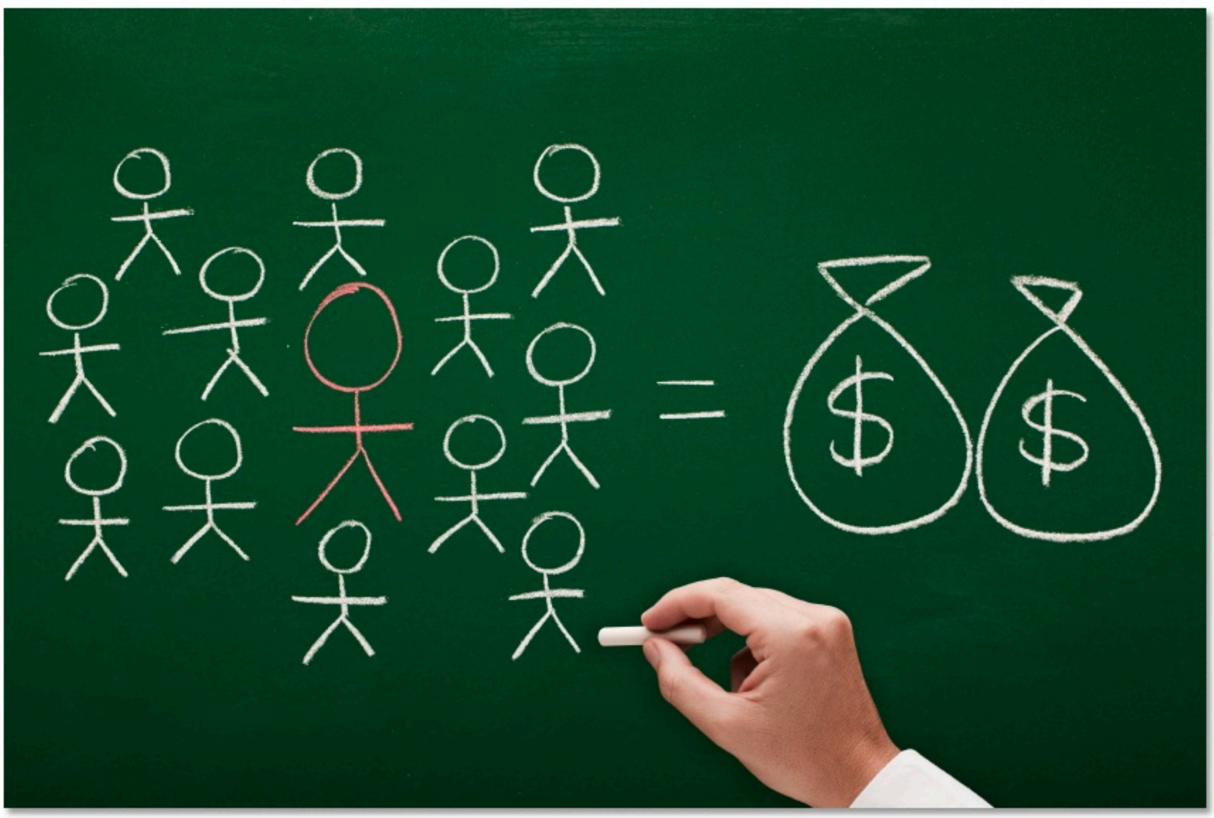
Understanding Peer to Peer Lending



by Peter Renton

LendAcademy.com

www.lendacademy.com

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Introduction

This free e-book introduces the concept of peer to peer lending to everyone. It provides some background and history as well as describes how the process works for both investors and borrowers. While peer to peer lending is now a global phenomenon this book will be focusing on the U.S. market in particular and how it works here.

If you have been curious about peer to peer lending but don't really know where to begin then this e-book is for you. This e-book will describe in detail how peer to peer lending works and the requirements for borrowers and investors to participate in peer to peer lending in the U.S.

Peer to peer lending is an idea whose time has come. We live in a highly sophisticated and interconnected world yet the banking system is still based on a centuries old model. There is no need for borrowers to obtain loans from a bank any more when they can turn to their peers, often with a lower interest rate. Borrowers can save money by taking out peer to peer loans and investors can earn great returns on their money.

