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The Rise of Peer-to-Peer Lending

Banking is short on innovation. Given the early and prolific use of technology by every financial institution this may seem an ill-informed statement. Retail and institutional banks have been early adopters of technology for back office functions (e.g.: account management, funds transfer, trading and trade processing) as well as leaders in pushing technology interfaces to the customer (e.g.: ATMs, online account access, online trading). But for all this innovation the basic banking products have not changed much since the Italians were the dominant merchants and financiers in the 15th century. Mathematics has improved how we calculate risk on many products, and therefore what we can collateralize and securitize, but in essence individuals invest in, and borrow from institutions that in turn invest in, and borrow from larger institutions as they have done for centuries. This dynamic may be about to change.

What's New?

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We are starting to see the emergence of a new individual to individual asset class. It works like this: borrowers sign on to an electronic exchange where their profile (credit score plus a few other questions) establishes their investment rating within which they can set at what rate they wish to borrow. Lenders sign on to the same exchange where they can set what rate of return they are looking for. So far, this sounds like a straightforward exchange that pre-dates even 16th century banking practices.

Here's the clever bit. Rather than a simple (and potentially high risk) one-to-one loan, a lender's capital is split into small increments that get parceled out among many borrowers of a similar investment rating. So, if an investor has $1,000 to lend, it may get divided into fifty $20 loans and similarly a borrower receives her $1,000 from fifty different investors. This has the effect of simultaneously reducing the risk of individual-to-individual loans and creating a new asset class for investors that eventually may even be securitized and potentially traded in a secondary market.

The exchange, in this case, has several roles. First, the exchange creates the meeting place for a sufficient number of investors and investees to gather. Second, the exchange establishes the legitimacy and investment rating of borrowers in a consistent and transparent manner. Third, the exchange manages the process of splitting and distributing each investor's funds in a cost effective and non-onerous fashion. The exchange may ultimately provide other services such as insurance to investors or collection services.

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The Driving Forces

It would be easy to assume that technology is the main driver of this innovation. Without our ubiquitous networks and web access, it would be difficult for such an exchange to create enough liquidity and to facilitate the contractual agreements between parties.

As with most innovations, more than one trend drives adoption. Consumers have come to a point where such an idea although new, may be shocking only in the fact that it has taken so long to emerge.

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Do-it-yourselfers — As consumers we are becoming more accustomed to, and more satisfied in, taking control and doing things for ourselves. The popularity of home improvement stores and airline online check-in are two disparate examples of the wide range of areas where we prefer to be in charge. In some sense, the concept being described here for investors is much like being one's own bank, and this will have obvious appeal among many do-it-yourselfers.

Customizers — Never satisfied with the way things are, we like our products and services to be "our way" whether it's a burger with no pickles and extra onions from the drive though or our PC ordered online. Part of the appeal of this product is the ability for each person to establish the terms most suited to his own circumstances.

Online financiers — Music downloading may get all the attention, but one of the most regular online activities after e-mail is online finance. We are very comfortable with checking balances and researching financial products online and fast becoming at ease with paying bills, trading, and investing.

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Winners and winners — The traditional models of "I win if you lose" and vice versa no longer apply to every business. Open source software is one example of where everyone benefits from contributing to, and using a set of products, with no single institution necessarily benefiting at the expense of others. An example of the appeal to find ways to invest not at the expense of others is the growing socially responsible investment fund market. To date more than 600 publicly available funds with over $127Bn under management classify themselves as socially responsible.

Big investors — There are a number of long term and short term options for investors. Interestingly, there aren't as many options for regular income production. Given the declining birth rate of many industrial nations and thus increasing uncertainty around future social insurance payouts, more and more boomers will be looking for opportunities not only for capital appreciation, but also income generating assets.

