Think Outside the Bank:

Peer-to-Peer Lending

by Douglas E. French

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GUIDE 1.0

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The banking business has been in complete upheaval since 2008. It is often the case that recessions break some aspect of the lending and borrowing business, but the real estate collapse did more than break the banks - it utterly wrecked their essential functioning.

The bailouts that flowed in the years following were not designed to refurbish the economy, but rather to fill up the coffers of the largest banks instead of letting them face the prospect of economic extinction. The rescues did what they were supposed to do but left calamity in their wake.

The business of banking has now moved on to reside -- to a large extent -- outside the conventional commercial banking model.

This is where the market steps in with wonderful innovations. Among the most impressive is a model of borrowing and lending much closer to

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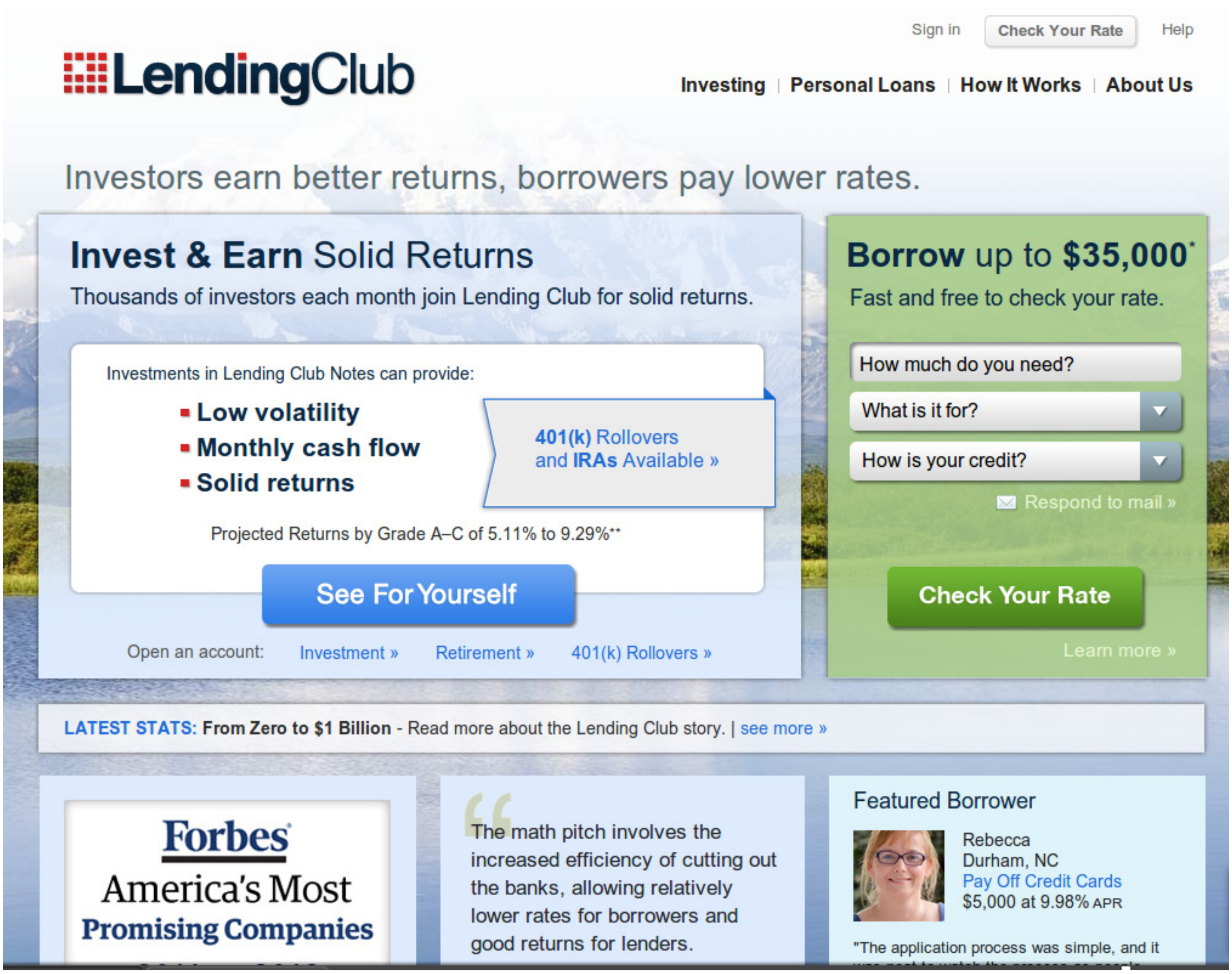
what we might see in a real market economy. It is called peer-to-peer, or P2P, and it means that those who want to borrow work directly with those who want to lend, bypassing the intermediary role that banks have traditionally played.

