FLAWED CLEVELAND FED WORKING PAPER MUST BE RETRACTED

Although a recent working paper by a researcher from the Cleveland Fed and two academics, "Three Myths about Peer-To-Peer loans," has already gotten a fair amount of negative attention, the paper is a case study of how in the field of economics, a lack of precision and lack of understanding of the subject matter can result in wild inaccuracies. While the Cleveland Fed has since admitted that they "created confusion" and has sort of retracted the "peer-to-peer" moniker, they have not yet changed the name of the report or acknowledged that the vast majority of their data set was made up of traditional loans, not online loans, of which peer-to-peer loans are but a subset.

The Marketplace Lending Association is now seeking a full retraction of this report. Why go so far? To reiterate what appears to have happened here: the Cleveland Fed researchers relied on a data set almost entirely of traditional non-online loans to grab 90,000 random borrowers for their analysis, labeled them peer-to-peer with no evidence that they were peer to peer, and then brutalized the new peer-to-peer lending industry with their analysis of those traditional loans.

Using data on traditional lenders makes sense if you are doing an analysis of traditional lenders. But relying on data on those old-style loans and then turning around and trashing the reputations of the start-up peer-to-peer industry that is trying to disrupt those old loans is an act of Orwellian academic malpractice. The entire purpose of the Cleveland Fed report is to debunk "three myths of peer to peer lending." That's pretty futile exercise when you are using a data set that is overwhelmingly made up of traditional loans.

How could they get it so wrong? They never bothered to check. They used a big consumer loan data set from TransUnion without even informing TransUnion of the scope of their analysis. And the problem with the TransUnion data is that, for that time periods examined, the researchers had no way to break out the P2P loans (or even online loans) that they actually wanted to look at, from the traditional loans. How do we know? Because TransUnion has said so. As the American Banker recently reported,

*"TransUnion sent the data to the Cleveland Fed a long time ago for a different study, and **none of the data the firm provided distinguished between peer-to-peer loans, so-called fintech loans and traditional personal loans."***

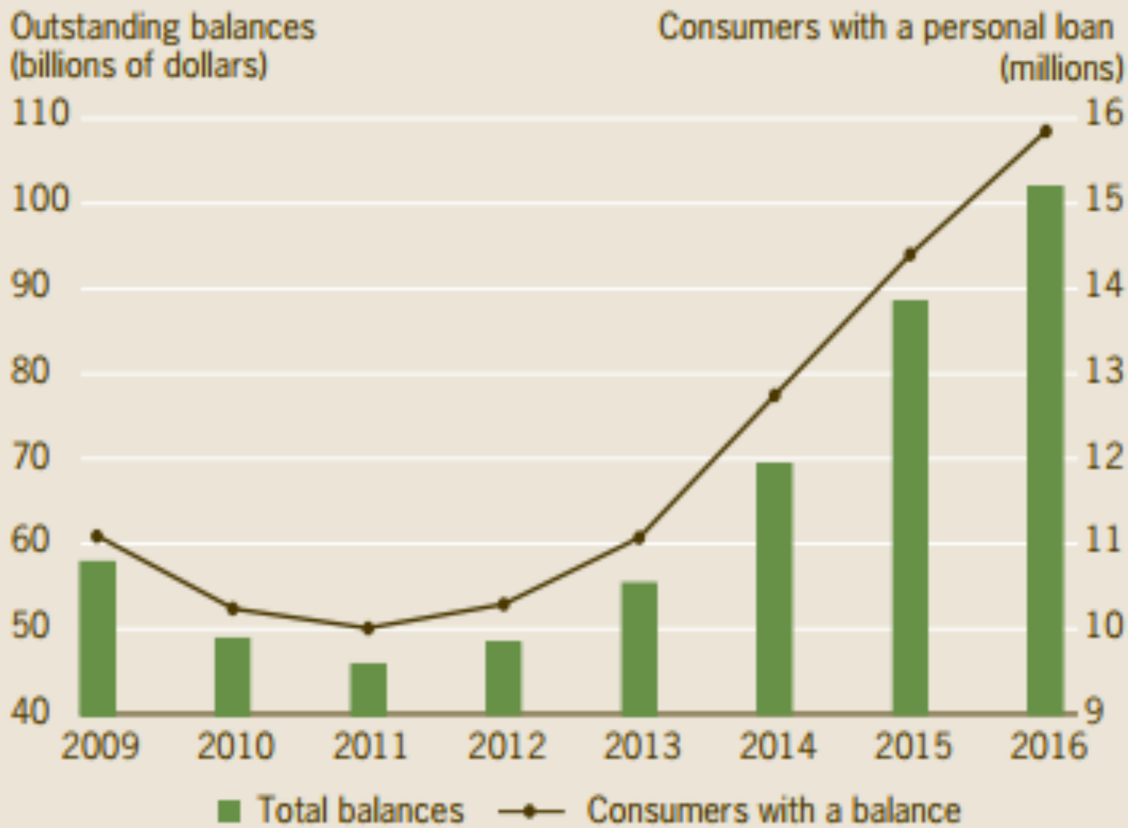
And TransUnion itself stated in the same American Banker article,

"We have no understanding of how the Federal Reserve Bank of Cleveland could have used our data to reach the conclusions they did."

