Marketplace Lending — A Growing and Dynamic Global Market
Structured Finance — A Growing and Dynamic Global Market

Contact Information

Imran Ansari  
Vice President, U.S. ABS 
Global Structured Finance  
+1 212 806 3902  
iansari@dbrs.com

Gordan Kerr  
Senior Vice President, Head of European Research  
Global Structured Finance  
+44 20 785 6667 
gkerr@dbrs.com

Chris D’Onofrio  
Managing Director, U.S. ABS  
Global Structured Finance  
+1 212 806 3284  
cdonofrio@dbrs.com

Claire Mezzanotte  
Group Managing Director,  
Head of Global Structured Finance  
+1 212 806 3272  
cmezzanotte@dbrs.com

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Introduction

Marketplace lending has rapidly evolved via financial technology (FinTech) to provide loan alternatives for both consumers and small businesses in the post-financial crisis era. This form of FinTech-enabled lending, commonly known as peer-to-peer (P2P) lending, has disrupted traditional banking across the globe by directly matching lenders with borrowers, typically through online platforms. Disruptive aspects of marketplace lending versus traditional banking include the deployment of a much more efficient origination process, an improved online lending experience and competitively priced loan products.

The debt capital markets have been used as a funding source for certain marketplace lenders; however, as a nascent industry, participants in this space have experienced challenges. First, most marketplace lenders do not have a long history of loan performance data that spans both periods of economic growth and decline. As a result, the validity of their risk modeling and underwriting decisions have yet to be fully back-tested, which may be limiting to wider investor confidence and the adoption of the asset class for now.

Second, these platforms have been facing new regulations and/or increased regulatory scrutiny as they have matured. Most platforms have shown a strong commitment to compliance with any new regulations so far, but they have yet to demonstrate a long term, sustained track record of solving various legal issues, which may continue to materialize in the future. Further, to the extent the originate-to-distribute business model is used by a number of marketplace lenders currently, this remains of some concern for securitizations, as the amount of “skin in the game” retained by the various platforms may not fully align lender and investor interests in all cases.

DBRS expects that as the marketplace lending industry addresses these various challenges, marketplace lenders, and particularly those that securitize, will likely adapt appropriately. This would benefit the sector’s investor base and therefore promote further expansion of the marketplace lending industry’s securitization programs and improve the credit quality of future originations.

An Evolution in Finance: Traditional Banking versus FinTech Lending

In the aftermath of the global financial crisis, the marketplace lending sector has blossomed, spurred on by advancements in FinTech. A growing distrust of traditional financial markets, a low-yield environment and more conservative bank lending had created an environment where marketplace lenders have been able to develop products that compete with traditional financial products, all through the use of FinTech.

Despite having improved over the last five years, the financial services industry is still the least-trusted industry overall, according to Edelman Trust Barometer scoring. For this metric, participants were asked to scale how much they trust businesses in each industry to “do what is right.” Financial services had an approval rating of only 54% compared with the technology sector, which scored 74% (Exhibit 1).

Exhibit 1: 2018 Edelman Trust Barometer by Industry

Source: 2018 Edelman Trust Barometer.
Against this backdrop, marketplace lending has opened up the previously bank-dominated lending market to many new individuals and investors by offering the opportunity to lend directly to borrowers rather than using a bank as an intermediary.

The original premise for companies in this space was to create an online FinTech platform to match individuals who wanted to borrow money with retail investors who wanted to lend, commonly referred to as P2P lending. The evolution of the P2P market framework has expanded to accommodate numerous different financial segments, from consumer lending, to property development, to pawn broking. In this report, DBRS will focus on the relatively larger unsecured consumer lending market.

As the opportunities for P2P lending platforms to enable funding in different segments have evolved, so has the investor landscape, migrating from retail investors to institutional funds. For example, in Europe, government-supported institutions such as the British Business Bank and the European Investment Fund have invested. The original definition of P2P, where the lender is an individual matched to a borrower, has migrated into the term marketplace lending.

Marketplace lending is broadly defined as the matching of borrowers with any lenders via an online platform without a traditional bank intermediary. These online platforms use various risk assessment techniques to provide an evaluation of the credit quality of the borrower so that a loan can be made and subsequently offers the loan as an investment to individual investors or pools multiple loans and offers investors access to each pool.

Initially, most P2P platforms in unsecured consumer lending operated strictly as an intermediary between obligors and lenders, employing an originate-to-distribute model where they generated revenue from origination and servicing fees. As the market has grown, this lending model has evolved to serve the same type of borrowers but has expanded the types of funding sources used, from solely retail investors to a variety of commercial sources, including warehouse lines, whole-loan sales to institutional investors and the asset-backed securities market. Further, originating platforms have also retained loans and residuals of securitizations to comply with risk retention, as well as to address legal and regulatory issues.

