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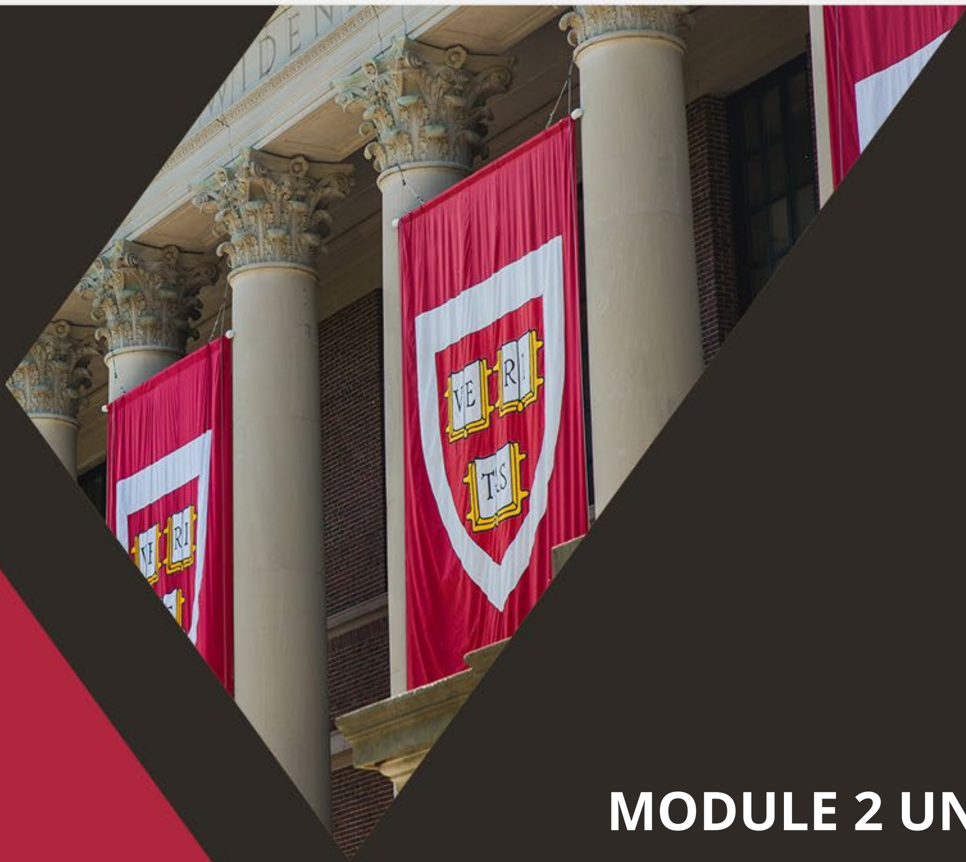

MODULE 2 UNIT 1
Peer-to-peer lending and the disruption of traditional financing

Table of contents

Learning outcomes:

LO1: Describe how peer-to-peer lending has changed the way in which finance can be accessed.

LO2: Discuss the impact of FinTech lending methods on traditional financial institutions.

1. Introduction

The 2008 financial crash resulted in the constriction of the global credit market. Financial regulations imposed by governments made it harder for both individuals and companies to gain access to loans. Banks were reluctant to issue loans and increased their interest rates. These factors resulted in the massive growth of the peer-to-peer (P2P) lending industry.

P2P lending, also known as marketplace or platform lending, is defined by its use of an online platform to connect companies or individuals that borrowers and lenders, however big or small, as opposed to a traditional bank intermediary. Whereas P2P lending connotes everyday individuals lending to one another – the origins of this model – marketplace lending has become a more popular term as many industry players have shifted their focus from individual to institutional lenders. P2P lending has been driven by technological innovations, allowing online platforms to assist in connecting lenders and borrowers. The lenders can be considered "investors" of sorts in the sense that they are investing in both the creditworthiness of the borrower and the borrower's ability to pay back the principal loan amount, plus the promised interest.