The market is providing solutions that permit all of us to participate in a system that is effectively freer than the banking system of the past.



For this reason, the peer-to-peer lending business is on the verge of disrupting the banking business in a big way. Through companies like Lending Club, customers can borrow directly from savers who wish to lend. In between, there is no army of bank vice presidents or their country club memberships to pay for.

The peer-to-peer model can work for lenders looking to earn a decent return on their money as well. On the other hand, banks pay little or nothing for interest in this brave, new, Federal Reserve zero-interest-rate-policy world.

It's time to think outside the bank.

The Growth of P2P Lending

The peer-to-peer lending business is growing. While it didn't even exist prior to 2006, P2P now essentially replaces the bank and its administration with technology. For lenders, it's much more straightforward. You are giving up the use of your money for a certain period of time (typically three or five years) as you pass the title of that money to the borrower.

While banks are currently paying depositors (lenders) virtually nothing, Lending Club, the largest P2P lender in the U.S., is paying 5.46% for "A" loans (the least risky), 8.77% for "B" loans, 10.25% for "C" graded loans, "D" rated loans are yielding 11.59%, "E" loans 12.77%, "F" loans 12.96%, and "G" loans 11.69%. These rankings are based primarily on the applicants' credit scores. Borrowers will be paying interest rates from 6.78% to 27.99%.

Neal Frankle investigated Lending Club for the wealthpilgram.com website. He found it to be a professional outfit that is conservative and growing, and wrote:

> ***"...borrowers have to have at least a 660 credit score or higher. That weeds out about 50% of all the applicants. Next, potential borrowers can't have any late payments on their credit report for the last year. That dismisses another 25% of the applicants. In all, Rob told me that only 10% of the people who apply for a loan at Lending Club actually get funded."***

This is not some sort of shadowy internet scam either. Lending Club announced this year that Google has invested in its business to the tune of $125 million. Lending Club's board of directors includes Kleiner Perkins' Mary Meeker, ex-chairman and CEO of Morgan Stanley John Mack, and former U.S. Treasury Secretary Larry Summers.

$2.6 billion in loans have been made to date

Not only does Lending Club have well connected and deep pockets behind it, but $2.6 billion in loans have been made to date. Each month, loan volume grows with over $203 million funded in September 2013. The average loan size in September was $13,800 with an average interest rate of 16%. The average FICO (credit) score of borrowers was 699.

Jamie Dimon isn't quaking in his boots, but maybe he should be. You can even roll your 401(k) into a lending account at Lending Club. With an account as small as $2,500 you can own pieces of 100 loans, effectively diversifying your risk.

There's an account type to fit your needs.

Individual account

An account just for you. Open an account »

Joint account

An account for two or more individuals holding joint interests.
For more information email Investor Services »

Trust account

An account in the name of a trust, with a trustee controlling the assets on behalf of a specified beneficiary.
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Corporate account