All the data in this e-book is current as of September 2015.

What is Peer to Peer Lending?

Peer to peer lending goes by many names. It is also called social lending, person-to-person lending or p2p lending. It can be defined in this simple way: individuals lending money to other individuals without a banking intermediary.

The official definition from Wikipedia is "a certain breed of financial transaction (primarily lending and borrowing, though other more complicated transactions can be facilitated) which occurs directly between individuals or 'peers' without the intermediation of a traditional financial institution." Basically, it involves people with money (investors) lending to people who need money (borrowers). Obviously this is something that has taken place since the invention of money thousands of years ago.

Today, with the explosive growth of the Internet and online social networks, this concept has been brought online. So now, borrowers can borrow money from people they have never met and investors can lend money to many anonymous borrowers just based on their credit information. There are dozens of companies all over the world enabling peer to peer lending, and in the United States there are two established companies: Lending Club and Prosper.

There are also many companies that do what I call direct peer to peer lending (direct p2p). These are primarily for people who want to formalize a loan arrangement between friends and family. Companies in the U.S. doing this today are ZimpleMoney, LendingKarma, National Family Mortgage and many more. They help setup loan agreements and manage the funding process for you. While these companies provide a valuable service the focus of this e-book will be on the mass-market p2p lending sites, Lending Club and Prosper.

I also want to make a distinction between peer to peer lending and microfinance. Microfinance typically deals with very small loans sizes (under $1,000) and are usually run by non-profit organizations. I am a big fan of microfinance organizations like Kiva (I loan money on Kiva) but they serve a different purpose and have different goals from peer to peer lending organizations like Lending Club and Prosper.

A Short History of Online P2P Lending

It wasn't until well after the new millennium began that for profit p2p lending began to emerge online. In 2005, Zopa launched in the U.K. as the world's first online p2p lender, and they are still going strong today as the number one company in the U.K. market.

In the U.S., Prosper began operations in February 2006 and within 9 months they had garnered 100,000 members and funded $20 million in loans. They had the market to themselves in the US until Lending Club launched in May 2007 as a Facebook application. Within a few months they emerged as a standalone website to compete directly against Prosper.

Quiet Periods

Both Prosper and Lending Club spent some time in "quiet periods" in 2008 and 2009. By a quiet period we mean that the companies still operated but they didn't allow new money to come in from investors. This was necessary because the Securities and Exchange Commission (SEC) demanded that they register all the loans on their platform as promissory notes with the government. Lending Club spent about six 5s in their quiet period from April to October 2008 and Prosper spent a little longer from October 2008 through July 2009. Now, all notes are registered with the SEC and all financial results for both companies are publicly available. The notes for both companies are now offered by a prospectus filed with the SEC.

Peer to Peer Lending 2.0

With the emergence from their quiet periods, both Lending Club and Prosper became more focused on risk management. The early loans made on Prosper in 2006 and 2007 didn't perform well for investors at all. Most investors lost money, caused by the high default rates. According to Prosper's own statistics page, just under 40% of loans issued in 2006 and 2007 defaulted. With Lending Club the numbers are slightly better, but still not good. Of loans issued before their quiet period, around 24% of them have defaulted.

Now, if you look at loans made in the first year after their quiet period, the default rates and the returns for investors are much better. As of this writing (most of these loans are still outstanding), the default rate for Prosper loans issued from July 2009 through June 2010 is just over 5%. For Lending Club during the same period, their default rate is around 4%. This is much better than they did before their quiet period.

Both companies have added to the attractiveness of p2p lending by adding additional "products" recently. Lending Club has recently added small business loans, although these are only available to preselected investors. As far as consumer loans go you can invest in both three and five year loans at both Lending Club and Prosper today.

Why is Peer to Peer Lending Becoming Popular?

Peer to peer lending is a rapidly growing industry. In the 12 months ended December 31, 2014 the total amount of money loaned by Lending Club and Prosper was $5.98 billion. That is around 147% growth over the preceding 12 months. Clearly, it is becoming more popular all the time.

To understand why peer to peer lending is growing so fast, we need to look at the advantages it provides for both borrowers and investors.

