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Friends with Benefits

Peer-to-peer loan websites easily connect borrower to cash — but will they last?

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In late 2011, Roseville financial advisor Kimberly Foss started getting concerned about the investment moves of some of her clients. Fixed-income vehicles were paying rock-bottom interest rates, so some of her clients were buying long-term corporate bonds, 15- to 20-year instruments paying 3 to 4 percent. "I was concerned that they were taking a lot of risk and weren't getting paid for it," Foss says.

That's when she discovered the peer-to-peer lending market. "P2P" sites like prosper.com and lendingclub.com match investors with borrowers seeking lower rates to do things like consolidate credit card debt, renovate a kitchen or pay for a wedding. Borrowers get 3- or 5-year loans at lower rates than those offered by banks and credit card companies. Investors get better returns than on fixed-income instruments like CDs and money market funds.

So Foss started testing out P2P sites with her own money. She stays conservative, lending only to the least-risky borrowers. In the almost

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three years since, she's gotten returns of 8 percent a year and not a single loan has defaulted. Now she invests in peer loans for some of her clients.

Foss' returns aren't unusual in the P2P world. With interest rates still scraping bottom, P2P proponents say it offers an alternative fixed-income vehicle that can boost earnings. But no one knows how P2P loans will do in the long run, especially in the face of an economic decline.

Peer Lending Comes of Age

P2P platforms have hit their stride, and the number of peer loans has grown 84 percent per quarter since Prosper launched in 2006, according to the Federal Reserve Bank of Cleveland. In that same period, originations for other types of consumer loans have fallen 2 percent a quarter.

Lending Club is in the middle of raising $500 million through an initial public offering this fall. And after Prosper broke its own record by making $100 million in loans in April, its investors put another $70 million into the company.

Meanwhile, P2P sites focused on niche markets are crowding into the space. Bay Area company sofi.com matches people looking to refinance their high-priced student loans with college alumni investors who want to give them better rates. Sites like breakawayfunding.com and fundingcircle.com specialize in businesses seeking startup capital. Others, like upstart.com, target borrowers who don't have much credit or work history but whom the company says are good credit risks because of other factors.

Though it's a new area of finance, Lending Club and Prosper dominate the space, with 98 percent of the P2P market. There's a good reason — they're the only sites that let people of average wealth buy loans. All of the other platforms allow access only to high-net-worth investors or institutional investors like hedge funds.

P2P's Promise

Prosper CEO Aaron Vermut thinks P2P could fundamentally shift the investment landscape. Historically in finance, if you wanted to get exposure to unsecured consumer credit assets, you'd have to buy stock in an issuer or a derivative from a bank, he says — you couldn't buy loans made to people. For Foss, it's "the greatest thing for capitalism; it's the free market at its best."

Getting on a P2P site is like spending a day in the life of a bank loan officer. At upstart.com, investors can view a list of people requesting money. No. 893, for example, is a Harvard economics graduate making $100,000 a year. The borrower has a credit score between 700 and 719 and is seeking a $5,000 loan at 7.89 percent interest to refinance credit card debt.

Both Prosper and Lending Club allow the investor to browse loans like that one and buy the whole thing or part of it. Upstart doesn't let its investors pick loans. Instead, the investor sets the parameters for the loans he or she wants, such as low-risk loans with 3-year maturities, and Upstart's system auto-invests on their behalf. Prosper and Lending Club also offer auto-investing, though it's not required.

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P2P sites grade borrowers' loan requests on risk and assign an interest rate accordingly. At both Lending Club and Prosper, for example, premium loans bring investors a return of 6 to 8 percent, while the highest risk earn between 26 and 30 percent.

P2P sites say they're selective in their screening. Lending Club says only 10 percent of its applicants are approved; they need credit scores of at least 660, which is considered a fair credit risk. Prosper's credit score cutoff is 640. Lending Club says it verifies either the level or source of income on about three-quarters of its borrowers, using a statistical model to identify potentially fraudulent applications. It also conducts some random income verification.

Peer lending experts say investors can expect returns ranging from 5 to 12 percent, depending on individual strategies and the credit cycle. By comparison, current rates on 3-year CDs and money markets range from about 1.3 to 1.5 percent. Loan terms on both platforms run either 3 or 5 years, and investors typically pay about a 1-percent fee to the websites.

Many investors like that the P2P market is noncorrelated, meaning it doesn't fluctuate with the stock market. That was important to 34-year-old Sacramento investor Shanto Ahmad after he lost more than 30 percent of his stock portfolio to the recession. He's since begun keeping his savings in cash, looking for an alternative.

Then 18 months ago, a friend turned him on to Prosper. Since then, he's spread about $45,000 in small increments across hundreds of loans. He's seeing annualized returns of between 8.5 and 10.5 percent depending on the month. And he says using the site takes him no time. He set up his investment filters when he joined, and Prosper automatically buys fractions of loans that meet his parameters.

