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Growth in Marketplace Lending Spawns Specialized Risk Services and Tools

From the likes of Monja, Orchard Platform and PeerlQ, new-breed analytics for a burgeoning class of credit

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By Katherine Heires

As hedge funds, family offices, wealth managers and other institutional investors crowd into marketplace lending – a global market projected to grow to \$150 billion or more by 2020, with the U.S., U.K. and China leading the way, according to Morgan Stanley research – the need for relevant and more sophisticated risk management tools and services grows as well.

The institutional money pouring into the sector has been motivated, in large part, by low returns across the investment spectrum. Marketplace – also known as peer-to-peer (P2P) – lending has emerged as an attractive, alternative asset class, providing average yields of 6% to 9% over relatively short periods of time, Morgan Stanley says.



David Snitkof, Chief Product Officer, Orchard Platform

"A lot of investors are tripping over themselves, trying to figure out how to get involved and get the most amount of profit in the shortest amount of time," says Don Davis, managing partner at Prime Meridian Capital

Management, which specializes in P2P/marketplace
lending strategies. Prime Meridian prefers to take a longer view of the sector, favors working with the more established platforms and makes a point of employing independent, third-party services to help assess and manage the risks of marketplace loans, Davis says.

There are more than 200 players in the roughly decade-old field, which is led by such prominent brand names as Lending Club, Prosper Marketplace, OnDeck Capital and Funding Circle. New entrants continue to come in, notably private equity firm Blackstone Group through its portfolio company B2R Holdings.

And investors are learning that there are risks aplenty.

Each company applies a largely technology-driven approach to credit-risk analysis based on a unique combination of data sources. They aggregate a great deal of data – typically 50 to 100 characteristics about each borrower – but as yet there is little of the standardization and infrastructure that supports mass production in mortgage and credit card lending.



James Wu, Chief Executive Officer, Monja

B2R Holdings, which in October announced the purchase of the domain name Lending.com, said it plans to generate upward of \$10 billion in direct consumer and small-business loans over the next three years by partnering with entities that can facilitate distribution.

"We're confident this technology can be used to disintermediate how lending is done across multiple industry verticals," said Lending.com founder and CEO Jason Hogg. The firm also plans to take loans from

origination through the securitization process.

Distribution of Risks

As the marketplace lending industry broadens beyond unsecured consumer and small-business loans

– including loans for medical procedures, legal actions, automobile purchases and alternative energy

products – so does the risk profile evolve.

Given that the lending platforms, in most instances, are pure intermediaries, the risk passes entirely to the investors. They must get up to speed on an asset class with a relatively short performance history and its own nuances, tendencies, and quirks. It is a time-consuming and complex challenge to aggregate and then standardize data from the many marketplace lending platforms for purposes of risk analysis. Most marketplace lending assets do not trade on an exchange, making real-time price discovery difficult. And expected default rates on the respective lending platforms can change frequently.

Taking note of the industry's rapid growth and the need to educate policymakers, the U.S Treasury Department invited public comment in July through a request for information on "(i) the various business models of and products offered by online marketplace lenders to small businesses and consumers; (ii) the potential for online marketplace lending to expand access to credit to historically underserved market segments; and (iii) how the financial regulatory framework should evolve to support the safe growth of this industry."

<u>Autonomous Research</u> reports, for example, that riskier borrower profiles were creeping into Lending Circle's higher-rated loan categories – and very likely into those of other platforms – at a time when interest rates for borrowers utilizing the platform kept falling.



PeerIQ's initial Securitization Tracker showed cumulative activity and reported five deals totaling nearly \$1.5 billion in the 2015 third quarter.

"Lending Circle discloses that the average interest rate on their platform is down 200 basis points over 18 months, but for some specific borrower profiles, our research shows rates could be down as much as 500 basis points," says Autonomous partner Matthew Lipton. "In other words, the credit base is quietly expanding," and this means more risk for investors.

Analytic Support

For those seeking help in managing these platform-type risks, companies like Orchard Platform and PeerlQ in New York and Monja of San Francisco have developed unique and competing approaches.

Orchard Platform, founded in 2013, is first and foremost "a technology infrastructure provider to the marketplace lending industry," explains chief product officer David Snitkof. The firm's algorithms match investors with marketplace platforms and specific loans that meet their risk criteria. Orchard essentially connects to a diversity of loan options and facilitates the risk process, among other activities.

With access and working partnerships with 133 lenders, Snitkof says, "We have unique access to loan supply with an execution system hooked into the loan originators. As loans come out, we can

run them through our investors' risk models and place them in an automated way."

Orchard also supports third-party modelers that investors can hire to build their own custom algorithms.

Orchard's co-founders are Snitkof, a former credit risk analyst at American Express Co. and Citigroup; chief financial officer Angela Ceresnie (who has a similar credit analysis background); CEO Matt Burton and CTO Jonathan Kelfer, together bringing credit risk, online advertising and financial technology experience to bear. The firm currently has a 15-person software development group and five data scientists. They have built proprietary models to evaluate the credit risk, using data provided by the platforms themselves, such as where the loans originated geographically, borrower's job, income, FICO score, etc.

"The more tools we can provide to investors to better manage risk, the more value we can provide," Snitkof says.

As a middleman, Orchard provides market data tools, research and historical performance information. Its Originator and Manager Database contains comparative data on fund size, portfolio leverage and originator counterparties. There is also an Orchard U.S. Consumer Marketplace Lending Index for benchmarking on loan vintage, grade, term and other metrics.