Borrowers

The financial crisis in 2008 had a huge impact on banks and financial institutions that is still being felt. Many individuals who had found it easy to get loans from banks before suddenly found themselves cut off.

Many people had used the equity in their home to borrow money in the past couple of decades, but with homes across the country dropping in value, banks became much more cautious with this kind of lending. Unsecured personal loans from banks became almost non-existent.

Many people who needed money found themselves resorting to credit cards with high interest rates. Clearly, there was a void in consumer financing and peer to peer lending helped fill that void. Borrowers found that their 28% credit card interest rate could be cut in half with a loan through Prosper or Lending Club. The fixed loan term, typically three or five years, is also appealing because borrowers can see how they can pay off their debt completely in a relatively short time period.

Investors

There are several advantages for investors. The biggest and most important one is the higher rate of return. Some Lending Club and Prosper investors are averaging at least a 10% annualized return, and the vast majority are earning more than 6%.

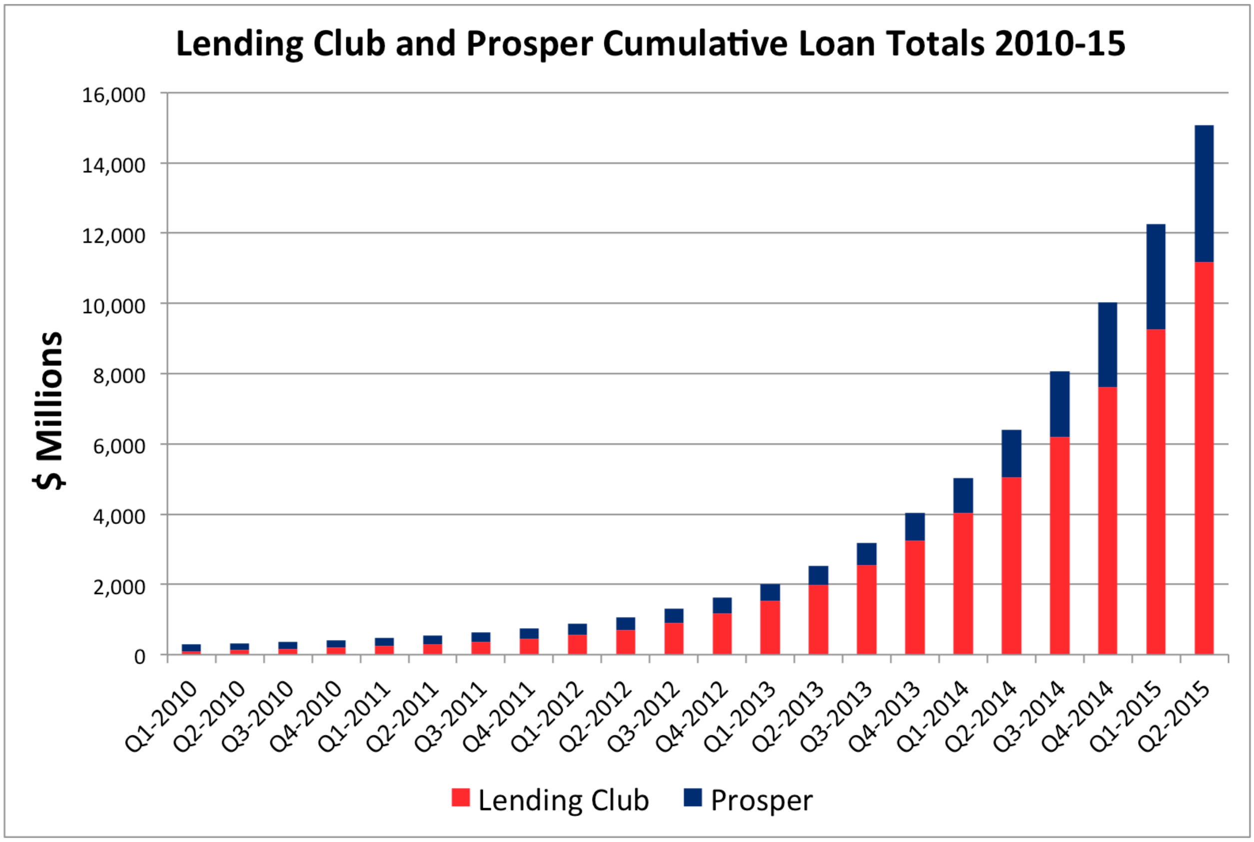
You can choose your level of risk with p2p lending. You can choose to invest in A grade loans where every borrower has excellent credit, where the likelihood of defaults are low. Or you can invest in higher risk, higher interest loans. Alternatively, you could choose some combination of these high risk and low risk loans.

