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EBay-Style Peer Loans Spur Wall Street Asset Craze

By Ari Levy and Dakin Campbell - Aug 26, 2013
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9 COMMENTS

+ QUEUE

Alex Farnum/Bloomberg Markets

Stephan, right, and Aaron Vermut, CEO and President of Prosper Marketplace, brought $20 million with them from an investment group led by Sequoia Capital.

On a June morning in midtown Manhattan, more than 300 investors cram into a conference room at the Convene Innovation Center, nibbling on pastries and waiting for Renaud Laplanche to take the stage. As founder and chief executive officer of LendingClub Corp., Laplanche has rock star status at this inaugural LendIt conference, where Wall Street investment managers clamor for insight into the world of peer-to-peer lending.

June 20 (Bloomberg) – Lending Club Founder and CEO Renaud LaPlanche discusses peer-to-peer lending with Deirdre Bolton on Bloomberg Television's "Money Moves." (Source: Bloomberg)

LendingClub CEO Renaud Laplanche expects to originate $2 billion in peer-to-peer loans this year as big asset managers clamor to get aboard. Photographer: Alex Farnum/Bloomberg Markets

SoFi CEO Mike Cagney, who makes education loans online, says the commercial banks have lost interest in consumer loans. Photographer: Alex Farnum/Bloomberg Markets

Laplanche, 42, a French securities lawyer turned Silicon Valley entrepreneur, expects San Francisco-based LendingClub to originate $2 billion in loans this year and double that in 2014. As he takes the stage, he's fresh off a $125 million investment led by Google Inc., Bloomberg Markets magazine will report in its October issue.

Armed with a muscular board that includes former Morgan Stanley CEO John Mack and former U.S. Treasury Secretary Lawrence Summers, Laplanche aspires to create the go-to Internet site for borrowers in need of funds for credit card consolidation, home improvement and small-business expansion.

When Laplanche leaves the stage, he is mobbed by money managers and clients, who spend two hours grilling him about LendingClub's loan programs.

LendingClub is one of a dozen firms in the U.S., Europe and Australia whose model is to create a marketplace for loans similar to EBay Inc. (EBAY)'s market for goods and services, with ordinary people lending money to other ordinary people via an online platform.

San Francisco Startups

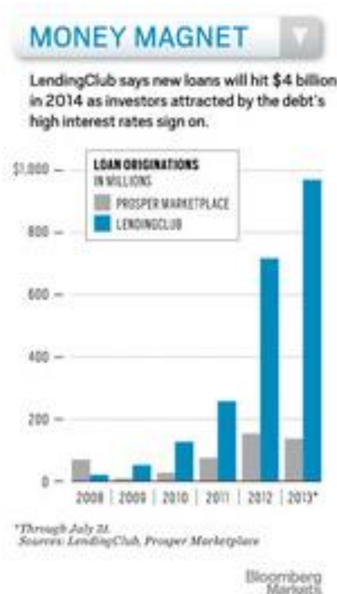
The other large U.S. peer-to-peer lender is Prosper Marketplace Inc., headquartered two blocks away from LendingClub in San Francisco's South of Market district.

Prosper expects to originate more than $500 million in loans next year.

"What we've done is radically transform the way consumer lending operates," Laplanche says in his speech. He says that LendingClub keeps staffing low by using algorithms to screen prospective borrowers for risk -- rejecting 90 percent of them - - and has no physical branches like banks. "The savings can be passed on to more borrowers in terms of lower interest rates and investors in terms of attractive returns."

Prospective borrowers go to the firms' websites to sign up. If they're accepted, they pay interest rates ranging from 6.7 percent to 35 percent a year, depending on their credit history, on three- to five-year loans of as much as $35,000. They pay that interest directly to a group of lender-investors, with LendingClub and Prosper acting as underwriters and taking a fee from each transaction. Lenders scan

LendingClub board member John Mack has encouraged his former colleagues at Morgan Stanley to recommend LendingClub loans to their clients. Photographer: Alex Farnum/Bloomberg Markets. Warhol Image: ©2013 The Andy Warhol Foundation for The Visual Arts Inc./Artists Rights Aociety (ARS), New York; Courtesy of Ronald Feldman Fine Arts, New York



the websites, read over prospective borrowers' plans for using the money and buy pieces of individual loans.

