



# Bauerle's Bank Notes

## Too Good to be True October 27, 2014

Vintage automobile collectors tell the story of a woman who advertised a beautiful, two-seat, Mercedes-Benz convertible for sale in Hemmings Motor News, the self-described "Bible of the Collector Car Hobby Since 1954." The listing read simply, "Magnificent 1969 M-B Pagoda convertible, red/tan leather, low miles, sacrifice, \$10,000 OBO." The first would-be buyer was stunned when he met the woman and inspected the car. "Your ad must have left a zero out of the price," he said. "No," she replied. "My husband e-mailed me very specific instructions." He said, "Kaylee and I are leaving for Mexico, never to return. Please sell Mercedes convertible and wire money to account no. XXXX, BBVA Bancomer Bank, Mexico City." Said the jilted wife, "So I am doing exactly as my husband requested."

Epic blunders often arise when logical progressions of thought are carried to illogical extremes. The failure of Long Term Capital Management in 1997 was one, in which many of the best and the brightest minds on and off Wall Street arbitrated anomalies in bond and sovereign debt pricing. Their bets soured when panic in the market for Russian debt led spreads to widen more than their model forecast or their cash reserves could tolerate. Other market participants' copycat trades caused LTCM's problems to put the entire market at risk. Only a hastily stitched-together rescue by the Federal Reserve Bank of New York averted calamity. The crisis of 2007-08 is another example, felt by all of us, because the magnitude of the crisis was far greater and so more difficult to contain.

Six years later, we are on our way to the next crisis. In my view, its seeds are being sown in the proliferation of Internet-based lending platforms that promise to match borrowers and lenders/investors without the inconvenience or expense of a bank's being involved in the transactions. I have previously written about Lending Club and Prosper, the two leading companies in this space. Lending Club has an IPO in registration at the SEC and is expected to debut with a multi-billion dollar market capitalization this quarter. Like the woman's convertible Mercedes, P2P intermediaries' pricing is unbeatable. Nearly all of the expense of operating a bank is taken away; so, however, are key aspects of a bank's functionality.

The Financial Times last week profiled the latest P2P venture debut, named Payoff. The company is currently completing a \$12 million fundraising round. Payoff offers customers a three year, fixed rate debt consolidation term loan marketed to consumer credit card loan borrowers. Fixed rate loan pricing ranges from 12-20%, favorable compared to average credit card borrowing rates. Payoff's comparative advantage is that its loan underwriting and pricing algorithm derives from the model used by the eHarmony dating website. The algorithm focuses intensively on customers' psychological makeup. Thus Payoff's terms of service say,

From time to time, alone or in connection with a product or service, Payoff may ask questions related to your behavior, personality, and other things related to how you think and feel. This information allows us to complete, in specific or in aggregate, psychological assessments. The assessment results and feedback are developed to meet professional standards and as such are subject to the limitations of psychological science. The information we collect from these assessments will be used to help us provide you more focused customer service, individualized web experiences, more accurate risk management and better financial education. Your assessment may use procedures that are not evident to you. Your feedback may differ from your own perceptions of yourself.

In this respect, Payoff is forthright about conduct that many credit providers and servicers engage in but don't talk about.

According to the Financial Times,

Such will be the shift from traditional bank lending in the U.S. that being a smaller, later mover does not matter. Many U.S. institutions already regard digital lending as a component of the retail lending market. Asset management companies and hedge funds back about 80 percent of loans written by Lending Club and Prosper, according to P2P analysts. Prosper's president, Ron Suber, describes P2P platforms as a technology solution for the banks themselves: likening platforms to the microprocessors at the heart of the fastest PCs.

Long Term Capital Management's leadership included legendary bond trader John Merriweather and Myron Scholes, coauthor of the Block-Scholes stock option pricing model. Former Treasury Secretary Larry Summers and dot.com investment queen Mary Meeker both grace the board of directors of Lending Club. In Payoff's case, the superstar quotient is filled by Mohammad El-Erian, former chief executive of bond investment juggernaut Pimco, former head of the Harvard endowment and chair of President Obama's Global Development Council.

Despite this application of genius-level financial thinking, none of these new era financial black boxes have what any well-run, old-fashioned bank has: liquidity available via the Federal Reserve System. As a national bank examiner said to an audience of bank CEOs and CFOs I was part of in May 2008, "You people are all concerned about capital. What you need to be focused on is liquidity." The events that followed later that year proved him to be prophetic. By all appearances, the P2P credit platforms appear to have painted themselves into a similar corner. We are left to hope that when the band stops playing, and their capacity to act as financial intermediaries stops with it, we all still have a chair on which to sit.