The main benefit of these systems is that even borrowers whose applications may not have been approved by a bank are able to access loans. The application process has also been simplified through online platforms, and the interest rates are more competitive than those offered by traditional financial institutions. The nature of P2P lending allows investors (lenders) to connect personally with borrowers and fund projects they feel are worthwhile. As investors in a financial product, they also receive higher rates of return and can build diversified investment portfolios.

As this new form of financing matures, various banking sectors are transgressing beyond their traditional stations to become specialized companies. These sectors include personal loans (what many consider traditional P2P financing), small-business loans, student loans, and real-estate loans (which will be discussed in depth in Module 4). However, as players in a new and innovative field, these companies have faced challenges not encountered by the traditional financial institutions against whom they are competing. Some of these challenges include:

- Sourcing funding for the loans offered;
- Addressing increasing regulatory issues aimed at providers of financial services;
- Scaling their businesses;
- Managing with high default rates; and

- Diversifying product offerings.

This casebook explores these challenges and opportunities by focusing on a few examples of P2P lending companies. These examples include the operations of Zopa and LendingClub in the personal-loan sector, the growth strategies of ThinCat in providing P2P services for small- and medium-sized businesses, and the success of SoFi in disrupting the student-loan sector in the US.

2. Zopa and LendingClub's disruption of the lending industry

Zopa (based in the UK) and LendingClub (based in the US) were considered "traditional" P2P lending services. By 2021, Zopa had adapted their services to include credit cards, loans, savings and car finance, and has since excited the P2P lending service industry (Jones, 2021). They mainly facilitated the provision of personal loans to individuals for everyday expenses, such as car purchases or household maintenance. Besides these everyday expenses, many borrowers used the P2P loan space to refinance more expensive forms of existing debt burden. For instance, an individual might have amassed $10,000 in credit card debt at an interest rate of 25%. They could go to LendingClub and take out a $10,000 loan at a 15% interest rate, pay off the entirety of their credit card debt, and essentially transform it into "cheaper" debt to finance.

Both companies operated on sophisticated online platforms that connected third-party investors to lend out to borrowers . Additionally, they provided services that assessed the risk associated with the borrower, allowing investors to make informed decisions on which applications to fund. This allowed investors to build portfolios, spreading their risk and improving their investment returns. Figure 1 illustrates how riskier assets, identified as the "C market" (which contains loan applications considered at high risk of default) received less funds in cumulative supply in Zopa's early years.

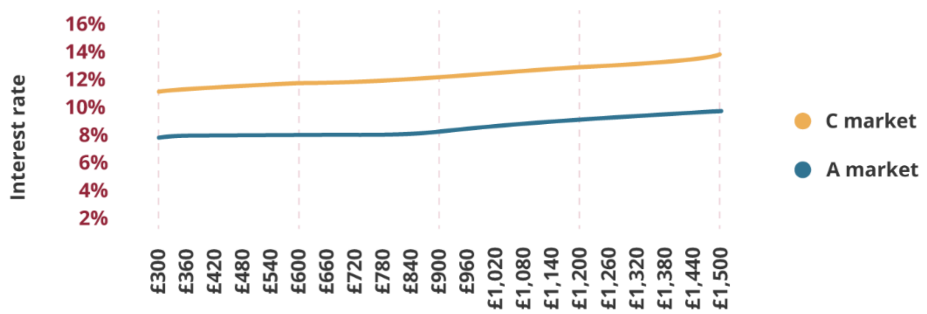

Figure 1: The supply of funds in two of Zopa's markets in 2009. (Source: Zopa Company Documents, 2009)

A problem that Zopa faced was that of funding often being insufficient to service the number of requests from borrowers. In Video 1, Professor Christopher Malloy continues the discussion about the functionality of these companies. He also outlines some of the challenges that Zopa and LendingClub faced and examines some of the strategies they were looking to adopt to overcome them.

Video 1: The functionality of peer-to-peer lending companies and the challenges they face.

