# The P2P Explosion: Business Models May Change, but Risks Still Need to Be Managed

## Demand for risk expertise persists and evolves as new-generation platforms disrupt traditional banking and lending

Friday, May 15, 2015

By Katherine Heires

Advertisement

BorrowersFirst, a year-old, 16-employee company based in Austin, Texas, says on its website that it aims to be a disruptive force in the fast-growing business of peer-to-peer lending. More than 100 such platforms now exist in the U.S. alone, vying for a slice of the multitrillion-dollar consumer credit market.

Overseeing risk systems for an innovative P2P loan provider is “exciting” and “ever-changing” – and definitely hard work, says Ben Duran, BorrowersFirst’s chief risk officer.

“The majority of new financial services are all online,” Duran notes. “So this is a risk area that is growing and where there is a lot of opportunity for someone with risk expertise.”

But it is a very different and rapidly changing environment when compared with more traditional financial risk management settings. The job descriptions and requirements are evolving accordingly.

Duran has been working with and developing consumer credit risk models for more than 20 years, including stints at Dell Financial Services and at Bill Me Later, which eBay acquired in 2008 and has since been rebranded as PayPal Credit. That experience has proved invaluable for building and frequently revising models in the online, P2P world, but that is not the only risk challenge the BorrowersFirst CRO faces.

A continual barrage of attempted frauds requires constant rethinking and updating of anti-fraud measures and cyber defenses.

“The fraudsters are always trying to poke holes in our system and to take your money,” Duran says. “We are always finding new ways to keep that from happening,” working with a lot of third-party data vendors and sometimes thinking outside the box. It is a cybercrime reality that once a breach is plugged, more

threats emerge. The team must be on constant alert.

Duran's credentials and the issues he is facing indicate how this new wave of financial services enterprises is in need of, and benefiting from, both traditional risk skills and online-oriented technical expertise.

**Growth and Buzz**

The online lending segment, consisting of such firms as Funding Circle, Kabbage, Lending Club, OnDeck and Prosper, is still relatively small, having originated $9 billion in loans last year. Total U.S. revolving credit outstanding was $885 billion as of February, and secured and unsecured non-revolving loans were $2.5 trillion, according to Federal Reserve data.

But this fast-growing, buzz-generating sector has come to the fore at a time when traditional banks, constrained by new regulations, are exiting or cutting back in selected areas. Meanwhile, the availability and falling costs of big data technologies and analytics have lowered boundaries to enter the business.

The sector is attracting not just individuals seeking to borrow or to invest in a portfolio of loans, but also institutional, hedge fund and family office investors – making the original "peer-to-peer" characterization a bit of a misnomer. Many in the field have come to define it as marketplace lending or alternative lending.

"Hedge-fund-to-peer" is how Karen Gordon Mills, a former head of the Small Business Administration and senior fellow at the Harvard Business School, put it at the LendIt USA conference in New York, which attracted more than 2,000 attendees in mid-April.

As an investment, "marketplace loans can add diversification to an institutional investor's portfolio," says Mark Shore, founder, president and chief investment officer of Shore Capital Management, which in its research and consulting business approaches P2P as an alternative-investment choice for some clients.

Don Davis, managing partner of Prime Meridian Capital Management, a firm that specializes in online P2P lending strategies, views the activity as "old-school banking done through the Internet."

"We work with only two or three of the biggest and better known platforms and those who we believe have the best risk management," Davis explains. "We don't want to be anyone's guinea pig."

**Host of Entrants**

According to Fitch Ratings, Lending Club and Prosper – the two largest consumer-loan originators in the sector – collectively issued $6 billion in loans in the U.S. last year. That's a small fraction of the nationwide total of $12 trillion.

However, a "Future of Finance" report by Goldman Sachs in March said issuance by Lending Club and Prosper grew more than 65-fold from 2009 to 2014. Since the fourth quarter of 2009, Lending Club and

Prosper together have boosted quarterly originations from $26 million to $1.66 billion in the third quarter of 2014, a compound annual growth rate of 129%.

Goldman projected that $209 billion, equal to nearly a quarter of consumer credit card loans outstanding, is “at risk” to move to online players over the long term. And P2P/marketplace lenders could increase their market share from today’s 2% to 15% over the next 10 years, said “Future of Finance” authors and Goldman equity analysts Ryan Nash and Eric Beardsley.

