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MODULE 2 UNIT 1 Casebook Video 1 Transcript

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CHRISTOPHER MALLOY: The peer-to-peer lending industry; where did it come from? It was born right around the financial crisis, because that was a time when large financial institutions essentially stopped lending to consumers and small businesses, and a bunch of FinTech companies came in and filled the void. They built these amazing platforms online that allow these businesses to upload a little bit of information and then essentially receive a loan.

A small loan, but a loan, and they receive it quickly. And that's something that large institutions can't do. Big financial institutions can't issue loans of the size we're talking about here, which is anything from a 15,000 dollar loan to a consumer, up to say a hundred dollar loan for an institution.

Imagine a consumer who will come to a platform and wants to get a loan. So, typically, they would have gone to a bank, now they can go online and get one of these loans. They have to input some information and then the job of the platform is to put them into grades, and those grades correspond to the riskiness of that borrower, and then the platform will essentially assign an interest rate.

A given loan, say, a 15,000 dollar loan, will actually oftentimes be broken down into much smaller increments, as small as 25 dollars. So, an investor can come onto the platform and invest in a loan in increments of 25 dollars. That's called the fractionalization of loans. Eventually, institutions started to want to join this market too. Now, institutions didn't want to buy 25 dollar loans, they wanted to have what are called whole loans, which is – essentially an institution will lend the entire amount of the loan. Now, that raised a set of problems and issues in the industry, where you have retail investors, retail lenders – and also institutional investors, institutional lenders – competing essentially for the same loans on these platforms.

And, as you can imagine, this raised a bunch of problematic issues because people worried that maybe the institutional lenders were getting preferential treatment on these platforms. And that led to the peer-to-peer platforms having to deal with this issue of how to balance retail demand on the lending side with institutional demand on the lending side.

Another aspect of the mechanics of these platforms, is that when investors lend to a consumer, they are basically lending at par, meaning they're lending at a hundred dollars. So, there's no sense in which a lender can really bid – originally in the early days of Zopa and LendingClub, they had that on offer, where an investor could basically place a bid and offer different prices. But the way these platforms work now is, essentially, you have to invest at whatever price that the platform gives you, which is basically a hundred dollars for a loan with a certain interest rate.

And those interest rates are just basic grades, say; ABCDEF, with just fixed interest rates. Now, the loans themselves are typically three to five-year consumer loans and they're structured like mortgages in the US where they are amortizing, which means they're paying down the exact – both the interest and the principal and an exact same amount all the way until the end. And that's attractive from a lender's point of view, because you're not waiting until three years later, or five years later, to get a big balloon payment at the end.

Another challenge that these peer-to-peer lenders have suffered is in the area of adverse selection. And what adverse selection means, is the person who comes to the platform to borrow money might not be the type of lender – borrower – that you actually want to give a loan to.

And that has arisen due to tons of competition in this industry. So, Zopa and LendingClub were two of the first peer-to-peer lenders, but then of course there have been dozens of more that have entered this industry. So now, imagine you are a borrower, and you go online, and you can get a loan from any of these different platforms, well, of course you're going to do a little searching around and try to find which platform might give you the best rates.

So, the problem with that is some of these borrowers will actually take out loans from multiple different platforms. And that's a phenomenon called loan stacking, where essentially a borrower was stacking up a bunch of loans across the lots of different platforms.

And so, that problem, which is what some of these big peer-to-peer lenders have really struggled to deal with in recent years, is around adverse selection – worrying that they're going to get the worst borrowers to come to the platform. Now, there are also a couple of specific challenges that both Zopa and LendingClub have faced as well.

On Zopa's side, they found it very hard to enter the US market, because of regulatory issues, and originally also they had offered an interface that didn't allow a lot of customization where a lender would come to the platform and they really couldn't see who they were lending money to. It was sort of packaged. And Prosper, which is another competitor in this space, had offered a very interesting interface where you could see everything about all of the potential borrowers, and that drew a lot of growth on their end.

LendingClub, at this point, did something quite clever, which was they struck a deal with WebBank – which is a bank in the US – where WebBank would originate the loans and then LendingClub would issue a note to investors, and that money coming in from investors was then used to purchase the loan. But from an investor's point of view – a lender's point of view – they now had a certificate, a note, and that note was registered with the Securities and Exchange Commission and was actually something that could be sold on a secondary market.

Now, the development of that secondary market has only just begun. It's essentially still in its infancy, but it is something that, as it continues to grow, will lead to widespread growth in this industry more generally. With the problem of loan stacking becoming more and more important on the consumer side, LendingClub, Zopa, and some of the other primarily consumer lenders were wondering if they could expand into other lending sectors.

And so, at that point, LendingClub started to explore medical equipment loans, small business loans, other loans that could potentially widen their reach. Now, the issue there is all of those areas require different competitive expertise and knowledge, and the question was; could LendingClub really tap into those markets successfully and offer a product that could compete with a set of new small business lenders that had also cropped up in this space? And would LendingClub be able to be as successful in that space as they had been in the consumer space?