds and the higher rates imposed on borrowers for access to those funds," explains Lloyd. "In this model, banks assume the credit risk and therefore bear the burden of loan defaults. As such, individual savers, whose deposits are pooled together, are insulated from borrower behavior." What's more, governments guarantee bank deposits in most countries. As depositors bear almost no risk, their savings go relatively unrewarded in terms of yield.

"I fear a large number of those seeking P2P loans are simply unable to get approved anywhere else."

P2P lending platforms, on the other hand, connect borrowers to individual lenders directly. In this model, credit risk is assumed by the lenders, who are compensated for their added exposure with higher yields than those offered by banks. The platforms provide reliable information and facilitate transactions in return for various fees levied on borrowers and lenders. The largest is an origination fee levied on borrowers, who, in the case of LendingClub, are charged 1-6% of the total loan amount.



UNTESTED QUANTITIES

While P2P lending platforms have built-in advantages such as lower operating costs, lower risk, and a less-burdensome regulatory environment, they tend to attract lower-quality borrowers. "Banks seek trustworthy debtors as banks bear the consequences of their lending decisions," Lloyd says. "Default rates are therefore kept reasonably low as loan-seekers deemed too unlikely to repay are politely shown the door. Many of these rejected loan-seekers turn to alternative lenders. While it's true that some borrowers may be drawn to online lending platforms for their better rates, I fear a large number of those seeking P2P loans are simply unable to get approved anywhere else."

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Rates of default at online lending platforms have thus far generally not been sufficiently high to curtail their growth. In Lloyd's view, however, this is more an indication of favorable credit conditions than the durability of the P2P model. "Online lending platforms have come of age during an era of steady and synchronized, if slow, global growth, benign credit conditions, and growing consumer acceptance of online and mobile financial services such as PayPal and AliPay. In addition, in many countries where P2P platforms operate, major banks curtailed lending activities following the global financial crisis, focusing instead on cleaning up their loan books. This created a near-perfect opening for lending innovators," says Lloyd. Despite some hiccups, P2P platforms have done wonderfully well in this environment. "Yet any credit model can look good in good times," Lloyd cautions.

Lloyd argues that borrowers' poorer risk profiles on P2P lending platforms may pose a threat to the P2P model, though it may only become apparent during the next downturn. Default rates could spike. While this would not bankrupt the lending platforms—loan losses, after all, fall squarely on the shoulders of the individual lenders—the number of willing lenders could plummet, leading to a decline in loans and fees collected. "Ultimately, one can only discern the long-term viability of a credit product after seeing how it fares in bad conditions," says Lloyd. "For this reason, P2P lending platforms are still, in my mind, untested quantities."

WEATHERING THE CREDIT CYCLE

Lending platforms, for their part, claim they will be able to weather the credit cycle due to their Big Data advantage. Online lending platforms, which are by nature tech-savvy, pride themselves on the use of sophisticated machine-learning technology and the sheer number of borrower data points—sometimes in the thousands—they take into consideration to assess risk. Some platforms even admit to analyzing social media posts of would-be borrowers. In theory, this fine-tuning of interest rates should allow P2P platforms to remain attractive to lenders throughout the credit cycle by compensating them more greatly during periods of greater risk.

Many banks, however, have made large information technology investments of their own in recent years, in part to defend against substitution from financial services startups, P2P lending platforms included. "Banks have woken up and significantly eroded the tech advantage they ceded to finance startups in the mid-2000s. In fact, some major banks may now be collecting more data on borrowers than lending platforms," says Lloyd. Also critical is the type of data to which they have access. While P2P lenders can normally pull consumer credit scores from national agencies, a large component of their risk assessment is based on hypothesized future behavior. Many banks analyze the same behavioral data as well as proprietary *historical* data such as salary histories and account inflows and outflows, which in combination could prove to be a superior dataset, he says. "Further, their deep pockets allow them to experiment with novel forms of data analysis and get a decision wrong every now and then," Lloyd says. "I'm not convinced the P2P players will 'out-data' the banks in the long run."

In tough times, however, even a purported data advantage may not be enough for P2P loans to remain attractive to lenders. One reason is their interest rates are usually fixed for the duration of a loan, typically three to five years. If the credit

environment deteriorates, lenders will not be immediately compensated for an upswing in risk. Though lenders looking for an early exit can sometimes resell loans on secondary markets, such deals are subject to additional fees and could require the lender to sell at a loss. Another concern in downturns: if the P2P platform goes out of business, individual lenders would face a lengthy loan recovery process that may not result in the full recovery of their principal. These drawbacks could scare off would-be lenders who may ultimately prefer the greater liquidity of other asset classes or safety of savings accounts.

SUCCESS IN SERVING THE UNDERSERVED

P2P lending may find most success in countries where the traditional banking sector ignores many of those seeking unsecured personal loans, or where a meaningful portion of the population lacks bank accounts to begin with. On a recent trip to China, Harding Loevner Financials Analyst Moon Surana, CFA found consumers to be embracing online lending and other banking alternatives in vast numbers. "Online marketplaces for financial products such as bill payments, insurance, credit, and investment vehicles are quickly gaining popularity in China, partly resulting from the failure of the state-run banking system to provide consumers with decent offerings," says Surana.

"Banks need to fight for every penny."

In such contexts, borrowers may turn to an online lending marketplace like Lufax and Renrendai, especially if they use other online financial products such as digital wallets. Investors in countries with an underdeveloped banking system, such as India, Indonesia, Philippines, and Russia, may also view P2P lending as a relatively straightforward opportunity to make a return.

Though P2P lending is still in its infancy, banks should not be complacent. "Banks need to fight for every penny," Lloyd says. "Ideally, banks would continually lower their operating expenses and improve lending decisions to provide both lenders and borrowers with more competitive rates. Even better would be to invest in or partner with P2P credit marketplaces, or even compete with them directly by launching online credit platforms of their own such as 'Marcus' by Goldman Sachs or 'Lightstream' by SunTrust Bank."

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