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The Secrets of P2P Borrowing

By Howard Rothman

NEW YORK (MainStreet) — Banks have grown more cautious about making loans to individuals for debt consolidation, small business development, home remodeling and other big-ticket expenses like car purchases and wedding bills. As a result, prospective borrowers who are less-than-model financial citizens often find themselves struggling to get such cash.

Piling on more credit card debt or hitting a money store should never be the preferred alternative, and thankfully these are no longer the only ways a credit-challenged borrower can go. A relatively new SEC-regulated online loan system known as Peer-to-Peer or P2P lending has recently gained a lot of steam and attention. And most experts agree it's become a legitimate option for many of those who, for one reason or another, are just not attractive loan customers for traditional banks.

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"It fills a really big need, which has grown since the recession as traditional financial institutions have been increasingly reluctant to make these kinds of loans," says Kimberly Foss, founder of Empyrion Wealth Management and author of the new book *Wealthy by Design* (Greenleaf, 2013). Foss says this is a huge development for borrowers so much so, that she's become a lender with one of the industry leaders.

Building on a concept pioneered about a dozen years ago to bring individual borrowers and lenders directly together online, it is now being used for business loans, mortgages, student loans and short-term notes for a variety of purposes. Those who want to borrow are matched with those who want to lend; P2P companies serve as underwriters and facilitate the loan and repayment. Even with the fees they take off the top, borrowers obtain loans at less than credit card rates while lenders regularly receive better returns than they could realize otherwise.

Relatively new process has grown fast

The first dedicated P2P to focus on the U.S. loan market was Prosper, which launched in 2005. Lending Club opened for business in 2007 and is now by far the larger of the two, which combined last year to issue nearly $900 million in loans for a wide array of purposes. Other firms concentrate on specific niches, such as National Family Mortgage, which facilitates home loans between family and friends, and Common Bond, which specializes in student loans.

All Prosper and Lending Club operations have been overseen by the Securities and Exchange Commission since 2009, and the industry gained even more credibility in recent months as Google invested $125 million in Lending Club and Prosper picked up additional venture funding.

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Most customers of the two P2P companies want to consolidate debt from revolving credit lines and are looking for $10,000-$25,000 at a lower rate. The majority of these loans are for three years, although many are for five and some can be for even longer. Rates depend on credit scores, but can be as low 10% to 12% versus 15% at a bank — if the borrower could get such a loan in the first place.

Both companies say new loan requests are snapped up by lenders within hours of being approved and posted on their sites. Simon Cunningham, editor of a comprehensive industry-monitoring site called LendingMemo.com, says loans can land in a borrower's bank account as soon as three days after they apply. "The rates are lower, it's all done online and it's quick," he says of the growing appeal.

The way P2P lending works

Borrowers initiate the quick and relatively simple process by completing an application on a P2P company's website.

According to NickelSteamroller.com, which provides online tools that help P2P lenders sort through funding requests, all Lending Club and Prosper applications are screened with proprietary underwriting software, and approvals can be granted for borrowers with FICO credit scores as low as 600, although both companies usually seek at least 660.

Once approved, interest rates are set according to the loan's perceived default risk and the application is posted anonymously on the company's website for lenders to bid on. When lenders agree to fund a loan, the borrower signs a promissory note, and the funds are deposited directly in his bank account. The P2P company also tacks on an origination fee of 1% to 5% and services the loan repayment via automatic monthly withdrawals.

As with traditional loans, says industry watcher Cunningham, late payments draw penalty fees and defaults can be passed along to credit-reporting agencies, sold to collection agencies or referred for court judgment.

Some critics complain the process could encourage irresponsible borrowing, but proponents say it is preferable to increasing even higher-rate debt. Others caution that P2P lending is not yet approved in all states, and restricted in some. (Lend Academy, the premier blog on the topic, offers a full state-by-state rundown here.)

But proponents downplay these downsides. Money manager Foss tells of a young man she knows who needed $5,000 to buy a used car but couldn't get a traditional loan even though the amount was small and he had a job. He was stymied because he was just out of college. He eventually got a P2P loan at 19%, she says, which was costly but allowed him to purchase the car.

Because he needed the money and couldn't get a loan from anywhere else, she adds, the rate didn't seem so bad at all.

--Written by Howard Rothman for MainStreet