Showing the Data Set Problems

The researchers also never checked with the industry to get a sense of size or scope or ask for information. How do we know that the bulk of the loans are traditional? A key chart from the working paper, claiming to rely on TransUnion data, shows the Cleveland Fed's working understanding of the outstanding "peer-to-peer," loan balances for this report.

Figure 2. Growth of Peer-to-Peer Lending



Source: TransUnion Consumer Credit Database.

Below, I have added a new portion to the chart, representing the actual P2P loan balances covering the same period according to publicly available information. In fact, from inception through the end of 2012, P2P had originated only $1.6 billion. As you can see, actual P2P volumes are so much lower that they didn't even fit onto the chart the Cleveland Fed created.

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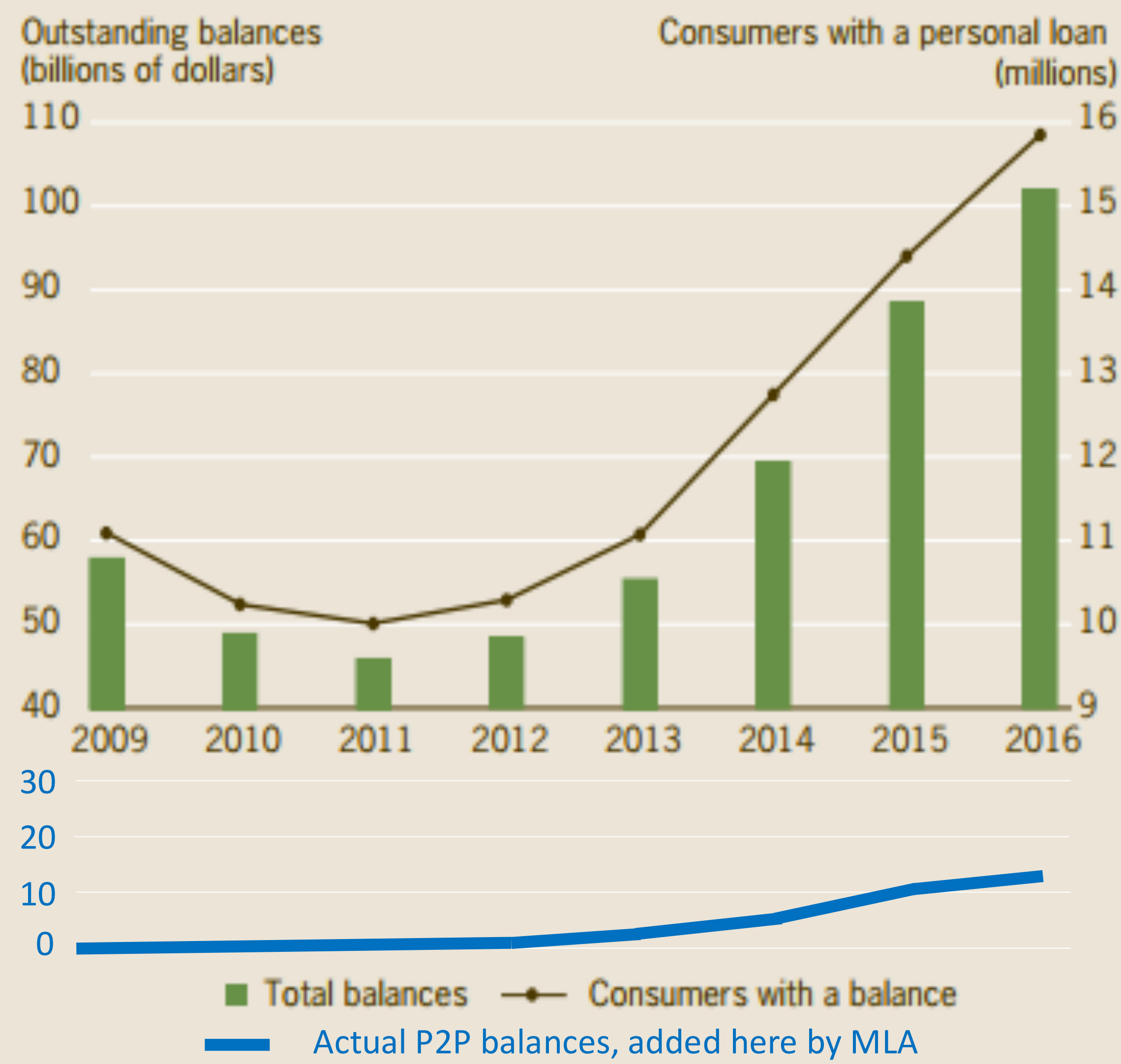
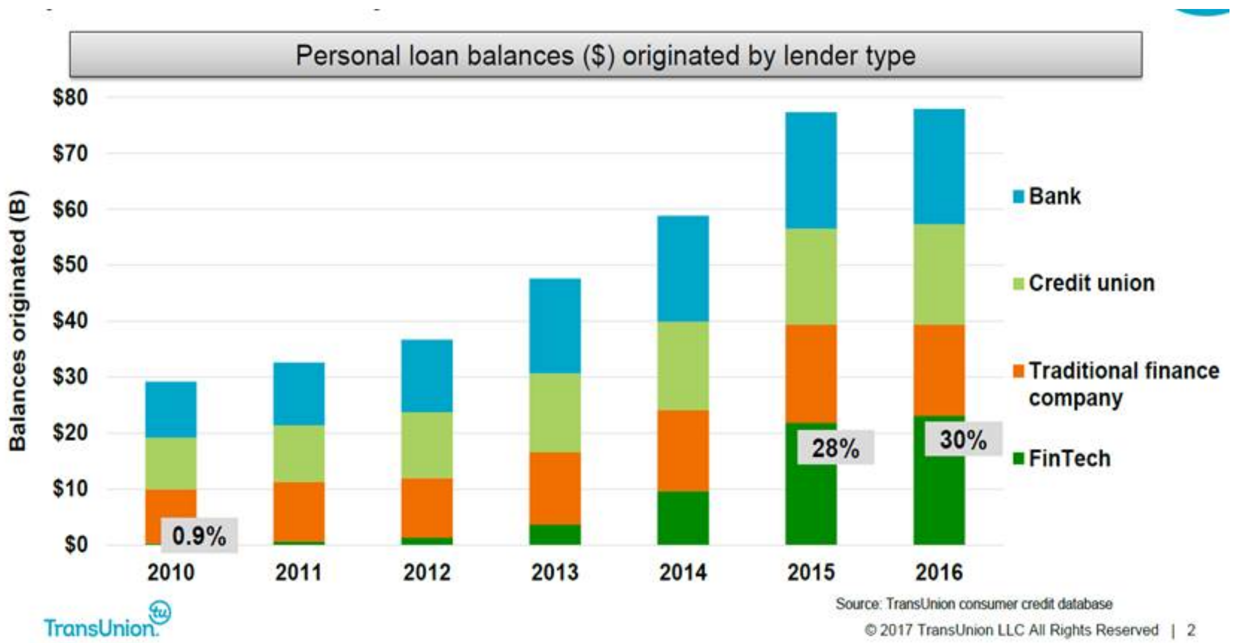


