Welcome to the 'Bank of You'

How to Use the Revolution in Personal Lending to Earn Market-Beating Yields

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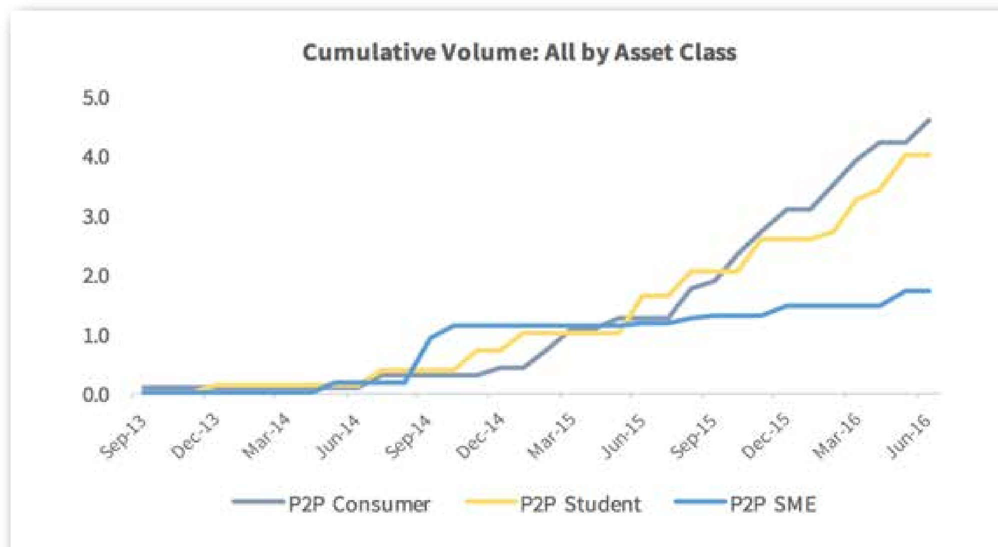
The New Asset Class That Helps Investors Beat the Market

Peer-to-peer lending (P2P), also known as Marketplace lending (MPL), is a new method of debt financing that enables individuals to borrow and lend money without the use of a financial institution. Online peer-to-peer lending platforms connect borrowers to investors, adding ease and speed to the process. P2P lending has grown rapidly in recent years and is a new source of fixed income for investors.

The first service to launch in the US was Prosper in 2006, followed by Lending Club in 2007. These platforms act as intermediaries between borrowers and investors, thus bypassing the traditional gatekeepers of credit… the banks. P2P lending is handled online only, which means these businesses operate at lower costs than traditional lending channels.

All P2P loans are unsecured, with consumer credit and student loans comprising the bulk of the industry (the chart below shows volumes in billions of US dollars).



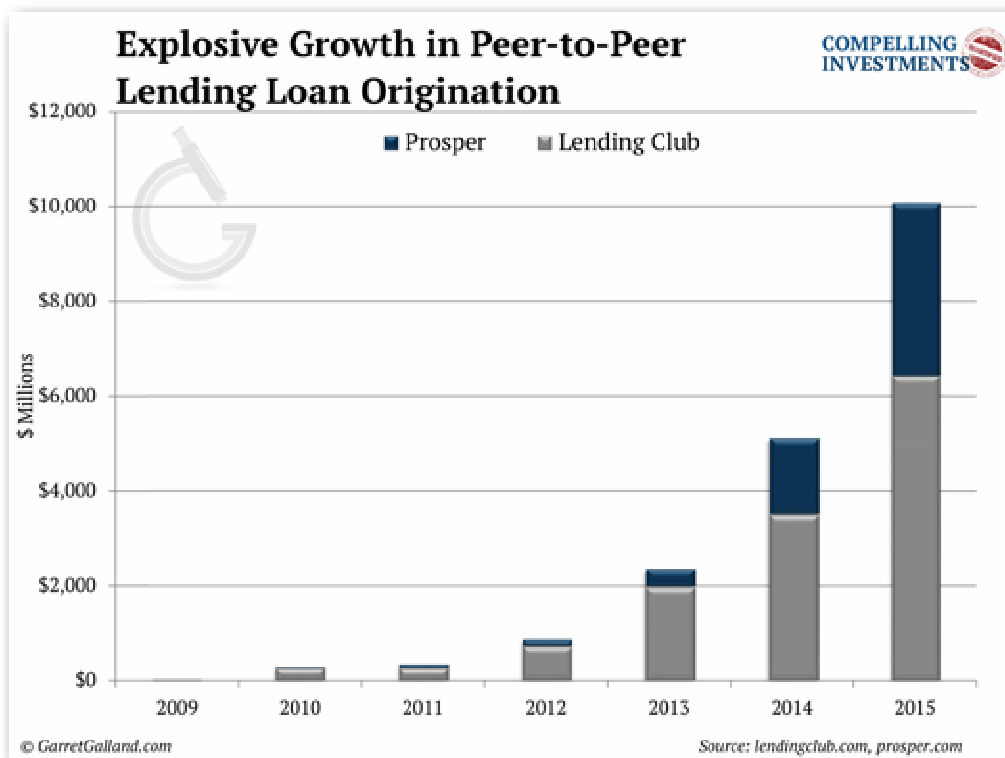
Although Lending Club and Prosper are the industry's two biggest platforms, many niche operators such as Upstart and Funding Circle have successfully entered the space in recent years.