Many people are drawn to peer to peer lending because you are investing in real people, not some faceless bank or mutual fund.

Peer to peer lending also adds diversification to an investor’s overall portfolio. You are investing in consumer credit, which is a different asset class from other investments.

The Growth of Peer to Peer Lending in the U.S.

The chart below demonstrates the growth of peer to peer lending over the last several years. Total loan originations at both Lending Club and Prosper are climbing at an incredibly rapid pace and the cumulative total recently passed $15 billion in total loans issued.



How Peer to Peer Lending Works

The basic premise of p2p lending is this: people sign up on either Lending Club or Prosper as a borrower or an investor. A borrower submits an application for a loan, and if approved the loan is placed on the website for investors to fund. Investors typically invest in a small portion of many different loans, thereby spreading their risk.

Borrowers

A borrower's loan will remain on the web site for a short amount of time, up to two weeks. During that time investors can ask the borrower questions in order to decide whether or not to invest in the loan. While no personal information is displayed, information from the borrower's credit report is provided for the investors, many of who screen these loans based on different criteria.

A number of things can happen while the loan is being funded:

1. The loan can be pulled off the platform because it fails some part of the verification process.
2. The loan can become fully funded, in which case it is taken off the platform and the borrower will receive their money less an origination fee (detailed in the table on the next page).
3. The borrower may cancel their loan and delete it from the platform.
4. The loan fails to obtain funding after 14 days. Although if investors fund only part of the loan it can still be issued if it funds above a certain percentage.

Investors

From an investor perspective, peer to peer lending allows you to directly invest in other people, thereby completely bypassing the banking system. Investors simply sign-up at Lending Club or Prosper, link to their bank account and then transfer money in.

Typically, there will be hundreds of loans to choose from for investors. Both Lending Club and Prosper allow investors an easy way to invest by providing automated plans. Prosper provides several different automated plans based on credit risk or you can build a customized plan based on your own selection criteria. Lending Club provides you with three automated options (low, medium and high risk), or you can use their slider tool to choose an average interest rate. Then you just choose the total amount you want to invest and your money will be allocated automatically among many different loans.

The other alternative for investors is to choose loans individually. You can use the filters that Lending Club and Prosper provide, and then browse through each loan one by one. While this method is more time consuming, many successful investors will only invest this way.

Borrowing Money

Who Can Borrow Money?

To borrow money on Prosper or Lending Club you must be a US resident, at least 18 years old, have a bank account and social security number. But even if you meet that criteria, not all states allow people to borrow money through peer to peer lending platforms. You must also have a decent credit score and have a good credit history. Lending Club and Prosper have slightly different requirements, which are detailed in the table below.

	Lending Club	**Prosper**
Minimum credit score	660	640
States Not Available for Borrowers	IA, ID, ME, MS, ND, NE	IA, ME, ND
Loan amount range	$1,000 - $35,000	$2,000 - $35,000
Origination fee range	1.11% - 5% varies by loan grade	1.95% - 4.95% varies by loan grade
Loan Terms	3 and 5 year loans	3 and 5 year loans
Interest Rate range	6.03%% to 26.06%	6.05% to 29.50%
Average loan size (2014)	$12,955	$12,543

You should check the websites for Lending Club: http://www.lendingclub.com/ and Prosper: http://www.prosper.com/ for the most up to date requirements.

Interest Rates

Both Lending Club and Prosper will assign each loan a grade or rating, and the interest rate will depend on that rating. They base this rating on a number of factors such as the borrower's FICO score and other information obtained from the credit report. Both Lending Club and Prosper use their own formula in determining the loan grade.

