



A tale of David defeating Goliath? LendingClub woes suggest otherwise

by [Ernest SIM](#)

Marketplace lenders (MPL) have offered borrowers an alternate avenue to procure loans from investors (loan buyers) through online credit platforms, expanding credit availability for individuals and enterprises. As the use of such credit platforms proliferates, the investor base of MPLs has also grown to encompass institutional investors besides individual investors. However, unlike traditional financial institutions such as banks, MPLs assess the credit profile of their borrowers through the use of algorithms that evaluate borrowers' by their credit variables and their online activity. Another source of distinction from banks arise from MPLs being subjected to less stringent regulatory requirements such as capital requirements. As a result, MPLs have the potential to disrupt financial intermediaries, due to their greater convenience and cost competitiveness relative to traditional brick-and-mortar financial institutions. With a [promising track record of stellar growth in loans facilitation in the US](#), the possibility of MPLs replacing traditional financial intermediaries does not seem farfetched.

At the forefront of the marketplace lending sector is LendingClub Corp. a firm based in the US which had a [huge IPO of over USD 1bn in 2014](#). Yet, since the turn of 2016, turbulence in the US economy indicated a bleak outlook for marketplace lenders such as LendingClub with mounting doubts over the ability of US marketplace lending firms to weather downturns. Amid conditions of declining growth in US, coupled with expectations of a rate hike in April following the Fed's revision of rates in December 2015 - both conditions that promote loan delinquency – marketplace lenders' loan securitization volume were scrutinized and found [to have halved since the end of 2015](#). With faltering loan securitization volume occurring while risk of loan delinquency is heightened, potential cracks in the marketplace lending model were exposed, raising [uncertainty](#) for the marketplace lending sector.

The growing headwinds faced by the wider marketplace lending sector had weighed down on MPL leader LendingClub with financial results reported by LendingClub suggesting that the firm might not be in prime condition. Total debt to equity for LendingClub has climbed throughout the period, rising from 330.86% in Q1 2015 to 450.22% in Q1 2016 - LendingClub had been ramping up its leverage over the past year (see Table 1). LendingClub also reported dampened Q4 margins with net income margins reported to have dropped from 1.54% as of Q4 2015 to 1.26% at the end Q1 2016. Furthermore, despite year-on-year improvements in net income margin from -3.28% in Q1 2015 to 1.26% in Q1 2016, LendingClub barely breaks even at net income margin of 1.26% as of Q1 2016.

	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016
Net Income Margin (%)	-3.28	-1.83	0.36	1.54	1.26
Total Debt/Equity (%)	330.86	367.54	403.24	438.79	450.22

Table 1: Financial data for LendingClub Corp. Source: Bloomberg

Correspondingly, the RMI-CRI 1-year Probability of Default (PD) for LendingClub rose gradually from 21bps at the start of the year to 54bps by the end of the first quarter with the increasing trend following through into the subsequent quarter reflecting the increasingly difficult environment LendingClub was operating in (see Figure 1).

On May 9, 2016, the exit of founder and Chief Executive Office Renaud Laplanche sparked a massive sell-off that sent the market value of LendingClub plunging by almost [USD 950mn](#). Laplanche was dismissed by the board on grounds of two incidents; one involving faulty practices of the sale of loans and another involving the failure of disclosing Laplanche's interest in a fund that LendingClub had interest in. Subsequently, the RMI-CRI 1-year PD for LendingClub shot above 220bps, peaking at 420bps on May 13, 2016 (see Figure 1).



Figure 1: RMI-CRI 1-year PD for Lending Club Corp. Source: RMI-CRI

The list of woes faced by LendingClub did not end with the dive in market value triggered by Laplanche's forced resignation; [difficulties in obtaining funding](#) for loans also surfaced. With transparency expounded as a core benefit of marketplace lending, the lack of disclosure on Laplanche's part which led to his departure, contradicts the claims of transparency, shaking the confidence of loan buyers. Consequently, LendingClub had announced [job cuts of 12%](#) of its staff in an effort to slash costs in light of the sagging profits. However, the blow from the ousting of LendingClub's founder was not limited to LendingClub. Contagion effects from the battered reputation of LendingClub was also reported, although the impact on other marketplace lenders varies with some [lenders coping better than others](#).