An account in the name of an entity that can be controlled by any designated representative.
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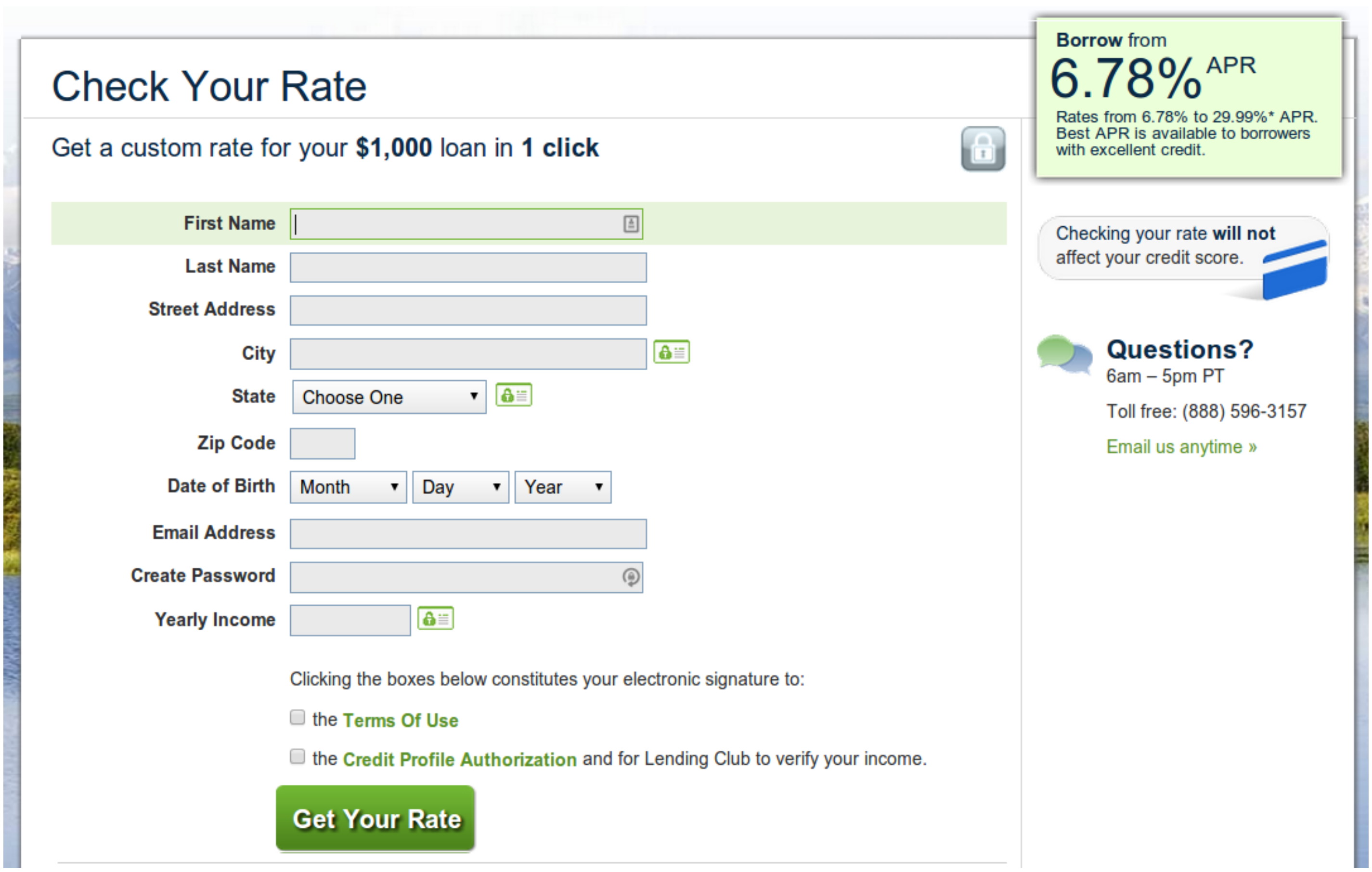
Custodial/minors