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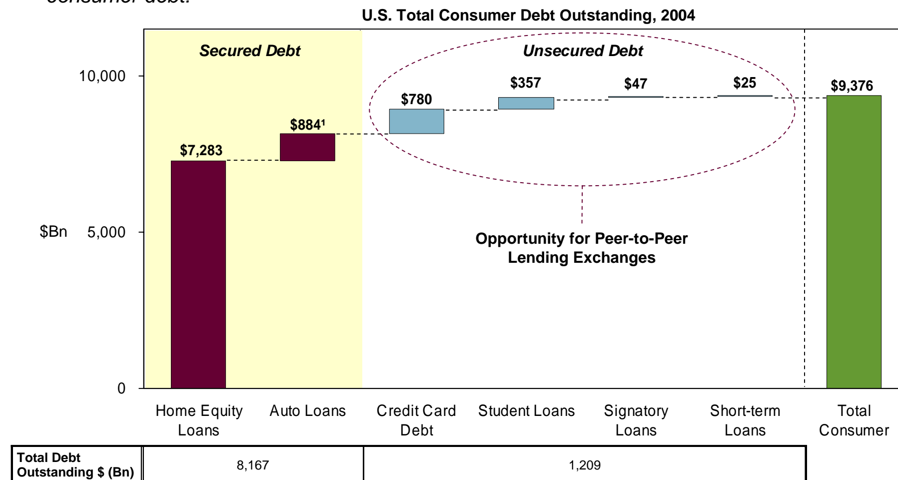
Bigger borrowers — Unsecured borrowing is big business. In 2004, unsecured credit in the U.S. became a $1.3 trillion market (excluding auto loans) with more than a 6% annualized growth rate. While credit cards are a primary source of borrowing, consumers are becoming increasingly unhappy with existing terms, and few other options are widely available. While the U.S. leads the consumer debt race, the trend is global with the U.K. and many European countries not far behind. Unsecured borrowing in the U.K., for example, is estimated at more than £200Bn annually including credit cards.

Market Map of U.S. Consumer Finance Industry

Unsecured debt represents approximately 13% of the total $9 trillion of outstanding U.S. consumer debt:



¹ Represent an auto loans special case as not all are secured or provided by car finance companies

Note: Credit cards include retail financing (such as Sears card) but does not include automotive or recreational vehicle loans included under "auto loans / other asset loans"

Source: Mortgage Bankers Association, Federal Reserve G19, FDIC, Stephens, Automotive News, Monitor Analysis

Just in Time

The introduction of this new kind of investment opportunity arrives at an interesting moment in investment history. The three traditional forms of assets — bonds, real estate, and stocks — all have uncertain upside for a variety of reasons. Rising interest rates will continue to push bond prices and their yields lower. Similarly, rising interest rates are likely to curb the real estate market both for private homes and REITs. Normally, a growing economy would bode well for the stock market. With the country at war and the trade deficit growing the equities market has been moving sideways with the only real bright spot being increasing dividends in the S&P 500.

Unsecured borrowing by consumers, however, is likely to continue to increase especially as the economy recovers. In addition, rising rates are likely to push consumers to seek lower rate alternatives through such products a peer-to-peer exchange. Actual default rates remain to be seen, but the combination of a relatively stable (i.e., market neutral) asset that pays high yields relative to both dividends and bonds is going to be appealing to a number of individuals. For example, it's conceivable that the 45–55 year old sets of individuals who are

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transitioning to a 60/40 split of equities/bonds as they near retirement will consider a 55/35/10 split of equities/bonds/peer lending as they gain familiarity with the new investment and seek more regular income. If default rates remain manageable and as the lending exchange become more familiar, this could rise, especially as the same 45–55 year old set moves into the 55–65 retirement band.

Ups and Downs

The benefits to participants in this system are relatively straightforward. Investors have access to a new asset class for their portfolio that may have higher rates of return than institutional accounts, and that at the same time provide a regular monthly income stream. Investees have the opportunity to borrow at more customized rates, and with greater predictability than they can from traditional sources such as credit cards. Smarter, credit worthy consumers may use this option as bridge loans to help them smooth their cash flow.

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Of course nothing is without risk. It still remains to be seen whether such an exchange can draw enough consumers to make it worthwhile to investors and borrowers. Similarly, the actual default rates for consumers will depend on the profiles of who signs up, as well as the efficacy of fraud protection and credit collection.

Net-Net

In short, the banking industry may be about to see the creation of its first real innovative consumer product in years. In the near term we may see both new and established players rush to create such exchanges. Ultimately though, network effects dictate that it is better to have a single consolidated network than many small competing ones. While established players may have an operational and brand advantage, the "open source" flavor to this model makes the entry of a new player to establish the market likely. We look forward to seeing who emerges as the market leader and increasing our options as investors.

Colin Gounden is a partner of Monitor Venture Services, a member of Monitor Group that accelerates the growth of new businesses through advisory and business development support. A sister entity, Monitor Venture Partners, supports entrepreneurs by providing early stage funding. Monitor Group is a family of professional service and investment firms with 1,000 professionals in 29 offices worldwide and over $1.5Bn under management. Mr. Gounden can be reached at: colin_gounden@monitor.com.

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