The current challenge for LendingClub and the marketplace lending sector involves restoring investors' confidence in the MPL business model. The marketplace lending model hinges on trust as faltering confidence in MPLs would dry up loan funding from investors and would stymie loan issuance, placing pressure on margins. Also, the fallout from falling loan issuance could potentially extend to the development of MPLs, stifling their growth. As the financial innovation behind MPLs rests on its data-driven algorithms, a prolonged fall in loan issuance would curtail the development of its risk-scoring algorithm as data availability to refine MPLs risk model gets relatively limited. Indeed, new CEO of LendingClub Scott Sanborn has sought to undo the damage, moving in to [woo investors](#).

Nonetheless, the setbacks faced by LendingClub does not portend the scenarios of an eventual demise of the MPL sector or the MPL sector reaching its peak. As reported in [a white paper](#) published by the US Department of Treasury, market analysts estimate that the addressable market for marketplace lending at USD 1tn with loan originations projected to reach USD 90bn by 2020, suggesting that there is a lot of room for expansion. The ongoing task then is the constant refinement of the data-driven credit models used by MPLs as it underpins the marketplace lending model's success. LendingClub has already seen a rise in [charge-off rates](#) despite broad improvements in consumer credits, indicating that LendingClub should pay greater heed to its risk-scoring algorithms. By developing their credit scoring models, MPLs such as LendingClub would be able to better distinguish between borrowers, improving overall credit quality.

Looking ahead, tightening regulations is another area that LendingClub and the marketplace lending sector has to contend with. [The white paper](#) published by the US Department of Treasury examined the prospects and difficulties of marketplace lending. Amongst the findings, greater regulatory oversight in terms of establishment of a dedicated regulatory body and provision of clear and definite guidelines for marketplace lending were voiced by various participants. More recently, the [2016 annual report](#) from the Financial Stability Oversight Council (FSOC) had highlighted the risks and the need for supervision for the marketplace lending sector. Both instances signal greater monitoring and surveillance of the marketplace lending sector by US regulatory authorities in due course. Undoubtedly, closer scrutiny and clearer guidelines would promote credibility in this sector, however, the operation costs for marketplace lenders would be driven up to match tighter standards, eroding the cost competitiveness MPLs have over banks through its streamlined, technology-centered credit-rating process.

With tighter regulations looming and MPLs' mettle untested through full credit cycles, it has yet to be seen if the marketplace lending model will be funneled towards balance sheet activities similar to banks or if they will thrive by selling, rather than holding loans. Either way, the future holds both promise and perils for LendingClub and the marketplace lending sector.

Credit News

Pensions stretched to breaking point after Brexit vote

Jul 17. The investors' rush to buy the safest government bonds followed by Brexit have pushed the bond yields down, adding to approximately GBP 85bn to the UK companies' pension scheme liabilities. It further hurts the UK's 6,000 private sector defined benefit pension schemes, many of which are already stretched to breaking point. These schemes were set up decades ago and guaranteed inflation-linked annual incomes based on salaries to 11mn employees. According to industry figures, nearly 5,000 employers in UK are now in deficit, while roughly 1,000 are on the verge of insolvency. The big shortfalls in the pension schemes will possibly force employers to rein in investment in their growth projects and push more companies out of business. ([FT](#))

Leveraged loans in Europe dodge Brexit woes as junk bonds falter

Jul 13. Loans remain resilient in the face of market turmoil following Brexit. There are at least four deals that have been struck or offered to investors since Brexit whereas there are no issuance of new bonds in the junk market. Leveraged loans are sought after by pension funds and insurance companies as they look for longer-term returns in low-rate environments. With bond yields hitting record lows globally, institutional investors have turned to low-volatility, higher-yield assets, such as leveraged loans. Leveraged-loan issuance in June rose to EUR 9bn, the highest since July last year, as companies raced to lock in low borrowing costs before the U.K. referendum. ([Bloomberg](#))

