Bauerle's Bank Notes

Unfinished Business

June 2, 2015

A cautionary tale of Internet financial services' vulnerability to fraud and one provider's band-aid approach to dealing with the problem appeared recently in Barrons.[i] Senior Editor Bill Alpert described awakening at 5:45 a.m. in his New Jersey bedroom to the ping of an inbound e-mail message from Uber, the neo-taxi service. The message asked whether he loved his just completed first ride as an Uber customer. The message included a GPS-generated map tracing his six mile route through London as well as a picture of the smiling driver, Mr. Adisa, who piloted the Uber-dispatched vehicle. Wrote Alpert:

A few hours later, they hit me for **a second ride**. While the first ride was free, Uber drained $454.54 - 292.79 British pounds - from my debit card for a **four hour tour** from London to the coast with the driver Maksud.

> **Uber doesn't take phone calls** so all I could do was leave a complaint online.
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> **Here's the problem**: While I waited for Uber to notice my fraud alert, I couldn't suspend my Uber account or pull the bank card they took for payment. I had set up an Uber account some time ago, but never actually taken any trips with the service (I'm a bus, train, walking sort of guy in a region that allows that).
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> The account system on Uber is such that they **won't let you remove the card** unless you've added another one for them to fall back on. Naturally, I didn't want to expose another bank account to hackers.
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> One other possibility was to **kill the whole Uber account**, but then I worried they'd never figure out how to refund me if I disappeared from their database. Besides, while they claim you can kill the Uber account from a computer browser, you can't kill the Uber account from your cell phone, which is all I had because I was away from home when the big fraud happened.
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> In any event, not being able to remove the card left someone in London with unimpeded access to my bank account until the next morning, when an **apologetic email** from "Noli at Uber" surmised that someone had swiped my password from

> another online service and illegitimately accessed Uber. The refund from Uber took several days to show up in my bank account and a new debit card took a week.

Unsaid by Alpert was that until his unhappy experience, he did not consider his Uber account to be a risk to his financial health. Or if he did, he assumed falsely that ample means exist to protect him. Alpert is a Columbia Law School graduate and has won awards for his investigative work; so he is hardly a clueless consumer. Did he uncritically click "I accept" to Uber's terms of service? Likely, yes. Did he fail to consider that federal law exposes his bank account to pilferage by means of a debit card to a greater degree than if he paid Uber with a credit card? Also likely, yes. Did he sign up for Uber's service because he was attracted by, or at least curious about, the company's claims that its technology provides a better taxi experience than yellow-painted Fords? Most likely, yes. Chastened by his brush with fintech crime, he wrote, "Uber declined to talk about the frequency of such frauds."

History abounds with examples of innovation followed by calamity, recriminations and eventual application of engineering and legal thinking to reduce the risk of loss and allocate responsibility for it sensibly when, inevitably, it occurs again. We are in the throes of another such cycle. In banking, Internet-enabled loan originators are mounting a frontal assault on the banking system. They are backed by the full faith and credit of, you guessed it, the financial system-cum-Wall Street. Exhibit A is LendingClub, whose website trumpets, "We are transforming the banking system . . . ."[ii] No less than Larry Summers, the former president of Harvard and Secretary of the Treasury under President Clinton is a LendingClub director. Wall Street floated the company's shares last December. The company's market capitalization is $7 billion.

According to the company's latest 10-Q SEC filing:

> Lending Club is the world's largest online marketplace connecting borrowers and investors. We believe a technology-powered marketplace is a more efficient mechanism to allocate capital between borrowers and investors than the traditional banking system. Consumers and small business owners borrow through Lending Club to lower the cost of their credit and enjoy a better experience than traditional bank lending. Investors use Lending Club to earn attractive risk-adjusted returns from an asset class that has generally been closed to many investors and only available on a limited basis to institutional investors.
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> Since beginning operations in 2007, our marketplace has facilitated $9.3 billion in loan originations. These loans were facilitated through the following investment channels: (i) the issuance of notes, (ii) the sale of certificates, or (iii) the sale of whole loans to qualified investors. In the first quarter of 2015, our marketplace facilitated $1.6 billion of loan originations, of which approximately $0.3 billion were invested in through notes, $0.5 billion were invested in through certificates and $0.8 billion were invested in through whole loan sales.
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> Our trusted brand, scale and network effect drives significant borrowing and investing activity on our marketplace. We generate revenue from transaction fees from our marketplace's role in matching borrowers with investors to enable loan originations,

servicing fees from investors and management fees from investment funds and other managed accounts. We do not assume credit risk or use our own capital to invest in loans facilitated by our marketplace, except in limited circumstances and in amounts that are not material. The capital to invest in the loans enabled through our marketplace comes directly from investors. Our proprietary technology automates key aspects of our operations, including the borrower application process, data gathering, credit decisioning and scoring, loan funding, investing and servicing, regulatory compliance and fraud detection. We operate with a lower cost structure than traditional banks due to our innovative model, online delivery and process automation, without the physical branches, legacy technology or high overhead associated with the traditional banking system.

