The Beginner's Guide to Peer to Peer Lending

What is Peer to Peer Lending?

Peer to Peer Lending (P2P) is an alternative form of financing from traditional bank intermediated lending. Potential borrowers and lenders are brought together on a website, in much the same way that Amazon brings together buyers and sellers of general merchandise. What is unique about P2P lending is that borrowers and lenders are both likely to be individuals, instead of a traditional business to consumer loan.

P2P lending has gained prominence in recent months as Lending Club in the US is preparing for an IPO. In Australia, Society One has attracted the country's second largest bank Westpac, as well as business moguls James Packer and Lachlan Murdoch as equity investors. Lending Club and Society One both specialise in personal loans, but the Australia website Balmain Private specialises in commercial property lending on a P2P basis.

How Does It Work?

Potential borrowers submit an application form to the website platform, very much the same as any other loan application. The platform's systems and staff then verify the critical information (borrower identity, credit history & employment), assess the risk of the loan, set the interest rate and put the application up on the website. Potential lenders review the available applications and select the borrowers they want to fund, in part or full. Once the loan amount is fully funded the website then passes the money from the lender/s to the borrower, minus an upfront fee.

Once the loan is made, the platform is responsible for the servicing of the loan, which encompasses processing repayments and chasing up missed payments. If the borrower defaults the platform handles the debt collection aspects but the lender/s bear any loss.

Why Does It Exist?

P2P lending is growing rapidly as it fills a number of gaps in credit markets. Firstly, P2P lending is primarily unsecured personal loans, which banks struggle to make at a competitive interest rate. These loans are typically for smaller amounts with a relatively high work load to establish and maintain. Banks generally prefer to offer potential borrowers credit cards as these deliver banks higher interest rates, a perpetual loan period and ongoing transaction revenue. As with many online orientated businesses, P2P lending has a lower cost of operation than bricks and mortar retail and thus it can offer lower interest rates than banks, which attracts potential borrowers.

Secondly, P2P lending currently offers high prospective returns to investors. In a world of ultra-low interest rates, gross returns of 6-25% are very attractive relative to bank deposit rates. For reasons explained later, these rates are likely to fall in the future but whilst competition is minimal and funding is somewhat restricted the higher expected rates of return will draw in potential lenders.

How New Is P2P Lending?

P2P lending in its current form dates back to 2005, but its roots can be seen right across capital markets. Non-bank lenders have brought together borrowers and capital providers for thousands of years. Stock exchanges have been fragmenting the ownership of companies into marketable parcels for hundreds of years. Corporate bonds have fragmented the debt of corporations for decades. Amazon has used the internet to bring together buyers and sellers of goods, with Amazon providing the platform for the products and the support necessary to facilitate the sales. In a sense P2P lending isn't new at all, it just uses modern technology to change the way some loans are made.

Is P2P Lending Risky?

Like all lending activities, P2P has the potential to range from very good to very bad. Subprime lending in the US showed that if done badly, supposedly 'safe as houses' residential lending can have default rates that exceed 50%. In contrast, many lenders to prime quality borrowers averaged default rates less than 1% per annum.

The first key test for P2P lending will come during the next economic downturn. Most P2P borrowers are living paycheque to paycheque, (if they had savings it is unlikely they would need a loan) and don't have material assets to sell. As unemployment rises, it is likely that default rates on P2P loans will also increase. There is limited data available predating the financial crisis but what is available for Lending Club shows that negative returns were recorded in 2007 and 2008.

P2P platforms have a range of risk grades and a potential lender should expect that loans with a lower quality risk rating are more likely to default, hence the higher interest rate. Conversely higher quality risk ratings indicate a lower risk of default and lower interest rates. Average annual default rates can range from 1-15%, showing just how diverse the risk levels can be between the best and worst borrower groups. Potential lenders should take care not to fall into the trap of choosing loans with high interest rates and hoping that they will (through either luck or skill) receive full repayment on all their loans. In the last few years net returns have averaged 5-10%, with the highest risk borrowers having slightly higher net returns.