Including a \$30 million Series B funding round in September, Orchard has raised \$44.7 million from the likes of Thrive Capital, Thomvest Ventures and Nyca Partners and such individuals as former Reuters Group CEO Tom Glocer, former Morgan Stanley CEO John Mack, former Citigroup CEO Vikram Pandit and former Goldman Sachs Group president and co-chief operating officer Jon Winkelried.

Moving forward, Snitkof says, Orchard has its sights on launching a secondary market for marketplace loans in 2016, to enable trading with price discovery and liquidity.

Beyond Traditional Tools

Monja, founded in 2014, is a "market insights" company focused on "helping institutional investors manage their risk exposure to marketplace lending," says James Wu, co-founder and CEO, whose 10-person team includes alumni of MSCI, Risk Management Solutions and Wells Fargo & Co.

Wu says institutional investors need to understand what makes this market different from other asset classes and to employ tools and models tailored for its risks.

"Traditionally, if you are an asset manager purchasing any loans with collateral or an asset-backed security, a lot of the risk management happens on the front end," Wu says. But in marketplace lending, with risk passing directly to investors, "it behooves [them] to do their own analytics."

Monja has proprietary models and selection algorithms for marketplace lending and portfolio evaluation, along with analysis services to help investors drill down into delinquency rates and improve overall investment performance.

Wu contends that even funds with their own credit models and strategies can benefit from Monja's focus on and familiarity with marketplace lenders – in particular, the two dozen in the U.S. that are larger and have longer track records.

Limitations of Credit Scores

"A lot of institutional investors focus on putting together a marketplace lending portfolio that is satisfactory, but they are not using all the data that is available to them," Wu says. Many will rely heavily on FICO score cut-offs or debt-to-income ratio cut-offs, but fail to employ alternative or regional data on borrowers or analyze loan investments in a more holistic way, he adds.

Such data support to marketplace lenders has been a growth driver for RevolutionCredit, a company founded in 2012 by Experian veteran Zaydoon Munir. He notes that the much-relied-upon FICO score is based on historical, transactional information, and what is lacking is a predictive, behavioral dimension that RevolutionCredit's "big data" can contribute. It is particularly useful when evaluating

borrowers in the middle ranges of credit scores – below super-prime and above subprime – which are not always definitive in identifying good risks among the "upwardly mobile."

Irvine, California-based RevolutionCredit is eyeing opportunities to help reach under-served populations outside the U.S., in emerging markets such as Mexico, Brazil and India. The company has been backed by, among others, Accion Venture Lab, Nyca Partners and Omidyar Network.

Monja's Wu notes that someone looking to borrow a round number – say, \$10,000 – is invariably a worse credit risk than someone looking to borrow \$10,520, because the latter usually has a specific purpose in mind. "There are many, many variables like this that you can and should use to analyze borrowers, and typically, managers are not using many of them," Wu says.

Monja can take on the tasks of normalizing, cleansing and massaging the enormous flows of data from the various marketplace platforms that are "not the best use of a risk manager's time," Wu says. "This way, your fund's risk manager can spend more time thinking about when the next recession will happen."

The Cycle Will Turn

PeerIQ http://www.peeriq.com/ states as its mission "to strengthen the P2P sector by increasing transparency, improving investment decision-making and enabling efficient risk management." In April it announced \$6 million in seed funding from a group that included Uprising Ventures, the aforementioned John Mack and Vikram Pandit, former Securities and Exchange Commission chairman Arthur Levitt, former Bloomberg CEO Dan Doctoroff and former Goldman Sachs Asset Management CEO Eric Schwartz.

PeerIQ co-founder and CEO Ram Ahluwalia, formerly of Bank of America Merrill Lynch and investment adviser Winged Foot Capital, says that although the marketplace lending sector maintains a low default rate, the credit cycle will inevitably turn, rates will change and losses will rise. He contends that the risk infrastructure has not kept pace with the institutional capital flowing in.

"Investors will need credit risk analytics that can answer many questions," he says, such as: What happens to peer-to-peer loans under different macroeconomic conditions? What will happen to defaults and prepayment fees? What does this mean to the value of your overall P2P portfolio?

PeerlQ and its analysts help investors answer these questions. They will roll out a model that shows the sensitivity of defaults and prepayments to macro conditions.

The firm's tools for historical analysis include risk and return metrics by region, vintage, grade, originator and other characteristics; scenario and stress-testing tools; price, risk management and settlement benchmarks. Beyond consumer and small-business loans, the firm is developing analytics for student loans.

Tracking Securitizations

PeerIQ in October introduced its Securitization Tracker, offering analysis that it said "will help improve transparency, foster standards, shape aggregator-led securitization programs and create greater awareness and liquidity in secondary ABS markets."

The company will also "be testing and creating new financial products that enable institutions to access and hedge risk in peer-to-peer lending and building analytics to provide pricing for these new financial products," Ahluwalia adds.

As organizations like PeerIQ seek to fill an analytical void, Lipton of Autonomous Research says potential users may have more immediate concerns.

"For many investors, getting enough access to marketplace-originated loans in the hunt for yield is the important thing right now, rather than having gobs of risk overlay," Lipton says. "Because personal debt-consolidation loans are not a new asset class, many asset managers already believe they understand credit analysis for this sector," and therefore are not turning to such services. Lipton believes it's too early to gauge these new risk services' long-term prospects.

Monja's Wu, on the other hand, says, "We're seeing a lot of interest in risk management tools for

marketplace lending and would not be surprised to see many other firms joining the party soon."

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