Newer entrants since the launches of Prosper (which was valued at $1.9 billion in a recent Series D funding round) in 2005 and Lending Club (valued at $8.9 billion in a December IPO) in 2007 include ApplePie Capital, Biz2Credit, BorrowersFirst, CircleBack Lending, CommonBond, Earnest, FundBox, Herio, LendUp, Orchard, Peerform and SoFi (now offering mortgage loans in addition to personal and student loans).

*Ben Duran, chief risk officer, BorrowersFirst*

**All-Star Investor Team**

On April 9 in New York, PeerIQ, which describes itself as “a financial information services company that connects peer-to-peer lending to the capital markets by helping institutional investors analyze, access and manage risk,” said it raised $6 million of seed funding. Lending Club backer Uprising and John Mack, former chairman and CEO of Morgan Stanley, led the round. Other investors include former CEOs Vikram Pandit of Citigroup, Dan Doctoroff of Bloomberg LP and Eric Schwartz of Goldman Sachs Asset Management, and former Securities and Exchange Commission chairman Arthur Levitt.

“Institutional investors have played an important role in the category by investing at scale via online lending marketplaces,” stated Ram Ahluwalia, a onetime Bank of America Merrill Lynch executive who is co-founder and CEO of PeerIQ. “Yet, future growth increasingly depends on expanding access to liquid ABS markets, which will unlock new sources of capital and lower funding costs.”

Ahluwalia said PeerIQ is supporting the next phase of growth by providing “independent and institutional-grade analytics needed for efficient deal structuring and better understanding of P2P across

new capital markets."

**Institutional Momentum**

Back in May 2014, Google helped to legitimize the sector by investing $125 million in Lending Club, for a 7% stake at the time. Now there are further signs of the institutionalization trend that PeerIQ is contributing to.

In September, CircleBack Lending, working with Jefferies, entered into an agreement to facilitate the sale and securitization of up to $500 million of consumer loans. Money manager BlackRock, which invested in Prosper in 2013, announced in January 2015 a plan to sell $327 million in debt in the form of rated securities backed by consumer loans arranged via the Prosper platform.

On April 14, Lending Club joined with Citi in announcing a partnership with value-driven investment manager Varadero Capital to provide up to $150 million of affordable loans to underserved borrowers and communities.

As the industry matures, so does its diversification across loan categories – into small business, real estate, franchising and student loans, to name a few. ApplePie Capital, for instance, targets the franchise business; CommonBond is a student loan specialist; and Bond Street, Liftforward and OnDeck are small-business lenders.

*Ron Suber, president, Prosper*

**Aggressive Recruitment**

With such developments comes demand for professional risk management in the areas of underwriting, pricing, servicing and collections – not to mention a call for risk-savvy financial engineers and data scientists.

Says Ron Suber, president of San Francisco-based Prosper, "We are definitely looking for risk management, technology and credit expertise, and we are hiring very aggressively in the engineering and technical worlds" to develop and refine credit models.

Funding Circle, a small-business-focused platform founded in the U.K. in 2010 and now expanding in the U.S., has 10 people on its risk team and 30 to 35 on its underwriting team, says U.S. managing director and co-founder Sam Hodges. He adds, “We are hiring extensively people with strong risk and data analysis skills in the areas of underwriting, risk assessment and portfolio analytics, as well as individuals who are building risk models themselves, based on extensive data analysis.”

Recruiters, academics and other observers agree that there are employment opportunities in the growing sector for risk talent, but they may not be for everyone.

Robert Iommazzo, managing partner at recruitment firm SEBA International, notes that nascent online lenders need people with strong analytics and modeling skills, but after a Series A or B funding round, these firms will be looking for a traditional range of risk expertise – though these individuals should have “a more entrepreneurial attitude and be attracted to working at an innovative, fast-paced firm,” Iommazzo says. “If you are a risk professional who enjoys dealing with a lot of reporting and regulation, this is not the environment for you.”

Iommazzo adds that at a Silicon Valley, Series A-stage start-up, compensation will be less than at traditional banks and will be largely in equity. But at a more established player like Lending Club or Zest Finance, “they will be paying risk talent closer to what a traditional bank will pay.”

*Peter Renton, publisher and chief blogger, Lend Academy*

**Global Opportunities**

Linda Kreitzman, executive director of the master’s in financial engineering program at the Haas School of Business, University of California, Berkeley, points out that to date, the majority of online lending platforms have been making unsecured consumer loans, and their risk managers will need presentation and communication skills. “The risk person is not so much controlling in-house risk as much as presenting and packaging risk appropriately to the right investors,” be they consumers or institutions.