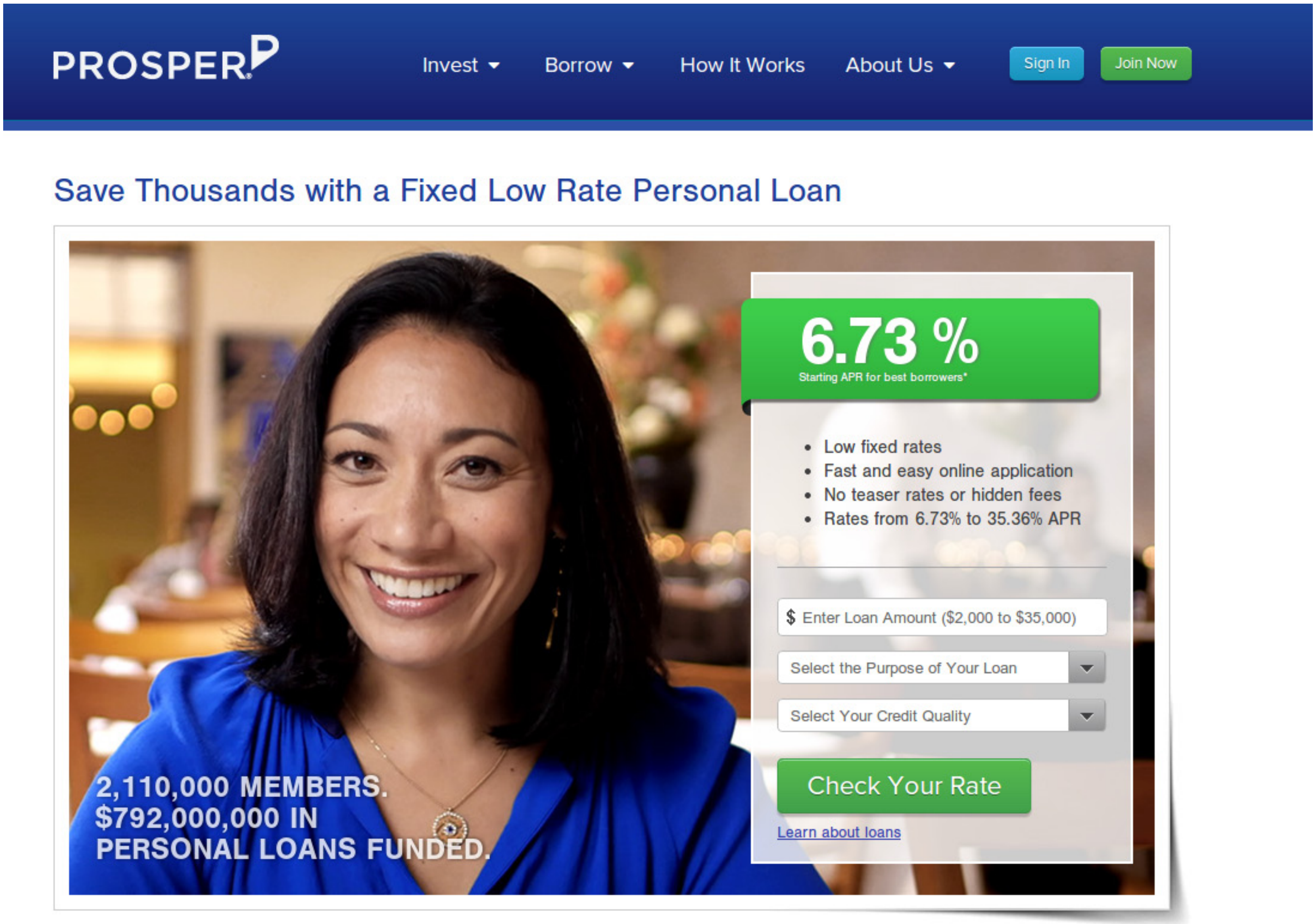
Includes Uniform Transfers to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA) accounts.
For more information email Investor Services »

There are 5 types of accounts that you can get at Lending Club. Not only is Lending Club a great place to invest but you can also get a loan. You can put in a requested amount and then fill out a form and they will give you a custom rate. This is not the end of the vetting process but it is a good start if you are interested in getting a P2P loan.



Alternative to Lending Club

Prosper is another peer-to-peer lender that has funded $647 million in personal loans. The company has a new management team that is charged with energizing the company, increasing loan volume, and improving loan collections.



On Prosper, borrowers make loan requests between $2,000 and $35,000. Individual lenders can invest as little as $25 in each loan listing they select. Investors consider applicants' credit scores, ratings, and histories, along with personal loan descriptions, endorsements from friends, and community affiliations.

Lending Club and Prosper have been in business for years. But the business has just begun to take off as investors look for higher yield, and younger, computer savvy customers look to borrow online rather than travel to a bank branch.

Peter Renton, who writes for the Lend Academy blog, says that P2P activity has exploded this year. Lending Club had 2,000 loans available in January; Prosper had 1,000 available in

November. That is no longer the case today, however. Now, according to Renton, both companies have between 50 and 200 loans typically available. He wrote that:

> ***"I think we will look back at 2013 and see this was the beginning of the mainstream acceptance of P2P lending as an investment. It certainly has caught the attention of large institutional investors. Not only that, but I have been told that new retail investors are also flocking to P2P lending in record numbers."***

...younger, computer savvy customers look to borrow online rather than travel to a bank branch.

