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Lending Club: leading the P2P market place

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With growth comes the need for change and the economies globally are growing at a mammoth rate. Technology is driving the way the world is functioning, whether it is socializing on virtual platforms, finding love, to buying or selling on a virtual marketplace or financial intermediation.

In the wake of the technological revolution there have been radical ideas that are waiting to transform the ways with which banking is done and one such idea is the online market place for financial intermediation where the borrowers and lenders come together to transact on need for funds. Lending Club is one of the largest of such virtual market places existing today and in this article, we will be discussing briefly on how the business operates.

Lending Club[1], was established in the year 2007 with the intent to make credit more accessible and is currently the world's largest peer to peer lending platform. The platform has over 2 billion borrowers accessing finance from lenders across globe. The platform facilitated over $7.6 billion of loan in a year which though is probably 1% of lending undertaken by HSBC in a year, but the sheer volumes indicate that the lenders and borrowers are moving towards dispelling the need for physical presence[2] of the financial institution to facilitate lending relationships.

Lending Model

The Lending Club works through a technological platform which intermediates between the borrowers and lenders i.e. it is a market place where borrowers raise loans from lenders without a physical interface.
Lending is intermediated by the platform in the following way:

a. The borrowers raise a requisition on the platform for the funding requirement.
b. Lending Club then evaluates the credentials of the borrower and assigns a credit score, grades the borrower for determining the interest rates chargeable to the borrower.
c. Once the borrower's application is approved, the application is made open for the lenders to express interest in lending to the borrower.
d. Once lenders' commitment is received against the loan amount requested by the borrower, Lending Club approaches the bank empanelled with the platform to disburse the amount to the borrower.
e. Thereafter, Lending Club acquires the loan from the originating bank from the proceeds received from the lenders.
f. The lenders are issued tradable notes/ certificates representing the exposure of the lender against the borrower.

[1] https://www.lendingclub.com/
[2] HSBC is one of the largest

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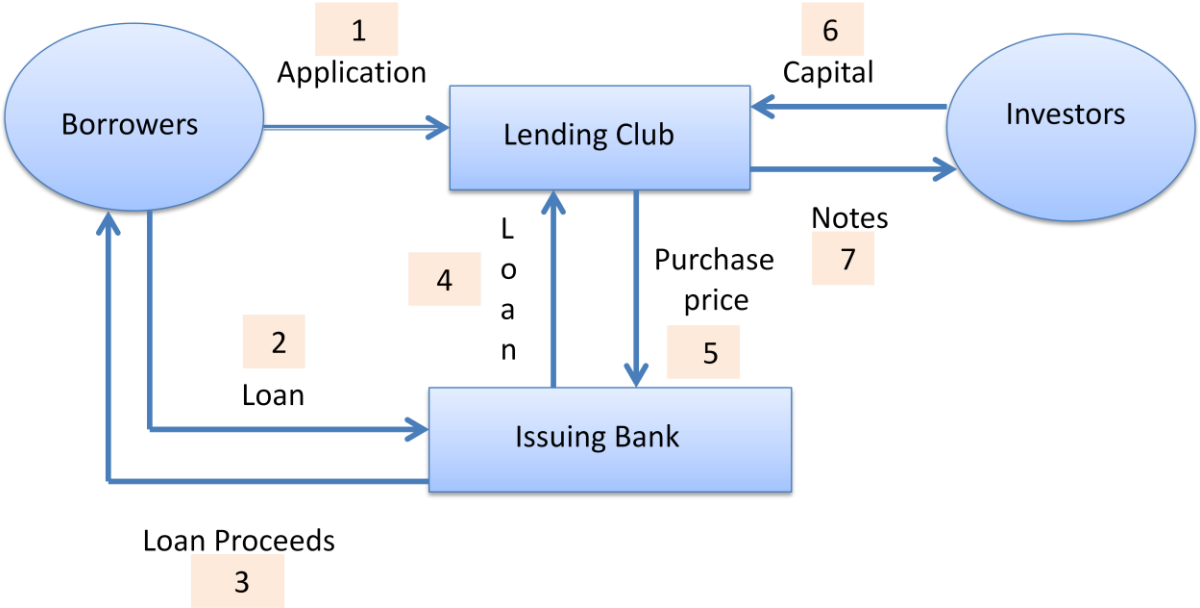
The dynamics of lending through the platform are explained with the diagram below:



