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Goldman Sachs Enters Consumer Lending: Regulatory Implications

What's Happening: Goldman Sachs recently announced that it is entering the consumer lending market and that it has poached a high-ranking executive and 15 year veteran, Harit Talwar, from consumer lender Discover Financial Services. This action is part of a trend of larger bank holding companies joining new technology-enabled lending platforms to seek out customers in the nearly limitless consumer finance market. At the same time, Citigroup and other banks interested in this market are predominantly teaming with firms such as Lending Club to provide financing rather than launching their own platforms. In fact, Citi recently announced the sale of its consumer platform OneMain to Springleaf, though OneMain also had an extensive network of brick and mortar branches as well as an online component. Until this point, Goldman has mostly limited its consumer lending to those in its ultra-high net worth private banking program.

Why It Matters: Although typically a new competitor in a still emerging sector does not merit a large amount of scrutiny, we believe that Goldman's entrance raises several important regulatory and political questions and is an opportunity for the non-bank competition to further distinguish themselves and insulate against adverse political and regulatory action. The primary question is what will the regulatory reaction be to this decision? For safety and soundness regulators such as the Federal Reserve Board, the answer will likely be mixed—positive in that Goldman is looking to become more like a traditional bank and put its growing deposit base to work, but skeptical because unsecured loans (especially if they are offered to a broad swath of borrowers) are often risky, though they do offer a high return on equity. Second, those agencies that regulate business conduct such as the Consumer Financial Protection Bureau (CFPB) and Federal Deposit Insurance Corporation (FDIC) will closely focus their examinations of this division on the advanced data analytics that Goldman is likely to use for underwriting, particularly guarding against any fair lending and disparate impact findings across its portfolio. We believe the treatment of Goldman and the CFPB's enforcement of disparate impact will be in stark contrast to the the bureau's "wait and see" approach with other new marketplace lenders. For these new non-bank entrants, the bureau and each of the other federal bank regulators have stated that they are monitoring the growth of the sector, but that it is not large enough and any complaints

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against sector participants are not of high enough volume to consider any new rulemaking for the foreseeable future, let alone enforcement actions. We fully expect that certain populist politicians, such as Senate Banking Committee Chairman Sherrod Brown (D-OH) and Elizabeth Warren (D-MA), will closely monitor the practices of this division of the bank and ensure that the CFPB and other regulators do so as well. The expected scrutiny of Goldman is an opportunity for other lenders to use their political and regulatory goodwill to showcase themselves and their business model in a positive light.

What's Next: The firm's new platform is expected to remain in the planning stages for the remainder of this year, but in 2016 it expects to begin to make unsecured loans of between $10,000-$20,000 to both small businesses and individuals. It is not yet clear whether these loans will be made under the Goldman Sachs brand, or if they will be made by a separate company on the larger Goldman Sachs Bank USA platform, which had around $73.1 billion in deposits and $37.3 billion in loans at the end of 2014. There are currently no plans to securitize the loans, but that is an increasingly common occurrence in this burgeoning sector and Goldman would be well-placed to do so in-house and use it as a way to manage credit risk. Also, auto lending, mortgages, and student lending are unlikely to be initial focuses of the new platform. The entrance of Goldman into this sector will attract even more scrutiny at the same time that several firms, such as SoFi, are going public and other firms such as Lending Club are growing by leaps and bounds. The next several months are an incredible opportunity for the smaller and more established companies to ensure that their brands are elevated compared to Goldman, and that their underwriting, lending, servicing, and portfolios (depending on the firm) would hold up to the same fair lending scrutiny that Goldman should expect to endure.

Shifting Business Model

Prior to the financial crisis, Goldman was a client and trading focused investment bank that had very little direct interaction with consumers, except ultra high-net worth individuals serviced through its private wealth management division. In a need for liquidity during the crisis, the firm converted to a bank holding company so that it had access to the Federal Reserve's lending facilities. This conversion helped the company emerge from the crisis in good financial health compared to its peers, but also forced the divestiture of numerous profitable enterprises and divisions. Most notable was the shrinking of margins from its trading business and the increased push to utilize less profitable deposits, bank certificates of deposit, and high-yield savings accounts.

This entrance into broader consumer lending is part of the bank's shifting model, though the choice of using online technology-enabled lending is based in large part

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on what management believes are the firm's existing competencies. CEO Lloyd Blankfein was quoted last month saying, "More of the activities of lending are being done in a more digital kind of way that kind of is consistent [with our traditional businesses]."

Regulators Watching Closely

It is not just the consumer financial regulators that will be analyzing Goldman's portfolio. We fully expect the Federal Reserve, FDIC, and Office of the Comptroller of the Currency (OCC) to focus on the performance of these consumer loans, particularly if the portfolio grows to considerable size. Loan performance is also a mixed bag for Goldman -- if there are too many defaults, safety and soundness regulators could push to curtail lending but the loans could have been made broadly and to a wide array of borrower backgrounds, pleasing the CFPB and outside activist groups. If the portfolio performs too well, then it will draw scrutiny from those activists and the CFPB for redlining or having too narrow of lending criteria that shuts out certain classes of borrowers. Goldman could previously get away with offering loans only to the super-prime when it was solely catering to private wealth management clients, but will have a hard time offering credit so narrowly to the public at large.

Even with an enhanced level of scrutiny, we believe there are significant advantages for Goldman to enter this business compared to the existing players. The largest strength is that the firm has a stable base of deposits with which to lend and has no fear of these deposits fleeing in a financial or economic downturn. The vast majority of other competitors rely on outside banking relationships, institutional investors, and individuals which could prove to be fickle sources of funding as was shown during the crisis.

Another advantage that Goldman has over some competitors in this space is that it will retain the credit risk rather than charge a percentage or fixed fee for underwriting and thus receive a far higher return on its equity compared to other types of lending with lower interest rates. As a bank, the firm does have to hold greater capital reserves against losses compared to its non-bank competitors, but on net, we believe it has determined that this type of lending will still be more profitable than other consumer financial products.

Critical Differences Between Lenders

Perhaps the most important opportunity for non-bank marketplace lenders is to create new, or better markets for consumer products where there previously was a lack of credit. Two potential such areas are refinancing student loans and offering unsecured small business loans. Federal regulators have stated that they are more

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likely to look at a firm offering a new product and creating a market for which there is demand with rose-tinted lenses. Therefore, firms like SoFi with student loans and OnDeck with small business loans have the chance to positively differentiate themselves from Goldman Sachs to both consumers and to regulators.

Should Goldman eventually choose to enter into those markets, then we would expect that the more specialized lenders will be faced with similar comparisons and scrutiny and should have their portfolios ready to weather the same type of statistical analyses for fair lending.

It is also important for investors to realize that nearly all politicians, activists, and regulators in Washington typically lump all non-bank lenders that utilize new technology platforms together. With the entrance of Goldman Sachs, these firms should be prepared to be asked the same questions about fair lending, even if their business models are entirely different -- i.e. they do not take credit risk and offer different products like mortgages and student loan refinancing.

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