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Peer-to-Peer Lending As an Investor

By Howard Rothman

NEW YORK (MainStreet) — The "Aha!" moment came for Simon Cunningham in 2011, not long after he landed his first real jok looking for a way to start socking money away for retirement. Proficient in technology, literate in financial matters and committe responsibility, Cunningham was hooked the moment he came across an article about a new way to loan money called peer-to-p lending.

The article described a quickly emerging industry that used online platforms to match individual borrowers with private lenders. with less than stellar credit were able to obtain loans, usually at lower than standard rates. Those with money to invest were ab people in need and realize returns often higher than they could get elsewhere.

It was a win-win, says Cunningham, who began investing almost immediately through the two primary P2P lending sites and nc blog called LendingMemo.com that advocates for the practice and helps others navigate its intricacies.

In the two years since he became involved, P2P lending has exploded. The largest player, Lending Club, crossed $1 billion in is loans last November after five years in operation and hit $2 billion just eight months later. Shortly after, it attracted a $125 millio investment from Google. Its rival, Prosper, has issued only about one-third as much but reports volume growth of 10% monthly. just picked up new venture funding and boasts of a board that includes former U.S. Treasury Secretary Lawrence Summers.

What's this mean to investors? "I've been one for more than a year," says Kimberly Foss, founder of Empyrion Wealth Managei author of the new book Wealthy by Design (Greenleaf, 2013). "This is the epitome of the free market. I'm a big fan."

A boom in less than a decade

The concept took root in 2001 when a startup called Circle Lending was formed to facilitate loans between relatives and friends launched in 2005, pitching the idea that unconnected individuals — credit-challenged borrowers and investors with money to le could be brought together online. Lending Club followed two years later and now has 85% of the market. (A few other compani National Family Mortgage, which formalizes home mortgages between friends and family members, and Common Bond, which specializes in student loans, serve other niche sectors.)

Getting underway just as the Great Recession was gaining steam, however, the industry initially struggled as a number of early defaulted. This caught the eye of the U.S. Securities and Exchange Commission, which determined that the loan notes being fu were in fact securities and initiated oversight in 2009. Fine-tuned underwriting and tighter controls followed, as did increased liq the secondary market that developed for buying and selling these SEC-regulated notes. And while some risk definitely remains stability has steadily improved and continued to win over investors like Cunningham and Foss.

It has also attracted a growing stream of would-be borrowers, most of whom are consolidating debt from revolving credit lines a for $10,000-$25,000 to pay it off at lower rates over three to five years. Many observers believe it will only become more attract traditional financial institutions remain restrictive in their lending policies. Some predict it will have the same disruptive impact o process that MP3s had on music purchases.

There are, of course, some caveats. The primary caution stems from the fact that these loans are unsecured, meaning lenders investment when borrowers default — and default rates still range from about 3% to more than 10%. But proponents note both have improved their vetting processes significantly; Lending Club, for example, approves fewer than 10% of its applicants. And can soften potential blows by diversifying with a large number of loans and limit their risk by choosing borrowers carefully. "The put into it, the more you can get out of it," says Cunningham.

How the process works

The amount people invest in P2P lending ranges from as little as $25 to more than $1 million. At any given time they can choos among hundreds of active loan requests, for which they can examine each anonymous applicant's income, occupation, credit s other relevant information like past defaults. They can then purchase fractional parts of as many of these loans as desired for a investment of $25 in each.

Once a loan is fully funded, the portion that each lender has committed is deducted from his holding account, and he's assigned rated share of the interest during repayment. For example, $50 invested in a $15,000 loan would return 0.3% of the interest pai month until the loan is paid off; at that point, the lenders get their principal back minus a servicing fee.

Most experts suggest starting with at least $1,000 and spreading this out as much as possible to reduce variance in returns anc platform averages. For example, Cunningham says, a $1,000 investment could be used to purchase 40 $25 notes. But he and suggest you're more apt to see higher returns if you invest in at least 100 to 200 loans, and note some big lenders have thousa companies themselves claim no one with at least 800 has ever lost money, and industry statistics indicate a well-diversified por bring returns of 7 percent to 10%.

Choosing borrowers is the most time-intensive part of the process, but key. Both platforms offer many ways to filter applicants, income or credit score or how many times they've been late on bills. This allows lenders to mix high-quality loans that carry low rates and lower default potential with riskier loans featuring much higher interest rates and more default possibility. Third-party LendAcademy.com and NickelSteamroller.com offer an astounding array of tools and information to help in these decisions.

Along with diversifying, Foss says it's smart to also "ladder" your notes as you would with bonds or certificates of deposit. "That they'll come due in successive periods, like every six months or one year," she says.

Drawbacks aside, P2P remains appealing

The biggest drawback remains default, but the P2P companies have been aggressive in weeding out poor risks as well as initia collection procedures when necessary. Another new issue has developed with the increasing participation of institutional invest have been attracted by the improved stability and high returns but drawn criticism for siphoning off many of the best notes befo individual investors can bid on them.

Additionally, several states ban borrowers and lenders from participating. A few others require investors have a minimum net w annual income. The list is available here.

According to a growing number of converts, however, the bottom line is positive if the process is approached with knowledge a "You don't want to dip into your emergency money, because there is risk associated with this. But that's why returns are better are with less risky investments," says Foss, who proudly notes that her return was 9% last year and she has not had any notes

--Written by Howard Rothman for MainStreet