Bypassing Banks

Masood Raja, an English professor at the University of North Texas in Denton, took out a three-year $3,500 loan from LendingClub early this year to purchase a Vespa motor scooter on eBay. He was assigned a rate of just over 10 percent.

"I liked that I didn't have to go to a bank," says Raja, 48. "The idea that small investors would be able to invest in this loan was very enticing."

Raja says that 72 lenders put money into the loan, buying chunks of as little as $25.

LendingClub says that from June 2007 to July 31 of this year lender-investors earned an average annualized return of 9.5 percent, compared with 0.1 to 1.5 percent in a bank savings account. Prosper's average return for the period from July 2009 to June 2013 was 9 percent.

Big Money

The new debt category's high returns have brought Wall Street money managers running, along with pension funds, sovereign wealth funds and family offices desperate for higher yields at a time when 10-year U.S. Treasuries generate less than 3 percent. They've offered to take over all of the loans the peer-to-peer lenders can gather in.

The outside investors are now bundling the small loans into much larger pools so they can be more easily sold to big institutions. LendingClub itself runs a subsidiary called LC Advisors, which sells funds made up of LendingClub loans to high-net-worth individuals.

LendingClub is also working with a Massachusetts-based investment firm called Arcadia LLC, which has proposed to up the ante by applying leverage -- that is, take bank loans to fund more loan purchases.

"This is without doubt an emerging asset class," says Andrew Hallowell, an Arcadia founder.

High Risk

Peer-to-peer loans can be high risk. When they were first introduced, default rates topped 17 percent. The loans remain unrated because the asset class is still too new for Moody's Investors Service and Standard & Poor's to take notice.

"The big problem is the whole issue of credit risk," says Bert Ely, a banking consultant in Alexandria, Virginia. "To the extent the person putting up the money is relying on someone else to do the screening, you have to ask whether this is an appropriate investment for some."

Peer-to-peer lenders issue their loans through Salt Lake City-based WebBank. They're regulated by the U.S. Securities and Exchange Commission. Although LendingClub and Prosper recruit borrowers in more than 40 states, in at least 20 of them lender-investors are not allowed to be part of the process.

"If you are going to be a lender in this state, you have to be licensed," says Ed Novak, a spokesman for the Pennsylvania Department of Banking and Securities. That rule, he says, applies to both banks and individuals.

Online Boom

By 2016, peer-to-peer lenders in the U.S. will be originating $20 billion in loans annually, according to Jason Jones, an organizer of the LendIt conference and partner at New York-based Disruption Credit, an investment firm focused on online lending. That doesn't include online loan programs not available to retail investors, led by San Francisco-based Social Finance Inc., or SoFi, which may hand out as much as $1 billion in education loans this year.

Brooklyn, New York-based CommonBond LLC is also in the student loan business, while Montreal-based IOU Financial Inc. (IOU) lends online to small businesses.

David Schuette, a 50-year-old network engineer in Lakewood, Colorado, took out a $10,000 LendingClub loan this year to consolidate credit card debt, on some of which he was paying 30 percent interest. LendingClub approved a three-year loan at 9 percent.

"It's a great idea to have the little guys helping the little guys," Schuette says.

Bank Credit Slumps

The online lenders owe a debt of their own to the commercial banks, which have cut back on consumer lending. Americans had borrowed $854 billion in open-ended or revolving debt, such as credit card loans, as of the end of June, a decline of almost $170 billion over the July 2008 peak, according to Federal Reserve data.

"The banks are not interested in expanding their business, and they're bogged down from a regulatory standpoint," SoFi CEO Mike Cagney says.

Prosper Marketplace, founded in 2005 by Silicon Valley entrepreneur Chris Larsen, was the first U.S. peer-to-peer lender. Laplanche started up LendingClub a year later.

Larsen's notion was to create an enterprise in which individual borrowers and lenders could negotiate loans, take the risk and keep the profits. His business was just beginning to take off when, in October 2008, under pressure from the SEC, he voluntarily shut down.

A cease-and-desist order followed a month later, alleging that Larsen was selling unregistered securities -- meaning the online loans retail investors were buying. Larsen suspended operations for nine months while he made his company SEC compliant. He left the firm in March 2012.

SEC Action

LendingClub had anticipated SEC action and had been working with the agency since April 2008, when it stopped taking money from retail investors. Six months later, it restarted as an SEC-registered company. To gain that registration, it agreed to automatically file with the federal agency every loan it made as a separate security.