FinTech’s Influence on Marketplace Lending Around the Globe

United States

Marketplace lending for unsecured consumer loans through FinTech firms in the United States, such as LendingClub, SoFi, Prosper, Upstart and Freedom Financial Network, has grown dramatically over the past decade. The aggregate personal loan market in the United States, which includes bank lenders, credit unions, finance companies and FinTech lenders, has grown to about $120 billion across 17 million borrowers as of 2018 compared with just $72 billion a decade prior (as reported by TransUnion).

Within the aggregate total of consumer lending, FinTech lenders have captured a substantial share of the personal loan market over the past eight years and now comprise over one-third of all new loan originations compared with less than 1% in 2010.
Small business marketplace lending in the United States has grown as well. Companies borrowing in this space are offered a variety of financing options that range from receivables factoring to unsecured and secured term loans and lines of credit, merchant cash advances and asset-based lending. According to a report by the Cambridge Centre for Alternative Finance, more than 130,000 businesses in the United States received approximately $10.1 billion in financing in 2017 through online alternative finance platforms, with nearly 87% financed through debt-based platforms.

FinTech lending platforms typically employ proprietary algorithms, machine learning and artificial intelligence in an attempt to better underwrite loans more efficiently than traditional lenders have done. Creating a seamless and fast experience for the borrower while assessing credit risk has allowed FinTech lending platforms to capture a large share of the consumer loan market from traditional lenders.

Europe
Marketplace lending in Europe has been slower to react to this FinTech opportunity versus the United States, despite being the home of Zopa. Formed in 2005, Zopa was the very first marketplace lending platform in the world. With this lag, the relative size of the European market right now is much smaller than the larger U.S. and Asian markets. However, growth rates remain very high as the region’s market expands. To date, most of the growth has come from the United Kingdom with total marketplace lending of over EUR 10 billion lent over the 12 years since the introduction of Zopa. Within Europe, a large number of lenders have established themselves in the eastern markets, where trust in banks and availability of lending may be lower than other markets. However, the amount of lending remains concentrated in the larger European markets.

For the unsecured consumer lending market in the United Kingdom, the largest market for marketplace lending in Europe, there are two large market participants, Zopa and RateSetter, with cumulative lending of GBP 6.6 billion between them. In 2018, Zopa lent out GBP 954 million and RateSetter GBP 664 million as of their latest updates. Following behind these two in terms of volume are Funding Secure and Lending Works, both with less than GBP 300 million in cumulative lending and less than GBP 150 million year to date. There are also a number of lesser-known names such as RateSetter in the consumer space, ThinCats in the business space and LendInvest, Lendy and Wellesley in the property sector.

Most of the platforms in the United Kingdom tend to be focused on the small and medium-sized enterprise (SME) and property sectors, while Europe has a larger number of consumer platforms and fewer in the SME sector and other lenders. Funding Circle — by far the best-known platform in the United Kingdom — has now expanded to lend in more than one market, originating loans in the United States, the United Kingdom, the Netherlands and Germany, with plans for further expansion, making it the most global of the lending platforms.

Growth within Europe has reached EUR 6.7 billion in cumulative lending, with EUR 3.1 billion of that originated within 2018. There are 18 consumer platforms listed on the Brismo site, spanning across many countries, with new additions regularly.
Asia
The Asian market has seen rapid growth in its alternative lending market. This is in part because of its still-nascent banking and lending sectors. The P2P market within China alone has grown by 41% to over USD 80 billion in new lending.

However, this growth has not come without its issues. There have been a number of high-profile fraud-related lender closures within the Asian region, notably China, where authorities over the past few years have continued to prosecute numerous offending platforms. This increase in the number of investigations and subsequently new legislation has placed further regulatory pressure on the sector.

Growth Hurdles
With an ever-evolving market, there are many variations of business models and operational platforms among companies. This presents a challenge for the market, investors and participants to correctly evaluate what each respective platform is offering in comparison with its competitors. It also confuses participants on how they should define the sector. A few of the main issues to evaluating the risks within the sector are as follows:

1. Lack of Performance Data through Up and Down Business Cycles
One of the concerns with marketplace FinTech originators is that the majority of their originations have not gone through a full credit cycle. As a result, it is yet to be determined if their more sophisticated technology-based underwriting methods will prove to be better at assessing risk relative to traditional underwriting methods.