Growth of the Peer-to-Peer Lending Industry

The 2008 financial crisis led to increased regulation on financial institutions to prevent a repeat disaster. As a result, they had to rein in lending. The new regulations caused credit channels to dry up, leaving borrowers stuck.

P2P lending created an alternative credit path for individuals and small businesses. 2.2 million users have both borrowed and invested on US-based platforms since 2006, and the number of users has increased by 59% since 2014.

Loan issuance in the industry has exploded since 2009.



Technology has helped platforms build the competing systems. Big data has enabled lenders to assess credit risk based on more than just FICO scores, which has sped up the process. Borrowers can now receive credit within five business days of application. Compare this to the average 33 hours spent in correspondence with banks just to submit an application, never mind actually getting the funds.

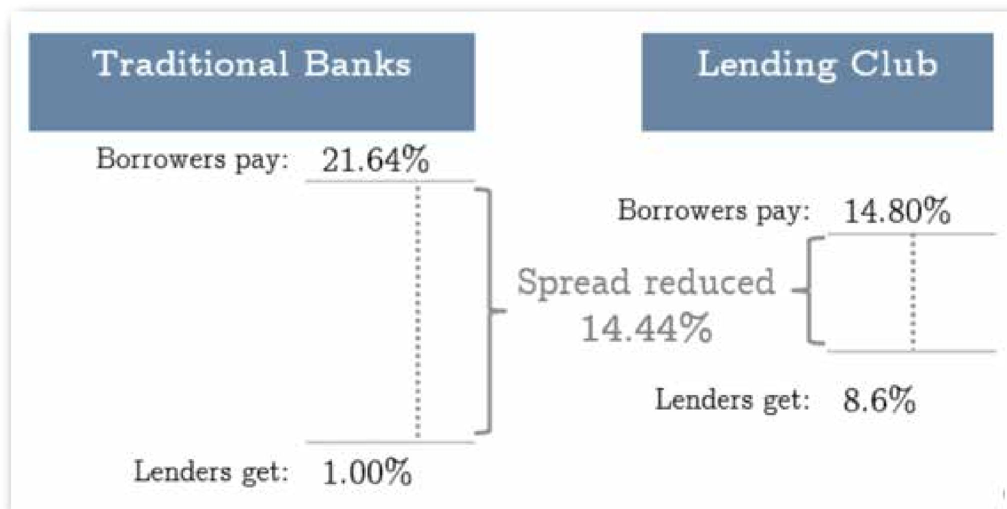
P2P lending has also aided investors in search of yield and portfolio diversification. Interest rates have been at all-time lows since 2008, with many historically "safe" investments like government bonds carrying negative yields. And two stock market corrections greater than 50% in the last 16 years have left investors cautious.

So, how can P2P lending offer borrowers and investors value?