> Our marketplace is where borrowers and investors engage in transactions relating to unsecured standard or custom program loans. Standard program loans which are part of the publicly available standard program, are three- or five-year unsecured personal loans which are offered to borrowers with a FICO score of at least 660 and that meet other strict credit criteria. These loans can be invested in through the purchase of notes issued pursuant to a note registration statement, and are only available through our website. Separately, qualified investors may also invest in standard program loans in private transactions not facilitated through our website. Custom program loans are only invested in through private transactions with qualified investors, for which notes are not available and are not visible through our public website. Custom program loans include small business loans, sub prime consumer loans, lending platform loans, education and patient finance loans and personal loans that do not meet the requirements of standard program loans.

WebBank, an affiliated Utah industrial loan company, makes the loans that LendingClub purchases and resells to "investors" rather than "depositors". By using this structure, LendingClub claims it is not a bank, but a fee-for-service "marketplace". Just as Uber claims not to be a common carrier subject to the jurisdiction of state public utility commissions and big city taxi and limousine commissions. Truth, however, cannot be completely avoided. LendingClub's website crows, "We are transforming the banking system . . . ." The 10-Q says the same in more muted tones, "We believe a technology-powered marketplace is a more efficient mechanism to allocate capital between borrowers and investors than the traditional banking system."

LendingClub's most striking feature is its growth rate. For the first quarter of 2015, the company reported operating revenue of $81 million on $1.6 billion of loan originations, both amounts <u>double</u> the level of Q1 2014. The company's website promotes the dollar value of "loans funded," by quarter and in toto, claiming >$9 billion since inception. Billions and billions served, just like McDonalds.

As a financial industry reference point, for Q1 2015, PNC Bank reported a $1.3 billion decline in consumer installment loans outstanding and a $1.4 billion increase in commercial lending. Nothing in the reported data on consumer loans suggests any correlation between LendingClub's increase and PNC's decrease. What is notable is that the volume of consumer loans trading on the LendingClub platform is on par with the ebb and flow of loans at a $300 billion, 50 year old bank whose market presence encompasses most of the Eastern United States.

As a regional banking reference point, $6.4 billion-asset First Commonwealth Bank reported total loans in Q1 2015 of $4.478 billion, up $171 million from $4.307 billion a year earlier. Again, the bank's numbers are not directly comparable to LendingClub's, since the bank data reflect net growth in the loan portfolio (i.e., portfolio balance less regular amortization, prepayments and the amount of any defaulted loans). The value of the comparison again is to demonstrate the high rate of LendingClub's growth compared to a well-established banking franchise carefully built over many decades.

Since it is still making losses, LendingClub suggests the profit potential of its business by reporting "adjusted EBITDA margin" of 13.1%, determined by dividing adjusted EBITDA (after adding back stock-based compensation expense) by operating revenue. In the prior year period, the same measure was 4.8%. The use of EBITDA as a measure of financial strength is itself a bid to attract investors attuned to non-bank financial metrics rather than traditional bank investors.

Because the company exists outside their jurisdiction, state and federal banking regulators are hard pressed to regulate LendingClub. The Consumer Financial Protection Agency has pursued one of the companies LendingClub acquired last year, claiming it engaged in false and deceptive practices.[iii]

The more fundamental issues the LendingClub business model presents include:

- Absence of an accounting reserve or capital cushion to absorb loan losses. Like CMO and CLO market participants pre-Dodd-Frank, LendingClub has no legal obligation to retain any risk of default or loss on the loans it originates. Loan investors, i.e., purchasers, bear 100% of the credit risk and may or may not hedge their exposure. Insofar as loan purchasers are non-regulated entities, the Federal Reserve and other agencies responsible for the integrity of the financial system have no means of understanding whether or to what extent credit risk has been mitigated.

  As the market for non-bank-originated loans swells, banks will face two particular hurdles. They have capital and loan loss reserve requirements that compel them to price at higher rates than LendingClub the loans banks make and hold on their balance sheets. Banks also have costs of personnel and facilities they must recover through loan pricing. Most are shedding branches and retraining personnel, but at a glacial pace compared to the rate of LendingClub's growth.[iv] WebBank, the LendingClub-affiliated bank that issues the loans it sells, reportedly has fewer than 50 employees.[v] LendingClub's pitfalls will become apparent when the credit cycle turns down. Until then, however, banks' earnings and stock performance are likely to suffer because of the financial burdens they bear but Lending Club and its followers shirk.

- Absence of protections customers have in other settings and mistakenly assume also apply to Internet-enabled commerce. Terms and conditions of the loan agreement and promissory note LendingClub customers e-sign are equivalent in most respects to standard bank loan documents. Its Terms of Use is where the company buries the razor blade in the apple. For example, under "Account Security," the Terms of Use say, "you agree to be fully responsible for all use of your account and for any actions that take place using your account." Under this provision, had the culprits who accessed Bill Alpert's Uber account instead hijacked his LendingClub account, they could have taken out a $35,000 loan for which Alpert would be responsible under the Terms of Use just quoted.

