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Financial Technology – MSBA

Assignment 5

Lending Club was born out of an idea to leverage technology to allow people to borrow capital directly from investors, saving the hassle and extra costs of banking intermediaries. Consumer Credit in the U.S. has grown incredibly rapidly since the mid-1900s and there remains a large need for access to loans. Lending Club CEO Renaud Laplanche transformed this idea of a peer-to-peer (P2P) financial network into a business in 2006 and began operating as a lending service on Facebook in 2007. LendingClub.com was later launched to bring the services to more users and aimed to match borrowers with lenders of similar interests. Lending Club met regulatory requirements and reduced risk by partnering with an FDIC-insured bank called WebBank. Lending Club also formed a subsidiary called LC Advisors, LLC that served as a general partner and advisor to private investment funds for qualified investors. Lending Club partnered with more and more companies as it grew and received several rounds of venture capital equity financing totaling $100 million in 2012, when it also achieved a positive operating cash flow.

Lending Club offered a strategic value proposition for both borrowers and lenders by creating an experience they described as ‘friendly, transparent, and empowering.’ Lending Club primarily made money by collecting fee income from borrowers and investors and keeping a lean cost structure with low loan origination costs to provide a superior value. With no physical branches and largely automated operations, Lending Club had a huge cost advantage over traditional banks and lending services. For borrowers, Lending Club offered lower cost and less friction in obtaining a loan. With the growing amount of credit card debt in the U.S., Lending Club offered an easier way to obtain a personal loan to consolidate or pay off debt that simply wasn’t offered by traditional lenders. One survey reported that Lending Club borrowers saved one-third of what they were previously paying on their loan interest rates, on average. For investors, Lending Club offered a transparent way to choose which borrowers to fund via the data of each loan application that was made public on the Lending Club site. Funding Lending Club loans was a risk-adjusted, stable, and hassle-free way to invest. Investors were consistently satisfied with returns on their Lending Club investments, earning an 8 percent return, on average.

The mechanics of Lending Club’s offering were such that loans were transacted through the issuance of Notes in either a standard loan or custom loan program. Borrowers were offered 36-month and 60-month unsecured loans between $1,000 and $35,000 at a fixed interest rate. The loans were structured like traditional fixed rate amortizing mortgages and had no repayment penalties. The interest rates of Lending Club loans were set by a three-stage process that involved evaluating a base rate published by the Federal Reserve, discretionary economic adjustments, credit modeling to forecast losses and likelihood of repayment, and adjusting for the expected default rate. Borrowers also paid a one-time arrangement fee to Lending Club ranging from 1.11 to 5% of the principal. Borrowers had to submit a loan request on the website, and after meeting minimum FICO and debt-to-income ratio criteria, their loan request was listed on Lending Club website for up to 14 days for potential investors to evaluate. The use of analytical tools and loan application data posted on the site allowed investors to fully assess the risk and returns of a loan and build their portfolios accordingly. Loans were typically provided by multiple investors in different amounts, and lenders could also sell their Notes in secondary markets. Once they selected a borrower to fund, investors purchased a Member Payment Dependent Note issued by Lending Club and registered with the U.S. Securities and Exchange Commission, which would then be transferred to WebBank and tied to the principal and interest payments of individual borrowers. Monthly loan payments were automatically collected from borrowers’ bank accounts and deposited into lenders’ accounts via Automated Clearing House. In the case of insufficient funds, a borrower entered a 15-day grace period before beginning the collections process in which Lending Club worked with credit rating agencies in attempting to collect the payment.

I believe investors should value Lending Club as a marketplace technology company, but its risk should be viewed in the context of a finance company. Lending Club does not hold any loans or cash, but rather facilitates transactions between borrowers and lenders, providing a lower friction, lower cost alternative to bank intermediary lending. Lending Club’s main value proposition and differentiation from traditional financial institutions is in the experience it provides to both sides of the lending marketplace, not in a financial product. However, as with any entity in the financial services industry, significant risks exist and must be addressed. With the operational risks of loan defaulting and defrauding, Lending Club had to be careful to incorporate those risks into its lending model and resist the start-up tendency to grow too quickly. The company was intentional in growing at a measured rate and understanding risks completely as they grew. I believe Lending Club’s positioning and mindset as an experience-focused marketplace technology company coupled with its comprehensive handling of financial risk was a key component to its success.

On another note, I do think that Lending club should be somewhat worried about competition because the name of the game is market share. CEO Renaud Laplanche believes that responsible and intentional growth is the reason for Lending Club’s success, and that the P2P marketplace is not a “winner-take-all” system; however I somewhat disagree. I concede that financial services like lending inherently require significant regulation and careful supervision, but the reality is that two-thirds of Lending Club’s revenue currently comes from interest on loans and one-third comes from origination fees – both of which are directly related to the number of loans/users on the platform. Lending Club only recently became profitable in March of 2013 after several periods of large growth. Any drop in growth could cause the company to again become unprofitable, especially as more venture capital gets poured into the market and newer competitors are able to better compete with Lending Club’s offerings. Such a stress on revenues could cause a desperate need for growth, incentivizing Lending Club to broaden its standards for borrowers and loan requests. If loosened requirements allow for more risky investments, it could potentially damage the company’s (or market’s) reputation. Additionally, Lending Club could consider entering new verticals in order to create new revenue streams by leveraging its existing platform to continue this trend of growth in a new market and stand out from competition.

I think that the main considerations in the development of the borrower’s credit model are meant to encapsulate the riskiness of any given loan based on the probability that the borrower will repay. Ideally, I would like to incorporate previous loan payment history, credit history, current income, debt to income ratio, size of the loan, level of debt, credit history age, education level, bill payment history, any metric of financial stability like home ownership, and the reason for the loan. All of the above metrics allow me as the Rick Officer to determine how financially trustworthy a person is, and would allow me to devise a weighted scoring system to determine loan-worthiness. I would also plan to incorporate “feedback” in my model, adding historical data from the Lending Club’s databases on who actually defaulted on loans, to try to improve my model for the future assessment of potential borrowers.