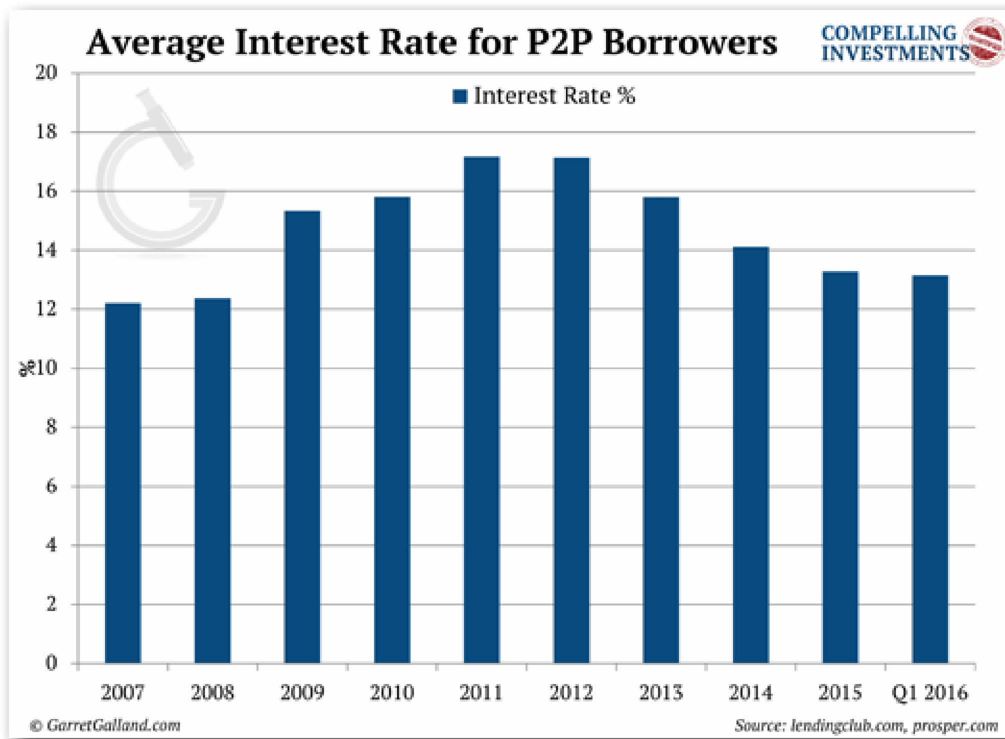
Peer-to-Peer Lending Value for Borrowers

Around 70% of consumer loans are used to refinance existing debt. According to a Morgan Stanley report published in 2015, the effective annual interest rate on platforms was on average 6.8% lower than those offered by banks. A study of 21,000 Lending Club loans found that the platform's rates were on average 7% lower than the borrower's existing loans.

P2P lenders can offer lower rates due to lower operating costs, one of their biggest advantages over traditional lenders.



The value appeal for borrowers is obvious: lower rates and quicker, simpler access to credit.



Peer-to-Peer Lending Value for Investors

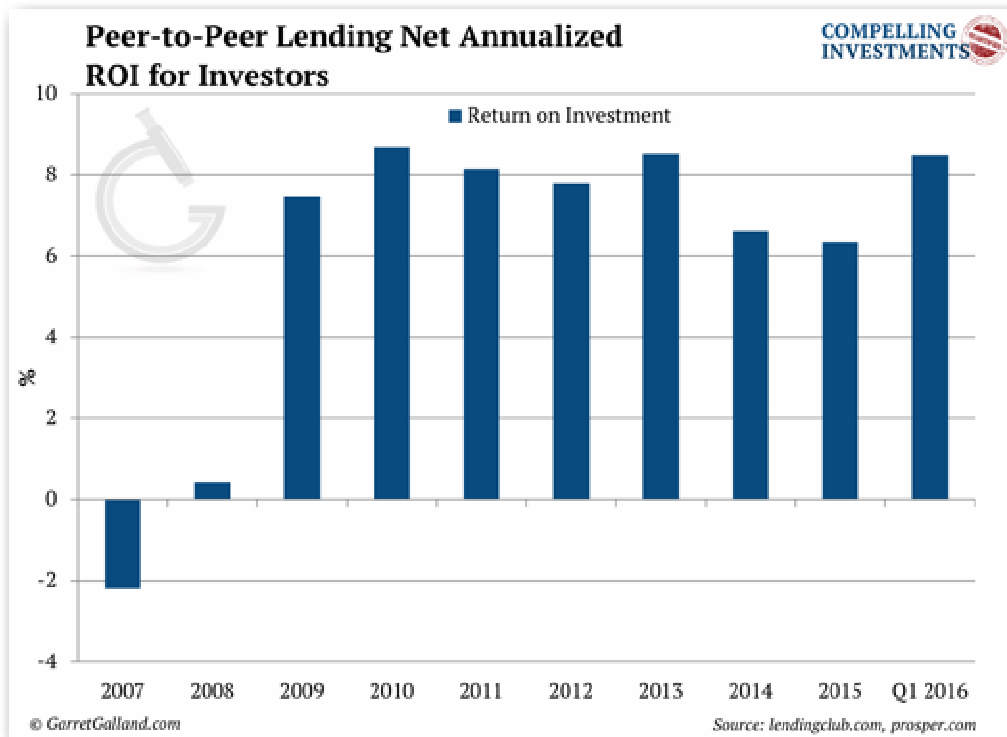
Compared to stock markets, P2P investments have less volatility and a low correlation. They also offer higher returns than conventional sources of yield. This table shows the correlation of P2P lending (labeled as MPL) to other asset classes (1.0 is perfect correlation).