As discussed in Video 1, P2P companies face various challenges in an ever-evolving market. One of the key challenges is that of fluctuating interest rates. With changes in interest rates, investors are more willing to place money in banks as they are risk-free compared to P2P platforms (Zhang, 2019). Closely linked to this is the challenge of high default rates on some loans to borrowers, which affect an investors willingness to fund loans. In such cases, borrowers may be unable to pay back loans, with high-risk borrowers being more prone to defaulting on repayments.

Because of these challenges, it is important for P2P companies to have diverse sources of funding. The following section explores how Zopa and LendingClub sought to diversify offerings to broaden sources of investor funding, and service consumer needs more effectively.

2.1 How Zopa and LendingClub diversified offerings

Both companies faced the challenge of securing funding to service the demand for loans. At first, the companies sought to diversify sources of investor funding by including institutional investors. They also identified strategies to move forward by considering expanding consumer offerings (for example, international expansion strategies) and offering small-business, home, and other types of loans.

Since its launch in 2005, Zopa strived to innovate and diversify its customer offerings. For example, after being awarded a full banking license in the UK, Zopa launched a variety of traditional financial products, such as loans, credit card offerings, financing for car purchases, and fixed-rate savings accounts(Jones, 2021). Although Zopa expected it would continue to address consumer concerns through delivering better customer experience and clearer pricing guidelines – issues often encountered with traditional forms of banking – Zopa closed its original P2P exchange in December 2021 to focus exclusively on banking (Jones, 2021). In its communications to customers, Zopa explained, "Sadly, over the last few years, customer trust in P2P investing has been damaged by a small number of businesses whose approach led to material losses for customers investing in those platforms. Linked to this, the changing regulation in the sector has made it challenging to grow and remain commercially viable" (Jones, 2021).

After this decision to focus on banking, Zopa raised US$300 million through funding led by SoftBank, placing the startup's value in 2021 at US$1 billion (Jones, 2021). SoftBank shared Zopa's belief in using artificial intelligence (AI) and technology to disrupt the traditional banking sector. Since AI and technology allowed for quicker scalability of offerings, Zopa expected this would provide a competitive edge against the leaders of the banking sector and accelerate growth (Browne, 2021).

Much like Zopa, LendingClub also expanded its customer offerings to include alternative financing options. LendingClub made a move into the banking sector with its 2021 acquisition of Radius Bank, a digital bank based in the US. Although LendingClub's move into banking is attributed to the purchase of Radius Bank, whereas other P2P lending platforms have sought to apply for banking licenses, it still marked a very powerful move by the FinTech company. The acquisition meant that LendingClub's customers would have access to a wide range of product offerings, such as a cheque deposit, bill payments, card management, and a financial management dashboard, and the company became much more profitable as a result. However, at the same time, LendingClub also discontinued its retail investor platform, and individual investors were no longer able to invest in its loans as a P2P lender (Renton, 2020). Instead, the platform decided to focus exclusively on institutional investors, such as hedge funds and banks, and both large multinational banks and smaller community banks (LendingClub Bank, n.d).

Explore further:

Learn more about LendingClub's acquisition of Radius Bank, the potential benefits of the acquisition, and what this meant for the marketplace lending platform.

In addition, learn more about Zopa's growth and offerings to compare where it has come from to where it is now.

Consider LendingClub's growth strategy by engaging in the poll below.

Poll 1: LendingClub's potential growth strategy (Access this casebook on the Online Campus to engage with this poll and view your peers responses).

Do you consider Zopa and LendingClub to be FinTech companies?
Yes, both companies still use technology to financially innovate.
No, they are becoming like the banks they initially sought to disrupt.

3. ThinCats and the provision of peer-to-peer loans to small businesses

The ThinCats product offering demonstrated the shift in scope of P2P lending from personal loans to small-business loans. The operational structure of ThinCats replicated those of Zopa and Lending Club. Consequently, some of the challenges ThinCats encountered were similar to those faced by these companies.