Borrower Fees

All borrowers will pay an origination or closing fee when their loan has been funded. For both Lending Club and Prosper, this fee varies depending on the loan rating. Lending Club will charge between a 1.11% and 5% loan origination fee (1.11% for three year loans rated A1). Prosper's fees range from 0.5% for AA rated loans up to 4.95%. The origination fee is subtracted from the loan proceeds, so it is important to ask for slightly more money than you need.

There are no pre-payment penalties, so borrowers can pay off their loan at any time without penalty. There are also no hidden fees. The only other fee a borrower may pay is a late fee, which is assessed if a loan payment is more than 15 days late.

Investing Money

Who Can Invest Money?

Investing with both Lending Club and Prosper is much more restrictive than borrowing. Only about half the states allow investors to open a peer to peer lending investment account.

Prosper allows investors in the following 33 states: Alaska, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New York, Oregon, Rhode Island, South Carolina, South Dakota, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

Lending Club allows investors in the following 36 states: Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Illinois, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Montana, Nebraska, New Hampshire, Nevada, New York, Oklahoma, Rhode Island, South Dakota, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, West Virginia, and Wyoming.

However, even if you reside in these states Lending Club imposes additional criteria on all investors. To be eligible, an investor must have an annual gross income of at least $70,000 and a net worth of at least $70,000, or just a net worth of more than $250,000. There are different requirements for California and Kentucky residents explained on Lending Club's website.

Getting Started With Investing

Assuming you meet the above requirements then you can become an investor. Getting started with peer to peer lending can be a bit daunting for new investors. Lending Club and Prosper offer hundreds of loans to choose from and a myriad of ways for you to invest your money. Some people that are eager to get started jump out of the gate without thinking through their options and end up disappointed with their investment returns. The shrewd investor does some initial planning and research in order to get off to a great start.

Here are a seven points to consider that will help you do just that.

1. Cherry Pick or Auto Plans

The first decision you need to make is whether you are going to invest in loans individually or go with one of the automated plans offered by Lending Club and Prosper. If you have a large amount to invest ($10,000 or more) I recommend you consider starting with an automatic plan or you can look at Lending Club PRIME (a special account with Lending Club that offers a completely hands off approach). If you choose to invest in loans individually, and this is really the only way to obtain above average returns, then you need to pay close attention to the points below.

2. Diversify

If there was only one word of advice I could give to all new p2p investors it would be this one: diversify. Don't make the mistake I made and spread your initial investment between two loans. What you want to do is diversify your initial investment as widely as possible. Both Lending Club and Prosper allow a $25 minimum investment in each loan. Take advantage of it. If you are starting off with $1,000 then fund 40 different loans with this money. Only if you are starting with more than $2,500 do I recommend you going over the $25 minimum. Then, I would still make sure that no loan is more than 1% (and preferably less) of your total p2p investing portfolio.

3. Don't Shoot for the Moon

You have a choice to invest in A grade loans that earn in the mid single digits in interest to loans of over 20%. Sure, you might think, a 20% return sounds much better. But keep in mind these are higher risk borrowers that historically have had a higher default rate. So a portfolio of loans that are earning over 20% could easily end up with a real world return under 10% once all the defaults have been taken into consideration. Whatever your risk tolerance, for new investors I would recommend a broad portfolio with a range of different loan grades. Having said that, I tend to avoid A grade loans, I think they are risky for a different reason. We are in a historically very low interest rate environment right now and it is highly likely that in two or three years interest rates will be much higher than they are now. If you can get 6% in an FDIC insured CD, it makes 7% in a p2p lending investment a poor choice. I personally prefer to invest in loan grades of B and below.

4. Use Some Simple Filters

So you have transferred your money in and have decided you want to invest in individual loans. You would login to your Lending Club or Prosper account and start browsing through the dozens, or even hundreds of loans. You suddenly realize you are going to be here all day unless you can narrow down your selections somehow. This is where filtering comes in. Both Prosper and Lending Club allow you to filter loan selections on their site. Prosper's filtering is much better than Lending Club, so what you can do for Lending Club is download the CSV file of all available loans and filter them in Excel.