Kreitzman also notes that opportunities are exploding internationally, and particularly in China, where consumer investment outlets were historically limited and where, as reported at the recent LendIt

conference, 1,575 marketplace lending platforms are operating and $41.3 billion in loans were originated in 2014. Among the China-based marketplace lenders are China Rapid Finance, Dianrong and Lufax.

Yirendai.com will seek to raise $300 million in a U.S. initial public offering, which would value the company at $2 billion and make it the first Chinese online lender with an overseas stock listing, according to an April 15 Bloomberg report. Investors in Yirendai's Beijing-based parent company, CreditEase, include Morgan Stanley's Asian private equity arm and venture capital firms IDG Capital Partners and Kleiner Perkins Caufield & Byers.

Kreitzman predicts that over time, risk capabilities beyond credit risk management will be sought after. And the rise of online payments and cryptocurrencies will call for "folks to understand risk, work around exchange rate risk, interest rate risk, etc."

Jamie Risso-Gill, director and consumer services practice leader at London-based executive search firm Per Ardua, says that new-generation, U.K.-based lenders such as Funding Circle, RateSetter and Zopa have been growing rapidly, and risk talent entering the space "will need to be savvy about digital technology."

**Cultural Variations**

David Mordecai, president of analytics and advisory firm Risk Economics and scientist-in-residence of the Accenture-sponsored FinTech Innovation Lab start-up accelerator program, says that there is a range of firms and competencies in the online sector: Some do a more robust job of credit analysis, netting, clearing, settlement and validation; other more tech-oriented operations may or may not understand the importance of traditional credit and risk management disciplines.

A challenge for risk personnel entering this arena, Mordecai says, is having to "make themselves understood by folks whose background may be solely limited to digital technology." Although risk professionals can bring great value to these enterprises, "they will have to work harder to get their message across and accepted" in a highly digital, "ad hoc" start-up culture.

Antony Williams, a risk recruiter with London-based LMA Recruitment, says those with quantitative credit or operational risk backgrounds will generally fit in the online sector, but will find "less formality and red tape" than in conventional corporate settings – which may be attractive to the entrepreneurially minded.

Richard White, a recruiter with Robert Half Management Resources in San Francisco, says it is inevitable that these free-wheeling start-ups will face tighter regulation, at which point "you will need to have even more, competent, experienced risk management professionals helping them to grow from a disruptive sector into a large play in the financial services industry."

Michael Tarkan, senior analyst with research firm Compass Point says derivative activities, such as securitizations or exchange traded funds, will similarly require more sophisticated risk management.

However, he adds, there are future uncertainties, including potential consolidation of P2P companies. “We don’t know how the business model will hold up in a rising interest rate environment, or when consumer credit losses pick up.”

**Discipline and Innovation**

Peter Renton, founder of the educational and blog site Lend Academy and creator of a fund investing in the P2P sector, asserts, “If you are an online lending site and don’t have a solid chief risk officer, you have no chance” of attracting institutional funding. “If you are a risk professional, this is one of the highest-growth areas you can look at for employment. It’s an industry that is doubling every year.”

Others highlight the pull of innovation. “The old way of just using a credit score will be superseded by a range of better technologies” in analytics and machine learning, says Chris Thompson, head of consulting firm Accenture’s risk management practice for North America.

Take, for example, Ascend Consumer Finance, which on April 14 announced $1.5 million in seed funding to roll out its proprietary Adaptive Risk Pricing technology, which applies behavioral economics theory in real time to dynamically readjust risk profiles. The objective is to more accurately assess the creditworthiness of nonprime borrowers, many of whom, as a result, “will move up into a prime score range within any 12-month period,” says Ascend CEO Steve Carlson.

Dynamic is an operative word throughout this burgeoning subsector of consumer lending.

“We will soon be on our sixth risk model,” Prosper’s Suber says. “We are constantly improving the system. There is no place else in the banking world today that is more exciting. We are changing history.”

*Katherine Heires (mediakat@earthlink.net) is a freelance business and technology journalist and founder of MediaKat llc.*

Share:

- •Bylaws
- •Code of Conduct
- •Privacy Policy
- •Terms of Use
- © 2016 Global Association of Risk Professionals