We have represented banks dealing with loans taken out by imposters. But in the physical environment, those cases are rare. Meaningfully greater in our opinion is the risk that computer hackers attack LendingClub and tap customer profiles to steal millions of dollars via fraudulent consumer loans before their gambit comes to light. Nothing in the LendingClub Terms of Use relieves customers of responsibility for those loans if that were to happen. Worse, although customers are afforded the chance to opt out of arbitration as a dispute resolution mechanism, if they fail to do so they are precluded from pursuing claims through class action litigation. That arrangement puts the Bill Alperts of the world at a disadvantage if LendingClub's mismanages account security.

The root problem is a combination of deficient consumer and business experience and expectations, disparities in knowledge about the Internet-based service's possible weaknesses and unequal bargaining power. Internet commerce has grown from e-mail exchanges and news feeds in the early days of America Online 20 years ago to encompass consumers' and businesses' financial well-being. Terms of Use were conceived to define and limit early website owners' responsibility for the information they published, a largely benign environment where risk of financial loss was slight. As financial transactions and relationships have become the common currency of Internet-based commerce, Terms of Use have become powerful contracts of adhesion to which most people pay no heed until after an accident happens.

- Originate-to-Distribute Risks. The 2008 Crisis revealed weaknesses in the system Wall Street built to originate and sell off credit products and derivatives. Inability to monetize loans that had been closed and funded but not yet sold to investors via securitization. Abysmal recordkeeping that made it impossible to determine who owned what loans or pieces of loans and was therefore entitled to exercise remedies.[vi] Loss of customer securities pledged to support loans to institutions that failed, like Lehman Brothers and MF Global. And nearly catastrophic market illiquidity.

  Decoupling loan origination from ownership of the assets themselves created unique risks. As stated above, originators' lack of skin in the game once loans were sold led them to make loans they knew would not be repaid and then dupe buyers into owning the debt. Too, originators' business model limited their revenue and income opportunity to fees derived from originating, packaging and selling loans. So they had no exit when the market became overheated. They had to produce ever greater volumes of new originations or their businesses would grind to a halt. LendingClub's business model has those traits too.

Dodd-Frank requires large banks and other systemically important financial institutions to plan for market crises. Companies like LendingClub remain free to do as they will, at least until the Federal Reserve determines they are systemically important. That duality is neither healthy for the financial system nor fair to its participants, including consumers, businesses and banks. The perils of systemic risk are a lesson Wall Street and other pillars of the financial community like Larry Summers claim to have learned. If that were so, LendingClub would protect customers to a greater extent than it does and offer greater disclosure about the risks of doing business through the "world's largest online marketplace connecting borrowers and investors."

One hopes that, like Bill Alpert's phantom Uber rides, the deficiencies of LendingClub and its kin surface sooner rather than later so the business model can be improved. One fears that the denizens of Wall Street and the Federal Reserve System will be blinded by the novelty and power of new era providers like LendingClub, or hoodwinked by the tech pioneers' confident reassurances that they have mitigated every risk in sight. In either event, the business of building an Internet-centric financial services economy is not finished, but just beginning.

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[i] http://blogs.barrons.com/techtraderdaily/2015/05/18/uber-the-450-fare-i-never-took-but-paid-for/

[ii] https://www.lendingclub.com/?lc_referrer=Google_Brand&gclid=CJe5_u7P9rkCFcd_QgodcRgAtg¶m2=GzB001zA001z2zDzg&gclid=CLjXl6fY7MUCFVMXHwodT6IAfw

[iii] http://blogs.wsj.com/moneybeat/2014/08/27/lending-club-a-look-inside-its-ipo-filing/

[iv] The Wall Street Journal reported Friday that J.P. Morgan Chase & Co. will shed "more than 5,000 jobs in an effort to trim costs and become more efficient." "The move comes as the nation's largest bank overhauls its 5,570 branches to rely more on technology and less on human tellers. James Dimon said Wednesday that the average J.P. Morgan Chase branch would lose one employee over the next two years, mostly through attrition." Wall Street Journal, May 29, 2015, page C1. Dimon has repeatedly called out tech platform companies like LendingClub as the most formidable competitor his bank faces. In his 2014 letter to shareholders, Dimon wrote, "They are very good at reducing the 'pain points' in that they can make loans in minutes, which might take banks weeks. . . . We are going to work hard to make our services as seamless and competitive as theirs. And we also are completely comfortable with partnering where it makes sense."

[v] Note [iii] above.

[vi] See U.S. Bank v. Pautenis, a decision published May 29 by the Pennsylvania Superior Court at 2015 PA Super 129. The court affirmed a trial court decision against U.S. Bank in a mortgage foreclosure action, an extraordinary outcome in a line of cases in which banks always win. The trial court found that the loan documents "totally lack trustworthiness" due to the presence in the loan file of "multiple versions of the mortgage and the note, with varying signatures, initials, witnesses and handwriting." U.S. Bank was the fifth in a line of banks or other parties responsible for the loan, the previous responsible parties having included

Washington Mutual, the FDIC, LaSalle Bank, and Bank of America. Consequently, U.S. Bank was unable to offer competent testimony as to many aspects of the loan history, the chain of custody for the loan file having passed through so many hands.

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