You can spend hours (or even days) playing around with filtering on a p2p lending statistics site. The most popular site for investors is Nickel Steamroller: http://www.nickelsteamroller.com/. They provide an extremely detailed back-testing tool and also order automation so you can invest in both Lending Club and Prosper through their APIs. Other good options for investors are LendingRobot: http://www.lendingrobot.com or PeerCube: http://www.peercube.com.

You can slice and dice previous loan ROI data in many different ways, but there is one filter I always use: Inquiries = 0. Inquiries means number of credit inquiries this person has undertaken in the last six months. It is recorded on a borrower's credit report. I like to invest in someone who has not been shopping around in many places for more credit. I use other filters, such as no recent delinquencies, but this one seems to have the biggest impact on ROI based on previous loans. We need to state here that past performance is no guarantee of future returns. This filter may not produce superior returns in the future, but for past loans on both Prosper and Lending Club, if you had chosen that filter and nothing else you would have increased your ROI considerably.

5. Read the Details of Each Loan

I believe that it is useful to spend some time reading the details of each loan. If nothing else, this will give you a feel for the different kinds of borrowers on the platform. I tend to avoid someone who hasn't bothered to give a good loan description (or any description) and if they have failed to answer investor questions then that is a red flag, too. You can always ask your own questions, keeping in mind of course, that people may not always tell the complete truth.

6. Start Slowly

As a new investor, you are probably all excited to get started and want to get all your money to work quickly. But if you have done the work of the other steps above you will likely only have a relatively small number of loans to choose from. For example, you might have $2,000 to invest and have narrowed your search down to 40 loans to invest in. So, you think you should just invest $50 in each loan. That is not what I would recommend. Stick with my diversification point above and stay with $25 per loan. Invest half your money now and then wait a week or two. There will be an entirely new batch of loans on the platform by then, and you can repeat the process. I know some investors with very strict investing criteria who have repeated this process many times before all their money was invested.

7. Avoid Taxes if You Can

Interest earned on your investments at Lending Club and Prosper are taxed at the standard income tax rate. They do not get the favorable tax treatment of stock dividends. So, if you are in the 28% federal tax bracket then you will likely pay 28% in federal taxes on all of your interest income earned from p2p lending. You can avoid this tax burden completely by putting your investment in an IRA. Both Lending Club and Prosper offer a no-fee IRA (with a minimum $5,000 investment) where all your interest can accrue tax-free. You can open a new Traditional IRA, Roth IRA or a SEP-IRA or you can roll over an existing retirement account.

Where to go from here?

This e-book has only covered the very basics of peer to peer lending. It is a young and very dynamic industry that is changing all the time. Serious borrowers and investors need to keep up to date with all the changes. There are many resources online that can help you with this.

Of course, if you haven't already I recommend you subscribe to my blog, Lend Academy: http://www.lendacademy.com/.

The blog is updated several times a week and any important developments are discussed in depth there. Other sites updated regularly with useful content for investors are LendingMemo: http://www.lendingmemo.com/ and Orchard: http://www.orchardplatform.com/blog/.

The Lend Academy forum is a gathering place where investors and borrowers come to discuss p2p lending. You can register and join the conversation or just follow along as a guest. There are hundreds of active members there where your questions can be answered very quickly. You can go to the forum here: http://www.lendacademy.com/forum/index.php.

Also, Lend Academy's sister company is the largest conference for the p2p lending community called LendIt. We have held three conferences in the U.S., the last one in New York had 2,500 people in attendance. Also in 2014 we expanded our conference series to the UK and China. Our next US conference will be held in San Francisco on April 10-12, 2016. You can find out details and sign up here: http://www.lendit.co.

We have only just scratched the surface of the world of peer to peer lending in this e-book. But hopefully now you will have a feel for what it is all about and why it is becoming so popular. I will be updating this free e-book every quarter and providing the new edition to all my email subscribers. So, if you have received a copy of this book from a friend then I encourage you to subscribe to the Lend Academy email list.

Whether you are a borrower or investor, peer to peer lending is the wave of the future. It is just getting started. One day in the not too distant future, I expect that most people will invest and borrow money this way. So come and join the 21st century way of lending money.