Figure 2 illustrates the growth of the P2P lending industry from 2017 to 2020, and the expected growth by 2027. The massive growth of this industry affords companies offering these services the opportunity to continue their growth by offering loans at lower costs than traditional financial institutions (should they make their services easily accessible via online platforms).

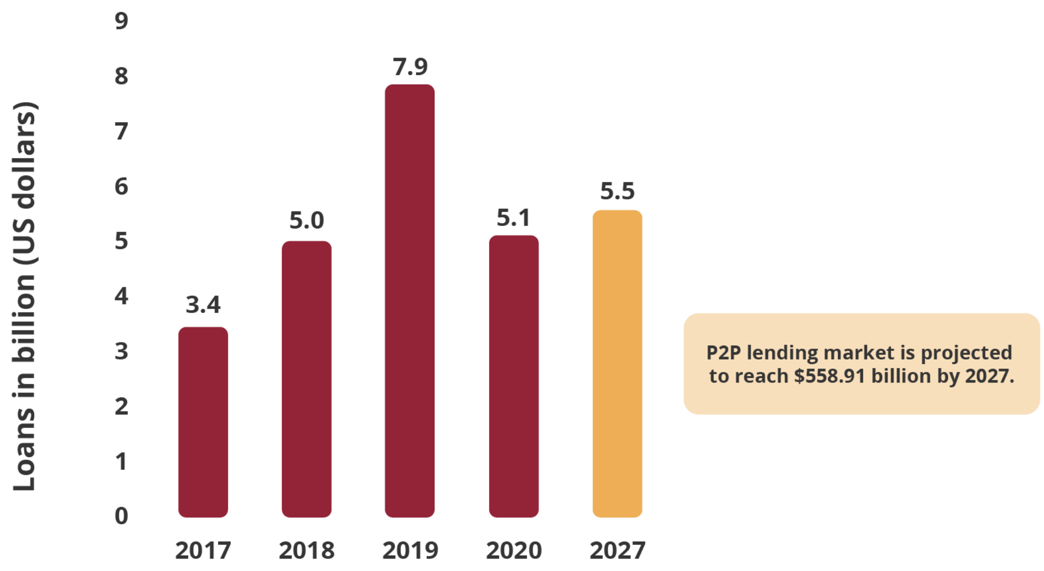

Figure 2: The projected growth of global peer-to-peer lending. (Source: Marketwatch, 2022)

As a company offering P2P services to small- and medium-sized enterprises, ThinCats entered a niche market in which it was one of the largest service providers in the UK. Figure 3 illustrates the size of this market in relation to the growing consumer P2P sector. As illustrated by this figure, ThinCats was positioned in a highly lucrative sector with options for continued growth.