Source: TransUnion Consumer Credit Database.

Additional source: Marketplace Lending Association

Taking 2012 as an example, the actual outstanding balances from the only two P2P lenders at the time, Lending Club and Prosper, were ~$1 billion in 2012, not ~$45 billion as the paper claims. The data problems in this working paper persist throughout. It claims that in 2016 the P2P industry was 10 times larger than it actually is (~$100 billion as compared to ~$10 billion). Perhaps 7% of the balances in the working paper's above chart was actually P2P loans. The remainder weren't "online" loans either; there simply were not $44 billion of online consumer loan balances in 2012 - a time period when people were still operating the original iPhone.

The working paper cites TransUnion as the source of its data on P2P, yet the paper contradicts the publications of TransUnion itself. The chart below from [TransUnion's own recent fintech lending report] puts all of fintech, of which P2P and Marketplace Lending are subsets, as having originated about $25 billion in 2016. That's the same figure in the comprehensive [U Chicago/Cambridge/KPMG report], and implies balances that are a fraction of the $100 billion claimed in the working paper.



Look how tiny fintech is from 2010-2012 – a key part of the study. For the Cleveland Fed's working paper's data set on peer-to peer loans (above) to have been so large, the data must actually included lots and lots of traditional finance company data, which is shown in TransUnion's data as the orange bar, and probably other loan data on top of it. *These are some of the exact products that marketplace loans seek to disrupt by giving borrowers better, more responsible, lower cost online options*!

An Alternative Approach

This is all pretty sad, not just because the industry's reputation is unfairly tarnished. And not just because organizations like NCLC used this analysis to try to sway Congress. It's sad because there are researchers at the Fed who do good analytical work of fintech loans, relying on accurate data sets. Recently, researchers at the Federal Reserve Banks of Philadelphia and Chicago conducted a study relying on the largest platform in the marketplace lending category – LendingClub – whose loans make up a majority of the real marketplace lending market. And these researchers reached opposite conclusions from the researchers that authored the Cleveland working paper. They found that LendingClub is expanding access to credit in underserved areas and doing so at a lower cost than credit cards offered by banks.

The study, titled "Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information" found that for a given level of risk, Lending Club charged borrowers lower prices than bank credit cards. Here's the key quote from the Philadelphia and Chicago Fed researchers:

"The results indicate that given the same credit risk (i.e., for borrowers with the same expected delinquency rate), consumers would be able to obtain credit at a lower rate through the LendingClub than through traditional credit card loans offered by banks."

Of course, this good news story about peer to peer lending got next to no attention when it was released, even though there was a whole day long conference on it in Philadelphia. So, to conclude, the working paper by the Cleveland Fed researcher must be retracted. The standard for accuracy in research associated with an entity viewed by many as a government body cannot be so low that it wrongly impugns an entire industry.