Prosper mimicked LendingClub's process to gain compliance, yet it wasn't until July 2009 that its registration was completed. In addition to filing every loan, both companies report quarterly and annual results, as though they were publicly traded.

"We have a regulatory reporting burden that's unlike just about any private company in existence," says Jeff Crowe, a LendingClub board member and partner at Palo Alto, California-based Norwest Venture Partners.

Class-Action Suit

LendingClub used the time it gained in the battle with the SEC to jet past Prosper, which made $153 million in loans in 2012 compared with LendingClub's $718 million.

Prosper was also hampered by a class-action lawsuit, filed in San Francisco Superior Court days after the SEC cease-and-desist order by a group of disgruntled Prosper investors. The suit alleged that because Prosper was selling securities illegally, lenders who had lost money were entitled to be compensated.

The suit was settled on July 19, with Prosper agreeing to pay $10 million over a period of years to the plaintiff class. The company settled without admitting liability or wrongdoing.

Prosper and LendingClub now thoroughly check the credit history of all applicants, they say. Borrowers accepted by LendingClub as of early July had an average credit rating score of 704 out of 850.

Prosper's annualized default rate for July of this year was 5.8 percent, down from 12.3 percent three years earlier. LendingClub's aggregate rate of defaults and charge-offs dropped to 2.5

percent at the end of the first quarter of this year from 6.7 percent at the end of 2009.

Revenue, Profits

LendingClub recorded $20.8 million in revenue in the second quarter and profit of $1.7 million. Prosper lost $5.7 million, not including the $10 million legal settlement.

The influx of institutional interest has changed the game.

Hallowell, of Arcadia, has a five-person team in Burlington, Massachusetts, recruiting institutional investors for LendingClub loans through an entity called Cirrix Capital LP. Cirrix is developing quantitative models to determine how the loans will perform in a variety of economic scenarios. Hallowell says Santa Clara, California-based Silicon Valley Bank has agreed to lend Cirrix approximately three times the amount of the capital it raises from investors to buy more LendingClub loans. The bank's rate: about 4.5 percent.

Prosper has also been pursuing institutional investors since a new management team took over in January. The firm's board brought in Stephan and Aaron Vermut, a father-son tandem, as CEO and president. They previously ran Merlin Securities LLC, a prime brokerage acquired last year by San Francisco-based Wells Fargo & Co.

Sequoia Invests

The Vermuts brought with them $20 million of fresh equity for Prosper, with venture firm Sequoia Capital, known for early investments in Apple Inc. and Google, leading the financing.

After the Vermuts arrived, monthly loan originations tripled to $30.3 million in July from less than $10 million in February.

"We created awareness by selling our business, leaving Wells Fargo and coming here," Aaron Vermut, 40, says in the company's new 15th-floor office overlooking downtown San Francisco. "So you've got a bunch of Wall Street guys now in the p-to-p business. That's generated attention, and people said, 'Look, this thing's for real.'"

Institutional Limits

Laplanche, a former French sailing champion whose 73-foot (22-meter) trimaran, "LendingClub," won the Transpacific Yacht Race in July, is wary of the flood of institutional clients. To maintain a diversified investor base, he says that no single investor -- aside from LendingClub's own LC Advisors funds -- will control more than 5 percent of the loans and that levered deals will fund no more than 15 percent of them.

"We're trying to build a business for the long run that's very sustainable and can grow through different credit rate environments," he says. "We're putting constraints on individual managers, on our own funds and on any large source of capital."

The capital continues to flow in.

A corporate pension fund committed $25 million to LendingClub loans in June, a month after a sovereign wealth fund invested a similar sum, Laplanche says, declining to name the institutions. Oppenheimer Holdings Inc. (OPY) has recently started offering LendingClub's funds to high-net-worth clients.

Mack, Morgan Stanley (MS)'s CEO from 2005 to 2009, joined LendingClub's board last year and then encouraged the wealth management division of his former employer to sell the firm's loans to its clients.

'First Class'

"I saw a first-class product that consumers should have access to," says Mack, who first put some of his own money into the loans.

As peer-to-peer lending balloons, Prosper founder Chris Larsen, who now runs an electronic currency provider called OpenCoin Inc., looks on with some sadness. His original notion was to democratize lending by taking the profits away from the banks and giving them to consumers.

"This is not an Occupy Wall Street solution," he says of the takeover of peer-to-peer by big money. If the regulators had permitted him to pursue his original dream, he says, "maybe it could have been."

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