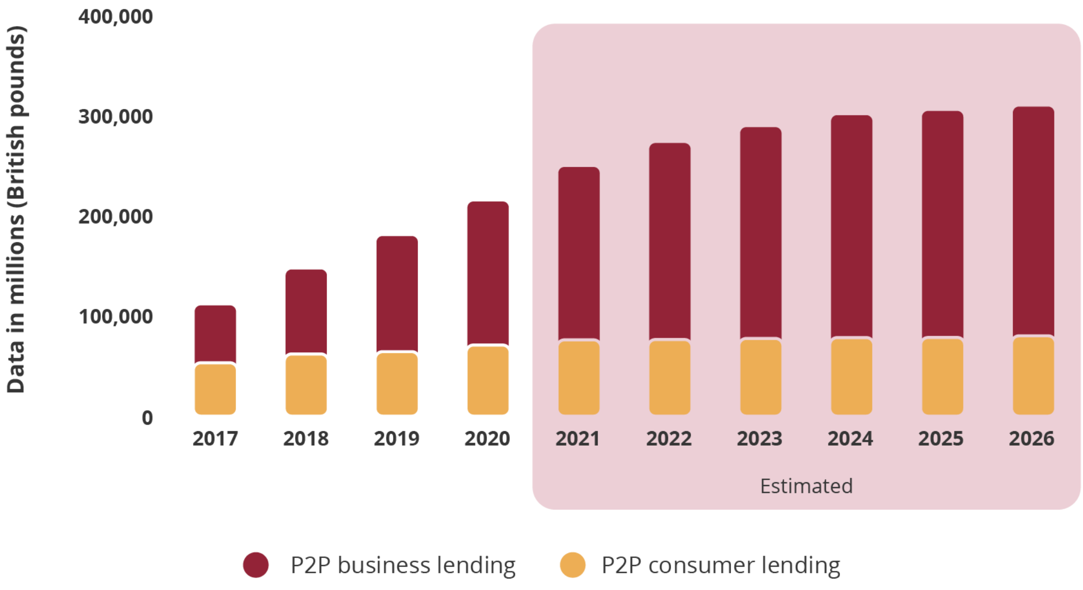

Figure 3: A comparison of peer-to-peer consumer and business lending. (Source: Statista, 2020)

While Figures 2 and 3 illustrate the potential growth for a company like ThinCats, some business challenges remain. To assess its potential future direction, watch Video 2 in which Professor Malloy discusses the path taken by ThinCats since its inception.

Video 2: Analysis of ThinCats' peer-to-peer lending for small business.

P2P lending companies are radically changing how finance can be accessed by a variety of people and companies. The ThinCats product offerings allowed small businesses access to finance that they may not have gained through traditional financial mechanisms. Yet, similar to Zopa and LendingClub's trajectories, ThinCats also closed its retail P2P lending platform in December 2019 to focus on institutional lending, explaining that "The number of loans funded by the P2P Platform has fallen significantly over the last two years, and it is no longer cost effective or practical to raise funds in this way. The ThinCats Group will continue to support the funding of mid-sized UK businesses through its institutional funding products" (Reynolds, 2019).

The next section explores the case study of Social Finance Inc. (SoFi), and discusses how the company dramatically changed the student-loan industry, adapted to overcome some of the challenges it faced, and introduced new products to ensure its growth.

4. SoFi and the disruption of the student-loan sector

SoFi was founded in 2011 by a group of MBA students at Stanford Graduate School of Business. As students themselves, they had identified the need for change in the student-loan industry. Using their understanding of the sector, they sought to apply P2P lending principles to student loans. They identified several factors that led to the growth of this industry, which is driven by increasing student debt. These factors included:

- The increasing number of students attending university;
- The increasing number of loans offered to students; and

- The increasing number of, and reliance on, loans to attend for-profit universities.

(Di Maggio & Costa, 2018)

SoFi saw that there was no risk-based analysis given for student loans. This led to the inherent mispricing of loans and inaccurate interest rates being applied. You will explore how student loans were traditionally priced and how SoFi sought to disrupt the sector in an interactive infographic later in this unit.

4.1 The challenges faced by SoFi

The interactive infographic will show how SoFi successfully managed to alter the student-loan industry. By identifying clients based on risk and potential earnings, and by partnering with alumni, the company was able to supply loans at the correct prices and offer graduates the opportunity to refinance their loans based on income. However, SoFi struggled to maintain its model of alumni-funded loan offerings and subsequently brought in institutional investors. Since then, the company also diversified their product offerings by entering other lending markets, such as personal loans and home loans, and other banking, investment, and credit products. In addition, their capital markets expertise and solid, sophisticated investors early on became one of their major differentiators from competitors.

To discuss some of the challenges of entering this sector and the future strategies available to ensure the growth of SoFi, watch the following interview with Ron Suber, one of SoFi's major investors.

Video 3: SoFi's challenges and solutions.

Consider the growth of SoFi, its success in providing loans to potentially high-earning clients, and the community they have built with these clients. It is important to reflect on possible future growth strategies and whether the strategies pose a possible threat to a growing business, as rapid expansion could place the core business at risk. SoFi currently offers products in wealth management, insurance, real-estate financing, investing, loans (including student, home, personal and small business loans), and healthcare. Much like Zopa and LendingClub, SoFi also obtained a banking license and traded its P2P lending model for originating loans for other network partners (Sheth, 2021). The development of SoFi Bank is a critical step for SoFi in diversifying its product offering to current and existing consumers.

