Bauerle's Bank Notes

The Rest of Us

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Fintech poster child LendingClub (NASDAQ: LC) blew a gasket last week, revealing it altered loan documents in a bid to sell in the secondary market consumer loans originated through its Internet lending platform. LendingClub's board of directors fired CEO Renaud Laplanche and three other executives said to be responsible for the misbehavior. The company's share price dropped 47%, and is now down 80% from its December 2014 post-IPO high price.

LendingClub's business model was to be a peer-to-peer lender, matching retail "investors" in consumer and small business loans with would-be borrowers. The model mirrored other Internet-based marketplace businesses including FreeMarkets, LendingTree, CraigsList and eBay.

Other financial services innovators like LendingTree and PayPal piggybacked on the banking system, using software and the Internet to speed transactions and increase optionality for bank customers seeking a loan or transferring funds. LendingClub took on established banks directly, offering an alternative channel for borrowers and lenders. CEO Laplanche publicly compared LendingCLub to Netflix and JP Morgan Chase Bank to Blockbuster Video.[i]

The company targeted millennial consumers whose affinity for e-commerce is well known. Thus our 29 year old son Philip received a LendingClub direct mail solicitation two weeks ago, offering a $40,000 unsecured loan with no or few strings attached. The advertisement pitched LendingClub as the banking equivalent of Amazon.com. Conventional bank loans are overpriced and passé, it said. The Internet makes everything faster, easier and less expensive; so bank with us at LendingClub!

Behind its cheeky insouciance, the company was working hard to fund its rapid growth. In Q1 2016, Lending Club issued $2.75 billion of consumer and small business loans, up 75% from Q1 2015 and four times the volume of Q1 2014. The peer-to-peer model did not generate enough money to support that growth rate. Yield-hungry institutional investors and hedge funds met the need for several years. Their support leveled off when market sentiment turned negative on high yield bond funds, business development companies and collateralized loan obligation funds.

Starting in 2015, LendingClub obtained funding from banks, the very institutions whose business model it derided as obsolete. A consortium of 200 community banks called BancAlliance bought $200 million of loans.[ii] According to the Wall Street Journal, "In February, Mr. Laplanche said banks provide about 25% of the capital for LendingClub loans. In the first quarter, that amount rose to more than one-third, as LendingClub funding from banks stood at $947 million, more than double the amount in the first quarter of 2015." [iii]

LendingClub's latest effort to replenish its capital was the busted securitization through broker-dealer Jeffries. Jeffries' legal counsel asked for changes in the wording of the limited power of attorney written into loan documents.[iv] LendingClub lawyers dutifully changed the text. Company personnel went on to post-date $3 million of loans whose documentation predated the change. That action made those loans appear to contain the preferred power of attorney language even though they did not. That kept them in the pool of loans being sold. Jeffries personnel spotted the discrepancies and forced Lending Club to buy back the loans. LendingClub did and its board of directors fired those it deemed responsible.

The fallout from LendingClub's blunder has just begun. Financial regulators, including the Consumer Financial Protection Bureau and the Treasury Department had already signaled their intention to cast their regulatory net over LendingClub and its peers. The Banking Law Journal will soon publish my article on that subject, titled "Embracing Differential Regulation." Because banks from BancAlliance-affiliated community institutions to Goldman Sachs were active buyers of LendingClub-originated loans, fire alarms surely sounded in every bank regulatory agency last week when LendingClub's news broke.

The harder question to answer is who gets hurt if LendingClub unravels? Goldman, Jeffries and BancAlliance banks have all quit purchasing loans. Because Lending Club makes its money on the tiny spread between the prices at which loans are bought and sold, it cannot get off the treadmill of loan origination and sales without going out of business. Since it is not a bank, an orderly FDIC receivership is not available. Instead, a chapter 11 bankruptcy filing is the most likely route to wind up the company. In that scenario, loan investors should eventually receive most or all of what borrowers pay on their LendingClub-sourced loans. But the automatic stay in bankruptcy could delay investors' receipt of funds and they might not be paid interest on the loans for the period after the bankruptcy filing.[v]

Because those scenarios are unattractive, look for LendingClub to try to sell itself to a big bank, quickly. The technology platform is the company's most valuable asset. Mr. Laplanche's assurances to the contrary notwithstanding, the company's extraordinarily creative people who set out to "transform the banking industry" are expendable, just like the rest of us.

[i] http://www.lendingmemo.com/lending-club-renaud-laplanche-interview/. Laplanche responded as follows to the question, "Why would it be so difficult for JP Morgan Chase to institute a culture-change?"

There are three factors. There is the physical infrastructure - the branches. It would be really hard for JP Morgan Chase to close 5,000 branches overnight.

Furthermore, Lending Club runs our entire operation on a nimble server farm in Nevada, a setup that has the same piece of code running on every single machine. Our platform was purpose-built. It does exactly what it was designed to do and nothing else. In contrast, the banks all run on disparate systems that came with the mergers of other banks, many built twenty-five years ago. Getting all these legacy systems to a place where they could run like ours, getting them to use technology that was developed in the past two years like we do, this is almost impossible.

The third and most important aspect is really cultural. The kinds of people who come to work at Lending Club are those who say, "I want to transform the banking industry. I want to create something new and innovative." With a very different talent pool you end up with a very different outcome.

[ii]"Lending Club Hit as Banks Retreat," Wall Street Journal, May 13, 2016, p. C1, col. 5.

[iii] Id.

[iv] "The Legal Tweak That Led to Disaster for Lending Club," http://ftalphaville.ft.com/2016/05/10/2161309/.

[v] "What Happens if Lending Club Goes Out of Business?," https://next.ft.com/content/17eee0d8-a9d1-33ba-a012-00d15c54c874.

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