Brazil's largest pension fund selling USD 606mn of bad loans

Jul 13. Brazil's pension giant which managed the retirement savings of workers from state-owned Banco do Brasil SA, Previ is seeking to sell USD 606.7mn worth of distressed real-estate loans which may take place at the end of 2016. In addition, Santander Brasil SA and Caixa Economica Federal have also unloaded their credit portfolios, amounting to BRL 2.6bn of non-performing debt and BRL 1.77bn of personal and corporate credit portfolios respectively. As Brazil's worst recession sparks a surge in delinquencies, firms specializing in the distressed loan business experience a boom. An analyst said there is an increasing number of investors looking at non-performing loans in Brazil which boosts the interest of sellers who had never considered it as an alternative before. ([Bloomberg](#))

Subprime auto-loan loss expectations rise

Jul 12. The rising likelihood of subprime auto-loan defaults is spelling trouble for the auto market and lenders in the US. According to credit rating company DBRS Inc., 18% of auto-loan principal dollars securitized by subprime lenders in 2015 are not likely to be repaid. In addition, the prices of used car are also weakening. The weakening prices may result in bigger loss for lenders as they can only recover a smaller portion of the outstanding valance. Banking regulator, the Office of the Comptroller of the Currency, attributed the problem to the increased competition between lenders, which led to less stringent underwriting standards. ([WSJ](#))

China's zombie companies stay alive despite defaults

Jul 12. Dongbei Special Steel Group (Dongbei) which has less cash than short-term debt continued to miss five payments on its USD 6bn debt after China let its state-owned companies defaulted on a bond payment this spring. The company had not filed for bankruptcy or underwent restructuring. China has the world's largest corporate debt to GDP ratio and its defaults doubled in the first half of 2016 from a year earlier. Its overcapacity problems and souring debts will "smooth out over a minimum 10 years", according to a consultant. Meanwhile, the IMF warned that the wave of defaults in China could ripple through global markets. ([WSJ](#))

Saudi Arabia's non-oil sector slips into recession ([FT](#))

DNB reveals sharp increase in bad loan provisions ([FT](#))

Singapore home sales fell in June to lowest level in four months ([Bloomberg](#))

Regulatory Updates

Bank regulator flashes warning light over commercial real estate

Jul 15. The Office of the Comptroller of the Currency (OCC), a leading US banking regulator, wants lenders to do more to manage their exposure to commercial real estate. The OCC signals that there is a rise in credit risk from increased lending and looser underwriting in the banking sector. Longer loan maturities, interest-only payment periods, and less restrictive covenants are adding risks. Lending growth for large banks accelerated to 5.9% in 2015, up from 3.6% a year earlier. Smaller institutions have also bulked up their loan portfolios, focusing on both commercial and residential properties. ([Bloomberg](#))

IMF urges action on Italy's bank bail-in

Jul 12. The International Monetary Fund (IMF) called for action over concerns relating to the bail-in of retail investors in Italy, noting that "very high" amount of non-performing loans and slow judicial processes were straining bank balance sheets. Talks between Italy and the European Commission to recapitalize local banks are stuck on whether creditors should face losses if taxpayer funds are used. Rules that took full effect this year require bondholders and shareholders to absorb losses in failing lenders in the events of a rescue, a process dubbed a "bail-in." IMF urged authorities to act faster on pro-growth reforms with "greater priority to lower and more efficient spending and less distortive taxation, including broadening the tax base and introducing a modern real estate tax." ([Bloomberg](#))

RBI braces for Basel Battle on sovereign bonds ([Bloomberg](#))

MAS probes operations of banks over 1MDB ([Straits Times](#))