4.2 The growth of SoFi's offerings and SoFi Bank

SoFi has continuously expanded its products and services, including making strategic acquisitions to improve its financial offerings for new and existing customers. One major acquisition includes Galileo, a business that offers back-end services for digital banking, which allows SoFi to connect with established banks' systems through APIs to build additional banking offerings. In January 2022, the company received full regulatory approval by the US Office of the Comptroller of the Currency (OCC) and the US Federal Reserve to receive a national bank charter through the acquisition of Golden Pacific Bank (SoFi Technologies Inc., 2022).

Golden Pacific Bank is now called SoFi Bank, National Association (N.A.). This critical acquisition provided SoFi with the ability to offer better features on their banking products and services, including a more intuitive banking interface, the ability to differentiate checking and savings accounts for ease of use and budgeting, provide a competitive industry-leading annual percentage yield for members, as well as automated savings capabilities. This was a huge step in SoFi's growth strategy, placing the company in a good position to be able to take the next step in developing their diverse portfolio by becoming a national bank (SoFi Technologies, Inc., 2022).

Since this acquisition, SoFi has continued to expand its offerings to now include banking accounts, an investment platform, personal and mortgage loans, and credit cards, amongst others (Luthi, 2022). As a bank, SoFi will be able to receive customer deposits and provide loans using their customers' deposits instead of having to fund their loan offerings as a nonbank, which involves externally contracting underwriters at extra cost (Azevedo, 2021). SoFi's goal is to continue to expand its offerings and reach in its customer-base.

Explore further:

To assess the further potential growth strategies available to SoFi, examine the product offerings listed on its website (SoFi, 2022)and consider which of these are the most viable in the long term.

From its beginnings as a P2P student loans provider, SoFi has built up an extensive range of products and services by identifying areas of financial services that are in demand or inaccessible and finding solutions to these needs. As a bank, SoFi can not only continue expanding and improving its financial offerings, but also provide financial and monetary solutions for more people at a competitive rate. SoFi can now meet the needs of their customers, business partners, and community more effectively (Luthi, 2022).

5. Regulations affecting the peer-to-peer sector

One of the challenges that P2P platforms face is changes in regulations that determine how these platforms are governed. In the UK, the Financial Conduct Authority (FCA) announced new regulations that will impact P2P investments. These regulations are designed to protect investors and ensure that platforms are being transparent in their dealings with lenders and borrowers. Some of these new regulations include:

- Clearer governance on credit risk assessment and fair valuation practices;
- Greater transparency around platform fees, services, and charges; and
- New or inexperienced investors being capped at 10% of investable assets (to limit their exposure to risk).

(FCA, 2019)

These new regulations not only protect investors, but also ensure that P2P platforms grow sustainably in the future.

Explore further:

Despite the challenges faced by P2P lending platforms, these platforms still experience some significant growth. Explore the growth opportunities of P2P lending and how these outweigh existing challenges.

6. Conclusion

The continued need for financing following the 2008 credit crisis led directly to the rise and popularity of P2P lending services. These platforms made financing available to those who may have been rejected by traditional financial institutions. Additionally, lenders were able to provide financing at lower interest rates, in a personalized manner, and in a way that offers good investment opportunities. The sector has since diversified from what were considered traditional P2P personal services to include small-business loans and student loans. Across the board, these companies have faced similar problems in funding their services and have sought to bring in institutional investors, breaking away from the P2P model. However, it appears that growth in this sector is set to continue.

Considering these changes, do you believe that P2P lending models will continue to grow? Will these lending companies replace traditional financial institutions in providing credit, or will they become more like the established financial institutions they originally tried to disrupt? Should these companies look to diversify product offerings to banking services as part of their growth strategy? Discuss your thoughts on these topics with your peers in the class-wide discussion that follows.

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