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Panel Discussion Takeaways

Key Considerations for Marketplace Lending Securitizations

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Morningstar Perspective

Marketplace lending securitization volume is on track to have one of its best years, with issuance already hitting $12.8 billion through the first three quarters of 2018, more than a 40% year-over-year increase, according to PeerIQ, a consumer credit risk analytics provider. The sector has bounced back after a challenging 2017 that saw governance and performance issues take center stage at select originators. In 2018, lenders have tightened underwriting standards and asset performance has improved against the backdrop of a robust economy and strong consumer optimism. Industry panelists at the Opal Group's Marketplace Lending and Alternative Financing Summit on Nov. 29 in Dana Point, California, were optimistic about the state of the MPL securitization market, but also noted that the sector has yet to go through a full economic cycle.

John McElravey, head of consumer ABS research at Wells Fargo Securities, LLC, kicked off the panel with an overview of the state of the MPL market in terms of issuance and relative value. McElravey noted that MPL asset-backed securities issuance has grown over the past five years to rival the flow of long-time sectors such as equipment, floorplan, or private student loans. This nascent sector saw bonds outstanding total $28.5 billion as of the end of September, accounting for roughly 4.5% of the total outstanding consumer ABS supply after a short five years in existence. Since early 2016, spreads on ABS backed by MPL assets have tightened along with the rest of the ABS market.

Next, the panel addressed the main performance factors having the biggest impact on MPL performance. Stephanie Mah, vice president at Morningstar Credit Ratings, LLC, noted four main variables: the economy, underwriting criteria, originator access to credit, and the regulatory environment. Mah noted the strength of the economy, with annual average hourly wages rising 3.1% in November, the fastest rate in nine years; unemployment remaining at one of the lowest levels in half a century, at less than 4%; and consumer confidence hitting an 18-year high in October. However, the trade war between the U.S. and China remains the wildcard as it could very well lead to economic stress, including job losses and higher prices for consumers down the road. The second factor is underwriting criteria and internal borrower risk assessment of issuers. As the sector has begun to mature, we've seen major originators tightening underwriting standards, including requiring higher FICOs, charging higher interest, or offering shorter maturities, although changes to internal risk models may not necessarily be immediately discernable.

In addition, originator access to credit is another variable, with the robust pipeline in MPL securitizations indicating strong investor demand for the notes. Rising interest rates in the coming year will likely result in higher financing costs for issuers if spread tightening does not outpace the interest rate increases. Originators' portfolio performance can also influence their susceptibility to such interest rate changes, whereby strong portfolio returns will give managers a wider cushion to offset higher financing rates. Lastly, the regulatory landscape remains clouded following the U.S. Court of Appeals for the Second Circuit's decision in Madden v. Midland, the introduction of the fintech charter from the Office of the Comptroller of the Currency (the federal regulator of national banks), and the fact that the current session of Congress is about to end, with the 116th U.S. Congress starting on Jan. 3. The uncertainty left by Madden v. Midland regarding the validity of interest rates charged on a line of credit in the Second Circuit (which includes New York) and whether the whole-loan sale backing MPL deals will be enforceable leaves the sector in a bit of a quandary.

The issuer perspective was also covered, as Karan Mehta, head of capital markets at Marlette Funding, LLC, provided his insights into the sector. Mehta remarked that he is seeing cookie-cutter MPL deals coming to market. However, the infrastructure remains opaque, which can sometimes make the process more difficult. Going forward, he expects to see some degree of optimization of platforms that will help facilitate transactions. In addition, the market is also starting to see more rating agency participation in MPL ABS as the nascent asset class has developed and more historical performance data has been collected. Credit rating agency interaction requires a vigorous analytical discussion and benefits the whole ecosystem as deals get analyzed from not only a credit perspective but also from an operational risk standpoint.

Kailee Balagia, a director at PWC, who rounded out the panel, noted that volatility in the general macroeconomic environment can create a bit of a storm and a threat to liquidity in the sector because spreads may widen even if credit fundamentals do not deteriorate significantly. The other panelists concurred, noting how intertwined the economy is with the sector. While all stated that they expect to see MPL lenders continuing to tap the securitization market in 2019, some also think originators may explore moving toward bespoke pass-through securities as another key financing alternative.

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