So how can investors earn high returns while borrowers pay competitive rates? "It is a more direct funding process between the investors and the borrowers," Renaud Laplanche, the CEO of Lending Club, says. "There's no branch network. Everything happens online and it is really powered by technology and the Internet. And we use technology to lower cost."

Approaches to Personal Lending

Every state is different as to whether you can buy new notes or must buy notes in the secondary market (in a few states, trading in these loans is prohibited). For instance, in Alabama, I must buy notes in the secondary market through a service called foliofn, which I'm directed to from the Lending Club site. I currently own 11 notes yielding an average rate of over 20%. Needless to say, my notes tend to be on the riskier end of the scale. At the moment I write this, I have one note 31-120 days past due (the rest are current). With the click of a button, Lending Club calculates what effect charging off that note would have on my portfolio. In this particular case, the yield on my investment would drop from 20.56% to 7.7%. Ouch.

Virtually all of the loans I've purchased are debt consolidation loans. In fact, 81% of Lending Club loans are for debt or credit card consolidation. I've had two notes pay off already in just a few months, and payment for all the notes are current. The only notes I'll consider buying are current and have never been late. Plus, I want the borrower's credit score to be trending up.

A note of caution, if you live in a state that requires you to buy notes in the secondary market, be careful not to pay too large a premium for the notes. If you do, you will own a note that, while performing, does not compensate you for the risk you take.

Dennis Miller, editor of Miller's Money Forever newsletter, told his readers recently that he and his wife had $10,000 in Lending Club spread amongst 400 notes. Where he lives, he is able to invest in new note issues and insists that borrowers have at least a 700 credit score. Also, he will only lend for three years rather than five. The Millers took a month to find 400 notes that met their criteria. Their portfolio is yielding 10.03% -- about half what mine yields, but likely with half the risk. Most of his notes are three year "A" and "B" notes, most of mine are 5 year notes rated "C", "D", and "E".

While we take different lending approaches, Miller and I feel the same about personal lending. "Jo (Miller's wife) and I believe most people are honest and borrow money with the intention of paying it back." If you don't feel this way, P2P lending is not somewhere you should invest. The fact is, most people pay because they want to (or have to) keep borrowing.

However, some people don't pay. The recent default rate for "A" loans at Lending Club was 1.3%, "B" defaults were 2.1%, 2.7% for "C" loans, for "D" 4.5%, for "E" 5.2%, for "F" 6.4% and for "G" 9.8%.

Yes, there is risk in lending. But at least with peer-to-peer lending you get paid for the risk.

Frequently Asked Questions

How long did it take to set up an account?

It only took me minutes to set up my account. Lending Club took a direct deposit from my bank, which took a day, and I was then shopping for notes to buy.

How quickly will I start making returns on my investment?

As soon as your money is lent you are making returns. However, your borrowers must make payments and ultimately pay back the principle lent. It will take some time to determine your rate of return.

What happens if a loan fails?

The company will put it out for collection, but in most cases your money is lost.

Is there a penalty for paying early?

No.

Does the interest rate change if they miss a payment?

No.

What kind of information are you given about the debtors?

In my case, being in a state where I must buy notes in the secondary market, very little. If you live in a state that allows you to originate notes, you receive a complete credit package with income information, credit scores, etc.

What do debtors see about me?

Nothing.

What is a good price for a secondary market note?

Try to pay as close to par as possible. There may be a time that performing notes trade at a discount and that would be wonderful. For the moment, do not pay so high a premium that the return doesn't match the risk. Say, the premium makes the yield on a note 8% for a 'D' rated debt consolidation loan. The rate sounds great, but not when matched with that kind of risk.

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Douglas E. French is a Director of the Ludwig von Mises Institute of Canada and a banking editor at Liberty.me. Additionally, he writes for Casey Research and is the author of three books: Early Speculative Bubbles and Increases in the Supply of Money, The Failure of Common Knowledge, and Walk Away: The Rise and Fall of the Home-Owenrship Myth. French was a masters student of Murray Rothbard's at the University of Nevada, Las Vegas.