Lenders should be careful to watch that there isn't slippage in loan standards over time. As the market develops and interest rates on P2P loans fall, there will be the temptation for ratings creep. Websites and lenders may not be comfortable seeing the returns on the best risk grades slip from 8% to 6%, with the risk for lenders being that the old 8% yielding loans had met more stringent risk criteria than newer 8% loans. Ratings creep could also occur as the pool of potential higher quality borrowers dwindles, pushing websites to offer loans to marginal borrowers as all of the higher quality borrowers have already obtained the loans they want. P2P lending is not yet approaching overcapacity, but as subprime lending and junk bonds have proven, what starts out as well rewarded risk taking can turn into a speculative bubble when supply of capital exceeds demand.

How Will P2P Lending Evolve?

P2P lending suits particular niches within the credit markets, but it doesn't offer the prospect of completely removing banks from the picture. Loans that are relatively small, that don't involve overdraft or revolving facilities, or that are considered higher risk are most suited to a P2P platform. Shorter term (three years or less) unsecured loans to individuals and businesses are therefore the ideal targets. Secured business lending that goes just beyond the credit criteria that banks will allow is also fertile ground. Debtor finance, which uses unpaid invoices as security, is another potential area for P2P lending.

As P2P platforms grow it is highly likely that individuals will be largely replaced by institutions as the lenders, as P2P platforms turn to cheaper institutional capital for their funding. This development would mirror the way that non-bank lenders in residential mortgages, commercial mortgages and auto loans obtain their funding through bank warehouses and securitisation markets. It is also likely that banks and finance companies will ultimately set up competitor brands or buy out P2P platforms completely. What banks currently lack is the technology and entrepreneurship to start competing websites, but as the platforms are proven to be profitable they will attract funding and takeover offers from banks.

The cost of funding advantage that banks and securitisation markets enjoy over individuals as lenders will also lead to lower interest rates for borrowers. It would not be surprising if the lowest risk borrowers obtained loans at below 5% in the US and 6% in Australia in the medium term. Lower rates will encourage more potential borrowers to use the platforms and repay their high interest rate bank and finance company loans. With debt refinancing being the purpose for more than 50% of P2P loans the profitability of credit card lending for banks and finance companies could decline substantially over time.

How Should Potential Lenders Analyse the Risk?

In analysing the risk of any credit investment, the 5 C's of credit are a good starting point. These are:

Character: assessing willingness to pay
Cashflow: assessing ability to repay
Capital: assessing the equity contribution of the borrower
Collateral: minimising the loss if the borrower defaults
Covenants: restrictions to stop the risk level increasing

Where the typically unsecured personal loans of P2P lending differ from most other forms of loans is that capital, collateral and covenants are largely non-existent. Borrowers haven't saved much (no capital) and own few or no material assets that could be sold if they fail to repay their loan (no collateral). Being personal loans there aren't going to be any material covenants. This leaves character and cashflow as the main items to assess the risk.

Character will be best shown by the borrower's credit history. Potential borrowers with a history of repaying their loans, credit cards and utilities on time and in full are the lowest risk. Borrowers with no history, or with a history of missing their obligations are higher risk. Cashflow assessment is a comparison of the borrower's income relative to their expenses. If the borrower has good employment history and an income that easily covers their rent and other general expenses as well as debt repayments then the risk will be low. If the borrower has irregular income and/or a scattered work history then the probability of default will be much higher. If the borrower doesn't have a meaningful excess of expected income after meeting expected expenses then the probability of default will also be elevated.

Conclusion

P2P lending is an interesting and potentially profitable addition to the credit investment universe. The use of new technology allows credit to be made available to more potential borrowers at lower interest rates. The place of individuals as the main lenders is likely to fade over time, with their replacements being banks and securitisation markets who can offer a lower cost of capital. As with all new markets, new entrants can be expected to spring up, with banks and finance companies likely to start competitor brands or buyout existing platforms. When analysing potential loans, lenders should focus on the character and cashflow of the potential borrowers and remember that the higher interest rates paid by higher risk borrowers doesn't automatically translate to higher net returns.

Written by Jonathan Rochford for Narrow Road Capital on October 9, 2014. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure

This article has been prepared for educational purposes and is in no way meant to be a substitute for professional and tailored financial advice. It contains information derived and sourced from a broad list of third parties, and has been prepared on the basis that this third party information is accurate. This article expresses the views of the author at a point in time, and such views may change in the future with no obligation on Narrow Road Capital or the author to publicly update these views. Narrow Road Capital advises on and invests in a wide range of securities, including securities linked to the performance of various companies and financial institutions.