ALTERNATIVE INTERESTS

PEER-TO-PEER LENDING COMBINES HIGH IDEALS WITH A HIGH ROI

BY CHUCK GREEN | ILLUSTRATION BY BRIAN TAYLOR

After their Booneville, Arkansas home was destroyed in a fire last November, acquaintances offered Katy and Gary Murphy a place to stay. While appreciative, of course, the Murphys realized the arrangement would grow stale quickly. The retired couple, who are breeders of specialty llamas, needed a new home, but though their credit was pristine and despite the fact they'd been customers for some time, their bank no longer extended personal loans.

But the Murphys found a home. To help purchase it, Katy Murphy obtained a loan from a peer-to-peer loan broker through a third party called the Lending Club. Murphy simply filled out an online application and, within days, received a loan toward the purchase of the home. "It was like a personal loan. It saved us," she says.

The Lending Club and Prosper are among those connecting borrowers and lenders through a formal arrangement, explains Ben Jackson, a senior analyst with the Mercator Advisory Group, which provides research and advisory services for the consumer payments industry. Lending Club and Prosper lenders make these loans because they can earn a better rate of return than on other potential investments, Jackson says.

P2p lending experienced strong growth in 2011, with 33,000 new loans for $330 million, according to Jim Bruene, editor and founder of The Finovate Group, a Seattle-based boutique banking technology research firm. That was up from 2010, when there were 18,000 loans for $150 million and 7,300 new loans for $62 million in 2009.

The industry experienced a rocky period during the credit crisis in 2008 and 2009 when the Securities Exchange Commission required both the Lending Club and Prosper to close for about six months to retool the way loans were disclosed, says Bruene. However, he expects strong growth going forward, with volume quadrupling over the next three years and hitting $1 billion in annual volume across more than 100,000 loans.

The SEC now requires that each loan be treated as a new "security" with the appropriate investment disclosures, "an odd overreaction to something that was already highly regulated and very transparent," Bruene notes.

The measure led to more overhead, along with "huge barriers" to entry for newcomers that aversely impacted both consumers and lenders, he says. Lending Club and Prosper were required to invest an estimated $1 million each on new compliance procedures "that pretty much replicated what they were already providing investors. But they're back to where they would have been if the SEC had stayed out of it," says Bruene.

After shutting down in 2008, Prosper relaunched in July 2009. Under the new SEC requirements, Prosper now files every individual loan with the SEC, making it one of the largest filers, behind large Wall Street filers such as Blackrock Capital, says spokesperson Laurie Azzano.

Lending Club anticipated the SEC ruling by proactively registering, which allowed it to keep its Web site open and continue to make loans throughout the registration process, says Scott Sanborn, Lending Club's chief marketing officer.

In general, p2p lending is an effective tool for lenders today because of stepped-up restrictive underwriting criteria. Investors also are drawn to the high-yield, short-duration income. As of mid-December of last year, returns by grade range from 5.82–13.17 percent. These returns have remained steady during the recession, says Sanborn. Investors can be individual or institutional.

And p2p lending gives borrowers "quick and easy" access to capital, especially compared with the high cost of revolving credit cards and the perception that banks aren't lending, says Breune. On the flip side, it's more difficult to qualify as a borrower. "But if you have good credit, it works well."

Furthermore, given that over the past several years the U.S. has experienced tighter credit, for borrowers, p2p or social lending simply disintermediates traditional financial institutions, where some borrowers might be unable to qualify for credit, or at least not at favorable terms, says Greg McBride, senior financial analyst for Bankrate.com. Consequently, p2p lending presents an option — or an additional option — for borrowers.

Since its inception in 2006, Prosper has originated more than $291 million in loans, says spokesperson Azzano. Prosper offers one-, three-, and five-year loans, with an average loan of roughly $6,500. The average return is 10.69 percent.

Lending Club has issued more than $470 million in personal loans since June of 2007, and currently issues more than $30 million monthly, says Sanborn. Notes are available in three- or five-year terms. Creditworthy borrowers request loans of up to $35,000; the club approves the top ten percent of submitted applications — representing only prime and super-prime borrowers — using strict underwriting criteria.

Still, a lender knows next to nothing about the borrower, says A. Heath Abshure, Arkansas Securities Department commissioner. "You can't assess that borrower's ability to pay. You rely on the 'review' by the platform, and the platform doesn't verify the information about the borrower."

"We take great care to provide lenders full transparency of the information needed to assess risk," says Azzano. Lenders receive a Prosper rating score, where the rating indicates risk level and corresponds to an estimated average annualized loss rate range, she continues.

Lending Club investors can view borrower profiles that include a description of their loan purpose and their credit history, including FICO score and debt, Sanborn notes.

In any event, Abshure also points out that a lender turns over all of his recovery rights to the platform. "You can't sue the borrower on the note, foreclose, or obtain any other traditional remedy on your own. Only the platform can sue on the lender's behalf, and it alone makes the choice to do it — and takes a percentage of the recovery."

Debt collection is a highly specialized and regulated area, observes Azzano. To be done effectively, "we believe, as do most other major financial services institutions, that it's best handled by professional, third-party collection agencies to yield the best outcomes."

Whatever the case, before committing their funds, investors should know what they're investing in, and the expected return and risks, says Jackson. "Nothing's a perfect predictor of whether or not someone will get paid back, but people need to dig into the terms and conditions."

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Investors also should be judicious about the extent they invest in p2p lending, adds McBride. "As with any other investment, it's imperative to understand what you're getting into before committing money. This isn't, by any means, a core holding of your portfolio."

Furthermore, despite social ramifications often associated with p2p lending, Mark Schwanhausser senior analyst, multichannel financial services, Javelin Strategy & Research, believes it should be approached like any other investment, and not some "warm and fuzzy" concept. "I understand the fascination with higher returns, but be pragmatic," says Schwanhausser. He advises average consumers to devote no more than about three percent of their overall portfolio to this type of specialty investment.

"Individual investors, in general, are still very risk averse," adds McBride. "There's a big need for due diligence and only lending money they can afford to lose."

Not all p2p services are available to both lenders and borrowers in every state; consult your financial adviser to learn about your options.