Online P2P lending nibbles at banks' loan business

New online lending platforms match people who need a small loan with those who have extra cash to lend. Person-to-person (P2P) lending sites aim to save costs by brokering loans without a retail bank directly between individual savers and lenders. P2P loans are unsecured, and although the lending sites typically do not guarantee repayment they do use a number of instruments to assess and limit credit risk, such as providing information on the borrowers, diversification of funds across many loans, and peer pressure to shame delinquent debtors. chart 1

Online P2P lending platforms sprawl. In 2005, Zopa in the UK was the first site. In the meantime, P2P lending sites have also popped up in the US and continental Europe. The business models differ, however: Zopa, for instance, does not showcase individual borrowers and matches savers with borrowers itself. The Californian outlet Prosper allows borrowers to explain publicly who they are and why they need the money. They may also organise in groups whose reputation (good, if all members pay on time) will affect the creditworthiness. Prospective lenders bid directly on individual loan requests. chart 2

Not all loans are serviced according to plan. Zopa says that its lenders experienced less than 0.2% bad debt, but Zopa does not lend to riskier borrowers. At Prosper, about 5% of loans (by volume) older than 6 months have been defaulted on, and there are payment arrears on nearly 10% of loans. chart 3

Lenders ignore high-risk borrowers. Lenders bear the entire credit risk (except at Germany’s Smava). Little wonder that they prefer low-risk borrowers. At Prosper, around 45% of loan requests by borrowers with an AA credit grade are being funded, but only 2.5% of those by high-risk borrowers. chart 4

Margins on low-risk loans are already razor-thin. Low-risk borrowers also qualify for cheap, standardised retail loans from traditional banks – this pitches P2P platforms into cut-throat competition. Examples from Germany illustrate how little room there is between the cheapest loan offer and the most generous – and in contrast to P2P lending, risk free – savings account. Thus it seems unlikely that P2P lending can ever be more than a niche product in this segment. chart 5

High-risk borrowers and non-standard loans are the untapped potential for P2P lending. Prosper has brokered loans worth around USD 69 m so far but had unfunded loan requests of more than USD 467 m. Unfunded high-risk loans make up USD 227 m (49%) of that pool. Albeit widely neglected so far, competition from traditional banks might push P2P sites increasingly towards these loans. This does not necessarily have to be a bad thing because here they can leverage their unique community power. chart 6

Peer pressure improves payment discipline of high-risk borrowers. Some P2P platforms use the power of their communities to screen and assess borrowers and to pressure for repayment. Moreover, some fickle debtors may feel more obliged to repay “real people” rather than an impersonal bank. Evidence from Prosper illustrates the difference peer-review and peer-pressure can make: default rates are typically much lower if borrowers have joined (and were accepted by) a group of borrowers – this holds in particular for high-risk and non-rated borrowers. chart 7
New online lending platforms match people who need a small loan with those who have extra cash to lend. Person-to-person (P2P) lending sites aim to save costs by brokering loans without a retail bank directly between individual savers and lenders. P2P loans are unsecured, and although the lending sites typically do not guarantee repayment they do use a number of instruments to assess and limit credit risk, such as providing information on the borrowers, diversification of funds across many loans, and peer pressure to shame delinquent debtors.

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Zopa says that its lenders experienced less than 0.2% bad debt, but Zopa does not lend to riskier borrowers. Not all loans are serviced according to plan. At Prosper, about 5% of loans (by volume) older than 6 months have been defaulted on, and there are payment arrears on nearly 10% of loans. Moreover, more than 21% of low-risk loans (with a credit grade of A or better) have been paid back earlier than agreed. This exposes lenders to re-investment risk because they have to find new and similarly profitable investments.

Lenders ignore high-risk borrowers. As lenders bear the entire credit risk (except at Germany’s Smava), they prefer low-risk borrowers. At Prosper, around 45% of loan requests by borrowers with an AA credit grade are being funded, but only 2.5% of those by high-risk borrowers. Lenders yield higher interest on riskier loans, but apparently, this extra yield does not suffice to compensate for the extra risk.

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