Essentials of the platform

While the model seems simple to execute there are key essentials to the platform functioning and are as follows:

a. The platform does not invest in any of the borrower accounts. This is to ensure that there is no conflict of interest in any of the borrower accounts that are evaluated for the lenders to take a bid on the exposure;
b. Lending Club only entertains borrower application which meets a requisite FICO score threshold. This is to ensure that too granular loans are not entertained on the platform.
c. Most loans that are open to all lenders to bid on, are standardised loans and run under the standard loan program.
    i. The standard loan programs are of tenure between 3-5 years.
d. Unconventional loans are not hosted on the platform for all investors. This is to ensure that the general investors who may not have the wherewithal to underwrite a non-standard/ unconventional loan do not take an exposure on such loans merely depending on the scoring/ grading provided by the platform.
    i. The platform calls these loans as custom loan programs and is hosted only for qualified investors only.
    ii. The custom program loans include small business loans, super prime consumer loans, education and patient finance loans and personal loans that do not meet the requirements of standard program loans.

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e. The model adopted by Lending Club is nothing but securitization, where the lenders are holding certificates/ notes representing interest in a loan originated by a bank.
f. Lending Club also indemnifies the lenders against the basic underwriting that it undertakes for any borrower account. This is most critical for a platform to provide considering the lenders are depending on the scoring/ grading offered by the platform, while making a bid on a particular borrower or loan amount.
g. The repayments from the borrower accounts are not commingled. There are separate bank accounts maintained for inflow and outflow of funds from the borrowers. This is necessary to ensure that the platform is not seen as a vehicle for pooling in of funds.

Each of these essential features are critical for any platform to gather the scale it desires and without which the entire purpose of a virtual platform gets defeated.

How does the platform earn?

The platform earns by way of:

i. transaction fees at the time of origination of loans;
ii. earns servicing fees for servicing the loans on an on-going basis; and
iii. earns management fees for managing the borrower accounts.

The transaction fees is payable by the bank to the platform. The servicing fees and management fees is paid by the lenders and the borrowers respectively on the platform.
The transaction fee ranges from 1% to 6% of the initial principal amount of a loan. The servicing fee compensates for the costs that the company incurs in servicing the related loan, including managing payments from borrowers, payments to investors and maintaining investor's account portfolios and may be around 1% of the amount received from the borrowers.

Secondary market facilitation

One of the key aspects of the platform is to originate the loans; the other key essential to the platform is facilitating liquidity on the investments.

Issuance of notes

The lenders invest in the loans by way of notes/ certificates acknowledging their exposure on a borrower account and the extent of exposure in the borrower's loan. The platform facilitates buying and selling of such notes to ensure that the lenders have the desired liquidity to exit or acquire exposure in the loan/ borrower any time during the subsistence of the loan. This however is done directly through the platform. However, the buying and selling of the certificates is done through the subsidiary of Lending Club.
Notes are issued both under the Standard Loan Program and under the Custom Loan Program. Typically the issuance, sale and purchase of the notes/ certificates are guided by the investment agreement entered by the lender/ investor with the platform at the time of listing itself on the platform.

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Whole loan purchase

Certain institutions such as banks and financial institutions seek to purchase the entire loan. To meet this requirement the platform sells the entire loan to these investors. In connection with these sales, the investors own the interest, title and rights on these loans. The platform establishes the investors account and also determines any limitation on the amount of investment that can be made.

Identifying risks of running the platform

The virtual market place for financial intermediation is certainly the thing for the future. However the model is susceptible to several risks. From scalability of the model, to tracking various borrowers and lenders on boarding the platforms to managing several accounts – the risks factors are humungous.

Some of the risks factors critical to any P2P platform are as below:

a. No peers or history available to rely on. Considering the fact that P2P is an innovation and by product of technological advancements, there are no precedents to learn from or rely upon for doing business. Lending Club and the peers are setting up business models to be emulated by the subsequent entrants in the market.
b. The larger the number of borrowers and lenders on platform, the larger is the success of the platform. Hence the success of the platform is dependent on number of borrowers and lenders using the platform.
c. For platforms following the Lending Club model, empanelment with banks and appropriate documentation will be a constant challenge and risk for the platform.
d. Data privacy is of utmost significance. The information provided by the borrowers and the lenders needs to be well protected by the platform.
e. Simplicity of the product offering and regular functioning of the platform are also risks that the platform needs to tackle.

Conclusion

P2P players are competing not just against other platforms; they are also competing against conventional lenders such as banks and financial institutions. Borrowers certainly have a natural inclination towards reaching the lenders the traditional way and moving the borrowers to a virtual platform will be challenge in shift of mindset. Lending Club for instance has existing borrowing of $7.6 billion which is not more than 1% of the lending by HSBC; however, it is without contention, that P2P is the next big thing in the financial intermediation space.