FinTech

Lecture 2. Raising money with FinTech

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September 19, 2024

Learning outcomes

- Describe how **peer-to-peer lending** has changed the way in which finance can be accessed
- Discuss the impact of FinTech lending methods on traditional financial institutions

Overview

Introduction I

- Background
  - 2008 financial crash → constriction of global credit market
  - Financial regulations by governments → harder to gain access to loans
- Growth of the peer-to-peer lending industry
  - Technological innovations: online platform connect lenders and borrowers
  - Lenders can be considered "**investors**"
    - They are investing in both the creditworthiness of the borrower and the borrower's ability to pay back the principal loan amount
    - They ask for the promised interest

Introduction II

- Features of peer-to-peer lending:
  - Simplified application process
  - Competitive interest rates
  - Lower credit requirements
  - High default rates
- Nature of peer-to-peer lending:
  - Allows investors (lenders) to connect personally with borrowers
  - Investors fund projects that they feel are worthwhile
  - Investors receive higher rates of return and can build diversified investment portfolios

Introduction III

- As players in a new/innovative field, P2P frims have faced challenges:
  - Sourcing funding for the loans offered
  - Addressing increasing regulatory issues
  - Scaling their businesses
  - Managing with high default rates
  - Diversifying product offerings
- This lecture explores these challenges and opportunities:
  - Zopa's and Lending Club's operations in the personal-loan sector
  - ThinCat's growth strategies in providing peer-to-peer services for SMEs
  - SoFi's success in disrupting the student-loan sector

Overview

1. Introduction
2. **Zopa and Lending Club: Disrupting the lending industry**
3. ThinCats: Provision of P2P loans to small businesses
4. SoFi: Disruption of the student-loan sector
5. Regulations on P2P lending
6. Academic reading
7. Conclusion

Traditional P2P lending

- Traditional P2P lending services: Zopa (UK) and Lending Club (US)
  - Personal loans to individuals for everyday expenses
    - Car purchases or household maintenance
  - Many borrowers also use P2P loan to refinance existing debt burden
    - Transform "expensive" debt into "cheaper" debt to finance
- Online platforms: connect borrowers and investors
  - P2P platforms assess the risk associated with the borrower
  - Investors could make informed decisions on which applications to fund
- P2P platforms allow lenders to build portfolios:
  - Spreading their risk
  - Improving their investment returns

Zopa's markets

- C market: loan applications considered at high risk of default

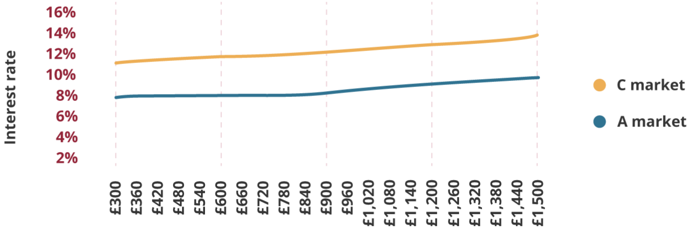

Fig. The supply of funds in two of Zopa's markets (Zopa Company Documents, 2019)

The challenges of P2P lending companies

- P2P companies face various challenges:
  - Insufficient funding
    - Insufficient to service the number of requests from borrowers
  - High default rates
    - Affect an investors willingness to fund loans
  - Fluctuating interest rates
    - Investors are more willing to place money in banks as they are risk-free compared to peer-to-peer platforms
- It is important for P2P companies to have diverse sources of funding

Diversifying their offerings I

- Why Zopa and Lending Club need to diversify their offerings?
  - Broaden their sources of investor funding
  - Service consumer needs more effectively
- How Zopa and Lending Club are diversifying their offerings?
  - Including institutional investors
  - Expanding their consumer offerings and offering other types of loans

Diversifying their offerings II

- Zopa
  - Apply banking license (savings account and later expand into credit cards)
    - The move into banking enable Zopa to acquire new customers because of the company's wider financial service offerings
- Lending Club
  - Acquire *Radius Bank*
    - The acquisition means that LendingClub's customers have access to a wide range of product offerings (cheque deposit, bill payments, etc.)
- Can Lending Club successfully integrate a bank into its FinTech model?
  - (A) Yes, borrowers will trust Lending Club to deliver
  - (B) No, the whole point of FinTech P2P is to side-step banks

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Potential growth for a company like ThinCats

- ThinCats (UK): P2P loans to small businesses
  - P2P lending from personal loans → small-business loans

Fig. Comparison of peer-to-peer consumer and business lending (Statista.com, 2020)

Business challenges faced by ThinCats

- P2P lending companies change how finance can be accessed by a variety of people and companies
  - ThinCats product offerings allow SMEs access to finance that they may not have gained through traditional financial mechanisms
- Question
  - Do you think P2P lending will fully disintermediate banking and lending?
  - Or do you think eventually P2P lenders will have to partner with these large financial institutions in order to grow?
    - because of some of the issues regarding the size of some of these loans

Overview

Disruption of the student-loan sector

- Social Finance Inc (SoFi)
  - Founded by a group of MBA students at Stanford GSB
  - Apply peer-to-peer lending principles to student loans
- Factors that led to the growth of this industry:
  - The increasing number of students attending university
  - The increasing number of loans offered to students
  - The increasing number of loans to attend for-profit universities
- No risk-based analysis given for student loans
  - Mispricing of loans and inaccurate interest rates being applied

How SoFi is disrupting the student loans sector

- SoFi supply loans at the correct prices:
  - By identifying clients based on risk and potential earnings
  - By partnering with alumni (model of alumni-funded loans)
- Video
  - Interview with Ron Suber: SoFi's major investors
  - Success of SoFi
    - Provide loans to potentially high-earning clients
    - Build community with these clients
  - Challenges faced by SoFi and future strategies

Overview

Regulations affecting the P2P sector

- Challenge faced by P2P platforms: Changes in regulations
  - Determine how these platforms are governed
    - Protect investors
    - Ensure that platforms are being transparent in their dealings
    - Ensures that peer-to-peer platforms grow sustainably in the future
- 2019 FCA regulations:
  - Clearer governance on credit risk assessment and fair valuation practices
  - Greater transparency around platform fees, services and charges
  - New or inexperienced investors are capped at 10% of investable assets
    - Limit their exposure to risk

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Academic reading

- Trust and Credit: The Role of Appearance in Peer-to-peer Lending
  - RFS 2012
- Peer-to-Peer Lenders Versus Banks: Substitutes or Complements
  - RFS 2019
- Prosocial Compliance in P2P Lending: A Natural Field Experiment
  - MS 2020
- Financial Reporting and Entrepreneurial Finance: Evidence from Equity Crowdfunding
  - MS 2021
- Social Capital, Trusting, and Trustworthiness: Evidence from Peer-to-Peer Lending
  - JFQA 2022

Overview

Conclusion I

- Need for financing $\rightarrow$ P2P lending services
  - **Disintermediation**: alternative to higher-cost traditional financial institutions by offering speedier and cheaper loans via online platforms
- Evolution of P2P lending
  - The sector has diversified from traditional P2P services
    - Include small-business loans and student loans
  - These companies have faced similar problems in funding their services
  - They sought to bring in institutional investors
    - Break away from the peer-to-peer model

Conclusion II

- Discussion:
  - Considering these changes, do you believe that peer-to-peer lending models will continue to grow?
  - Will these lending companies replace traditional financial institutions in providing credit?
  - Should these companies look to diversify their product offerings to banking services as part of their growth strategy?