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Interest soars in US peer-to-peer lending

By Matt Kennard and Shannon Bond in New York

AP

When Greg Dawson wanted to start his own photography business after graduating from college in 2003, he knew he needed money for expensive equipment and marketing materials to spread the word. He walked into his local Bank of America branch, asked for a small business loan – and was rejected.

"I was just starting out in my career, with college debt and no assets," he said. "They just laughed at me."

A Google search, however, led him to Prosper, the pioneer of the peer-to-peer lending sector. P2P lending connects borrowers with lenders, with P2P companies taking a percentage from both sides of the transaction.

In the wake of the financial crisis, bank lending remains depressed even as hints of confidence have begun to return, and people are again turning to P2P lenders to start small businesses.

Over the past year, Prosper has seen 367 per cent growth in loans funded, reaching a total of more than $271m at the end of September.

"We're basically a toll booth," said Joseph Toms, Prosper's chief investment officer. "We charge an origination fee to the borrower of 2 to 4 per cent, and the investor pays a 1 per cent toll."

"By letting investors invest in the loans they want, we lower mediation costs and lower interest rates to borrowers," said Renauld Laplanche, chief executive of Lending Club, another leading P2P company.

Lending Club has posted similarly strong expansion, Mr Laplanche said. "We increased our loan funds from $10m a month last year to $28m [in October]." Lending Club has been issuing loans since 2007 and is now administering more than $400m in funding.

Loan rates depend on the credit quality of the borrower but are generally lower than comparable bank loans, the companies say. Prosper said its rates range from 8 to 28 per cent.

Industry leaders attribute their success to improvements in technology, which have made grouping lenders easier, an improved regulatory climate and a demographic boost from ageing baby boomers looking to invest.

Greg Melara, a self-described “semi-retired” investor who lives in South Carolina, said he began lending through Prosper in 2010 after taking “a big hit” during the recession. “I decided to look for an alternative rather than equity,” he said, and has averaged about a 15 per cent annual return.

“I find that the number of defaults is small and reasonable compared to the rate of return you get,” he said. “My returns have actually slightly increased over the past year.”

Widespread frustration with the financial system, epitomised by the Occupy Wall Street movement, has also contributed to interest in P2P, executives say.

“On the borrower side there’s a tremendous amount of anger against banks,” said Mr Toms. “Banks dominate consumer lending. They sit on $2,400bn, but the way that that market operates, it has created a structural barrier preventing investors from investing in it.”

Mr Laplanche added: “There’s certainly an emotional appeal for some customers if they have to pay interest to people like them rather than the banks.”

But, ultimately, it is investors who will determine the future of the P2P market, says Greg McBride, senior financial analyst at Bankrate.com.

“The investors are looking for yield, looking to further diversify their portfolios, particularly given the economic uncertainty here and abroad,” he said. “If you’re bullish on economic prospects, you may look at the risk-adjusted return on peer-lending more favourably.”

He noted that the market shrank during the financial crisis because defaults increased and investors took flight. The further expansion of P2P lending may be hampered by the recent market turmoil surrounding the eurozone debt crisis, he warned.

P2P companies say they have improved their operations since the crisis, changing their model to squeeze out borrowers with lower credit scores.

Lending Club says it focuses on prime borrowers, rejecting 90 per cent of applications based on credit quality.

It is not only the US that is seeing an increase in interest in the sector. In July, a UK-based start-up company, Funding Circle, which aims to provide a platform for P2P lending, raised £2.5m. Another new UK start-up, Spacehive, hopes to crowd-source funding for public projects outside of traditional lenders.