ANALYSIS

MARKETPLACE LENDING

Strength in numbers

The internet is unlocking new and disruptive ways for debt investors to access untapped areas. **Claire Coe Smith** explores what UK marketplace lenders can offer

Traditionally, the world of private debt, and indeed private markets as a whole, has been an exclusive club. Funds often demand commitments out of reach to anyone but institutional investors, while the companies they target are subject to hurdles few can clear.

But can technology change this? Using online platforms, marketplace lenders are introducing retail and commercial borrowers to credit providers and in the process – as some industry participants argue – are opening up new opportunities for debt investors and challenging the traditional banking model.

By making use of advances in technology, platforms can quickly make loans to small businesses, consumers and real estate borrowers in a way that gives them a significant competitive advantage over the banks, and can offer investors attractive yields.

Sachin Patel, chief capital officer at Funding Circle which has financed 26,000 small businesses in the UK with an average loan size of £70,000 ($91,500; €76,600), says: "The type of business the banks do is very manual, with individual bankers going out to build relationships with management teams, and bespoke covenants negotiated on every transaction. In a £1 billion loan portfolio, they may have 20 or 30 loans, typically lasting five to seven years, and delivering a yield of 6-8 percent.

"What we have is an asset class that delivers the same yield, but with tens of thousands of loans in a portfolio of that size, and with typical durations of 23-25 months. That means there is much more granularity and half the duration. Lots of investors now have allocations to several mid-market corporate managers, but the themes in the private debt sector are all around a wall of cash chasing the same businesses, and what we offer are small SME loans that are differentiated from a credit perspective."

Marketplace lenders are also challenging in consumer loans, and increasingly in the real estate space where loan sizes are larger.

FLEXIBLE

Rod Lockhart is managing director at LendInvest Capital, an alternative lender in the short-term property finance space, which both runs regulated funds and has an online investment platform that allows investors to build their own portfolios of investments in real estate loans.

"We can lend against different types of property loans and match the right type of capital to the right type of loan, which creates a much more flexible model than perhaps you might have at a debt fund

raised to exploit an opportunity in a specific area," he says.

The business has over £500 million in assets under management, and an average loan size of about £600,000, though it can finance loans up to £20 million. Lockhart says investors can onboard via the online platform in a matter of hours, whereas the process can take up to three months offline. Investors also benefit from more sophisticated investor reporting.

"We see it as inevitable from the investor side that lending will continue to move this way," he says, though the model only works up to a certain deal size.

"The part of the market where the technology we have produced is most relevant is in loans of up to about £10 million. Beyond that, the people doing those loans are only lending one or two loans a month, and having this technology is much less relevant. At the moment, our competitive advantage is really about the efficiency in the operating model, and using technology to speed up the whole process."

LendInvest still uses a team of manual underwriters, and every property is visited by a third-party valuer before a loan is agreed, but even that process is speeded up through the use of technology.

Funding Circle also employs a team of manual underwriters. Patel says: "It doesn't make sense to meet all the companies individually, so what we use is a lot of data. We have built a very good credit engine that allows us to credit-assess these businesses and price risk accordingly, and then layer on manual underwriting.

"I absolutely think we will grow in terms of loan size, but we probably cap out at around £1 million. We are not going to be eating the lunch of the larger managers, because when you get to larger mid-market corporate loans, that really does require a much higher-touch approach."

Both Patel and Lockhart argue that they are offering investors a new option, and a means to access a new part of the private lending space, rather than necessarily challenging existing debt players. Funding Circle even works alongside high street banks, with Barclays, Santander and

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RBS all referring business to them, and other banks lending through their platform alongside other investors. The government-owned British Business Bank has pledged to lend £40 million through the platform to small businesses in search of funding.

While marketplace lenders are seen as complementary to the core banking model in places, in other areas they are clearly competitors.

Simon Deane-Johns is a consultant solicitor with the law firm Keystone Law, and specialises in online financial services. He was previously general counsel and company secretary at Zopa, the world's first online peer-to-peer lending platform, and says banks are being challenged by marketplace lending. "Borrowers and lenders should benefit from the lack of a fat intermediary in the middle that needs to soak up lots of the return with its own interest margin and fees, which means more of the return can be left on the table for the lenders and borrowers respectively," says Deane-Johns.

"There has been a lot of scaremongering about the fact that marketplace lending hasn't been tested by different savings and credit conditions. But I helped start Zopa in 2005, when there was lots of competition for deposits and banks were paying higher yields and offering cheaper credits. Even then, Zopa was able to show that if you take a bank out of the middle you can leave more of the returns to investors and borrowers."

Robert Stafler, chief executive of Fintex Capital, which manages portfolios of marketplace loans for institutional investors, principally across consumer loans and UK property lending, notes that the marketplace lending sector varies significantly between European markets, with the UK being the most advanced.

He also argues marketplace lending is an industry not an asset class, because each platform is so different depending where it is operating and whether it is tapping consumer, real estate or SME loans.

"We live in a world where yield is incredibly difficult to find, and cash is abundant," he says. "If in the traditional routes you can't find the returns you require, you look for alternatives, and that is what has given rise to this phenomenon over the past decade."

Marketplace lenders offer private debt investors access to a class of high volume, smaller loans that they might not otherwise be able to tap into. Going forward, these platforms will make use of their technology to set up funds targeting bigger investors interested in the space, while more established private debt managers may well adopt some of the technology themselves, and set up their own funds targeting the SME market. ■

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PLAYING BY THE RULES

Fewer regulations covering marketplace lending meant a double-edged sword of flexibility and risk, yet this is changing

One of the big advantages that marketplace lenders have over banks is that they are subject to regulations that are far less stringent. Where they are running funds, like LendInvest, they operate under AIFM regulations, and as lenders they must comply with core elements of the Financial Conduct Authority handbook, including the watchdog's principles and relevant rules.

"It has been a source of frustration for some of the banks because they have been chastised for not lending to these SMEs, who are seen as the lifeblood of the real economy, but are required to take a much more prudent approach to their credit decisions and have thus been unable to compete with the marketplace lenders," says Simon Fulbrook, a partner with the law firm Goodwin in London.

The FCA has indicated plans to apply more stringent regulations to the sector, amid concerns platforms are outgrowing the current regulatory regime. Fulbrook says: "It's broadly accepted in this lending space that greater regulation is going to come. It's not only an unfair playing field for financial institutions lending to SMEs, but the lack of regulation also presents greater risks to investors, consumers or borrowers, who could be subject to bad terms or poor lending decisions."

Rod Lockhart at LendInvest adds: "We don't see the increase in regulation that's come in over the last few years as slowing down, and that's something we expect to continue to deal with. The regulatory burden on the banks has been far greater than it has been for us as an alternative lender, and that does give us a competitive advantage, but that is partly offset by the ability of the banks to raise deposits and access a very cheap source of capital."