Some of the larger and more established lenders in this space, including LendingClub and Prosper, are becoming seasoned platforms and have substantial static pool data sets. Zopa now has over a decade of history on its lending platform. This concern will ultimately be assessed fully when the marketplace lending industry experiences its first post-crisis recessionary period. However, until then, time continues to work in their favor. As algorithms and artificial intelligence evolve and have larger amounts of historical data, it could be reasonable to expect that they will be better able to identify borrowers that are likely to default.
2. Regulation — When? How Severe? Impact?

Regulatory concerns remain for this sector, and it is yet to be determined when and how disruptive any regulation could be, especially in various jurisdictions. In the United States, a common arrangement between the marketplace lender and the partner bank is where the marketplace lender typically performs the sourcing of the loan, including marketing, identifying loan prospects, loan application processing, maintaining the relationship with the loan borrower and servicing the loan. Meanwhile, the partner bank originates the loan, holds the loan for a short period of time, then sells the loan to the online lender or to an investor. In this arrangement, the partner bank is considered the “true lender.”

The primary reason that online lenders use a bank partnership model is that it facilitates the streamlined and efficient origination of loans by utilizing the bank’s regulatory and compliance framework, lending licenses and ability to export the bank’s rates nationally. However, this arrangement raises regulatory concerns as it could be viewed as an outsourcing of regulatory compliance. It also adds costs to the online platform but potentially not more than building the regulatory compliance infrastructure directly. To date, many regulators have maintained a hands-off approach as these platforms grow, particularly within the U.S. market.

As the regional markets mature, and the participating platforms grow, the potential for even further regulation is a risk. In the United Kingdom, the regulator for the industry has been involved for a while but has not been heavily directing the market, instead taking more of a supportive and direction hand rather than putting on the brakes. However, there is currently a concern that the U.K. regulator will remove access to many retail investors on the back of losses experienced by some crowdfunding platforms and lack of education offered on the risks to these investors. This is a contradiction to its previous stance on the sector, which was supportive of it as a source of competition to traditional finance and an efficient way of connecting investors and borrowers.

As the marketplace lending sector has evolved, online lenders and partner banks have generally demonstrated a strong commitment to complying with rules and regulations and addressing regulatory concerns. Many lending platforms and partner banks have dedicated significant resources to legal and compliance teams and have promoted a culture of operational transparency in an effort to mitigate potential and known risks that exist in the marketplace.

3. Know Your Customer

FinTech lending platforms typically use an Internet-based system to originate, underwrite and distribute loans. This electronic approach allows for the potential risk of fraud, identity theft and loan stacking. However, as platforms have matured, they have taken significant measures to combat nefarious activities through proprietary algorithms designed to detect fraud and patch any loopholes that have emerged over time. Plus, many FinTech lending companies have used technology to advance customer checks and make them easier and faster to process. For example, in the United Kingdom, banking platforms Monzo and Starling Bank give customers the ability to take a photo of their identification as well as a personal video to identify themselves without the need to speak anyone.

4. Investors — From Retail to Institutional

A lack of scale and the variability of demand through retail investors alone have prompted platforms to migrate toward institutional investor interest. While this does create a more stable pool of funding, it also adds a number of challenges and concerns. There is potential for negative selection for retail investors, demand for higher yields and possible incentivizing platforms into riskier credit.

To date, there has not been any noticeable deterioration in lending standards. Instead, increased scale allows many of the largest marketplace lending platforms to actively refine and strengthen their underwriting standards to be more competitive with better-quality borrowers. The platforms have also dynamically adjusted their underwriting over time to account for any signs of unexpected borrower performance. The nimbleness of these platforms, their ability to quickly adjust for signs of worsening credit, is a positive for investors and other market participants.
Securitization Offers a Viable Funding Platform — but Caution Should Remain

The securitization market offers marketplace lending participants a valuable tool for lending platforms, or their institutional backers, to obtain funding. The use of securitization allows marketplace lenders to increase the velocity of their committed capital in order to allow continued new lending and volume growth.

**Exhibit 7: Unsecured Consumer Cumulative and Quarterly Volumes as of December 2018 ($ Millions)**

From a securitization investor’s perspective, caution should remain. Lessons from the global financial crisis have made the business model of originate to distribute through securitization a major concern, as lenders using this approach have to balance opposing goals of retaining skin in the game with growing the business. Skin in the game is one of the major analytical considerations that results in ratings for the top classes of securitizations in the lower-investment-grade categories. However, with increased data availability that shows good historical performance that is demonstrated over more business cycles, solid risk management, evidence of solid underwriting policies and structural alignment of interests, higher securitization ratings may be achieved. To date, DBRS has rated approximately $7.7 billion in unsecured consumer loan transactions.
Note:
All figures are in U.S. dollars unless otherwise noted.

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