Will P2P Survive a Recession?

Peer lending's flattening of the loan market has made it one of the hottest areas of finance. About 18 months ago, in search of better returns, institutional investors — hedge funds, sovereign wealth funds and, weirdly, banks — started sinking millions into P2P loans. In fact, these players' demand for loans outstrips supply by two or three times, according to Matt Burton, CEO of Orchard Platform, which provides technology tools for institutional P2P investors.

Still, there's almost no record of how P2P loans will perform during a downturn, when borrowers start losing jobs and getting behind on mortgage payments. Prosper survived the recession, but its model was different at the time. It offered investors eBay-style bidding on individual loans. Vermut has no data on Prosper's loan performance during that period but says it wouldn't be relevant now anyway.

P2P default rates already appear to be slightly higher than those of banks. Of total money invested yearly, Lending Club's loss rate is 3 percent, while at Prosper it's 9 percent, according to statistics compiled by industry analyst Simon Cunningham. Meanwhile, banks' charge-off rates on consumer loans have stayed between 2 and 3 percent for the last two years. Sacramento Lending Club investor Jim Hartley says his default rate has run about 3 percent.

P2P loans also don't necessarily perform like liquid assets. A secondary market has developed for investors to sell their loans before their 3- or 5-year maturities are up. But only well-performing loans trade at or near their original sales price. Investors who try to sell loans that are delinquent do so, sometimes at a huge discount.

And not many financial advisors appear to use P2P for their clients. Sacramento financial planner Debbie Grose of Lighthouse Financial Planning says that discussing whether to move into P2P is "a great conversation to have" with clients. But her firm doesn't use P2P for its portfolios, in part because, for Lighthouse, peer lending doesn't qualify as a real fixed-income instrument: "Fixed income in our mind is intended to be more risk averse," she says. "These introduce just a little more risk than what we're comfortable with."

Upstart founder Dave Girouard acknowledges the concern but says all investment vehicles take a hit during a downturn. And Vermut argues that consumer loans performed relatively well during the recession. Indeed, the portion of capital that banks lost to consumer loan defaults during the height of the recession was about 7 percent, according to Federal Reserve data. But those data didn't capture consumer loans made through peer lending sites.

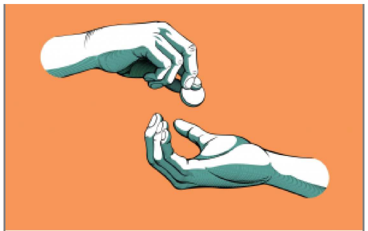
Use With Caution

For investors willing to try peer lending, experts agree on a few best practices. Most important, they should place only a fraction of their portfolios in P2P. Foss counsels her clients to keep that proportion at no more than 10 percent, and for most of her customers it's about 5 to 6 percent.

Investors also should diversify within the P2P space. Though it's possible to purchase whole loans, experts don't recommend it for retail investors. Instead, retail investors should buy loan fractions and split the money into at least a hundred loans ($5,000 distributed among 200 loans in $25 increments, for example.) Vermut also counsels investors to spread their money across a range of risk levels.

And buyers also can maximize their returns with good tax decisions. Lending Club and Prosper both allow retail clients to open an IRA account on their sites, and that's the better choice since earnings on a regular account are taxed at ordinary rates, Burton says.

For now, peer lending has something many other investment vehicles don't — enthusiastic fans. "Will these sites be around in 10 or 15 years?" Hartley asks. He hopes so — he spends only 10 to 15 minutes a week on Lending Club now but hopes to have more time once he retires to refine how he picks his borrowers.



Stop, Drop, Open Up Shop

The region's new Small Business Development Center sends a clear message: We want YOU for the Capital Region

Existing business expansion is the single biggest source of job creation in the United States, accounting for nearly two-thirds of new jobs nationally, according to the Bureau of Labor Statistics. That's why the Sacramento Metropolitan Chamber of Commerce is bolstering small businesses by kicking off a one-stop shop for regional employers looking to grow and expand.

NOV 17, 2014 *John Blomster*

Bank of Tomorrow

New sources for business loans

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Commercial Lending Forecast

Softening standards with a chance of loans

This year could provide some of the first expansions in bank lending since 2008. So is the market back up to speed? No. But banks are slowly and smartly increasing their appetites for commercial lending, and the Capital Region will see its share of transactions.

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Social Network

How crowdfunding connects strangers — and your business – to money

"Small Market, Big Heart" tells the story of the Sacramento Kings and their fans' fight to hold onto the team. But the 80-minute documentary — packed with NBA archive footage and interviews with Kings' executives, local politicians and sports entertainment personalities — isn't from the NBA offices or an established production company.

FEB 12, 2013 *Andrea Kennedy*

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