	US Stock	PAC Stock	EU Stock	US SmallCap	Real Estate	US Bonds	US Tips	High Yield Bonds	MPL
US Stock	1								
PAC Stock	0.85	1							
EU Stock	0.88	0.88	1						
US SmallCap	0.96	0.80	0.82	1					
Real Estate	0.82	0.69	0.71	0.86	1				
US Bonds	0.08	0.14	0.14	0.07	0.26	1			
US Tips	0.09	0.14	0.15	0.07	0.28	0.76	1		
High Yield Bonds	0.75	0.67	0.70	0.72	0.69	0.32	0.33	1	
MPL	0.19	0.14	0.14	0.13	0.18	-0.13	-0.02	0.01	1

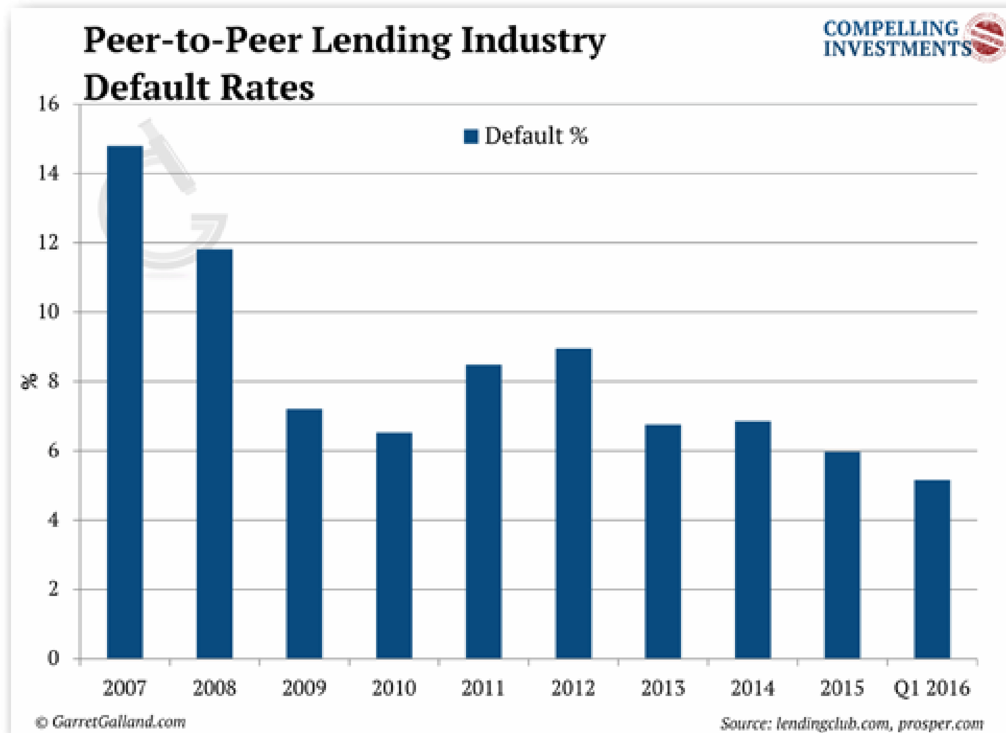
The sector is also very easy to enter. An investor can set up a profile in less than a day and invest as little as $25 per loan. Each loan is broken up into hundreds or thousands of pieces known as notes. The key to P2P lending diversification is to invest small amounts across a portfolio of notes. Once invested in a loan, investors usually start receiving payments within 30 days.

Median loss-adjusted returns for investors average 7% on a 36-month loan. The industry has grown exponentially since its inception, but it still accounts for less than 1% of total unsecured consumer and small-business loans in the United States.

Here we can see returns across the industry since inception.



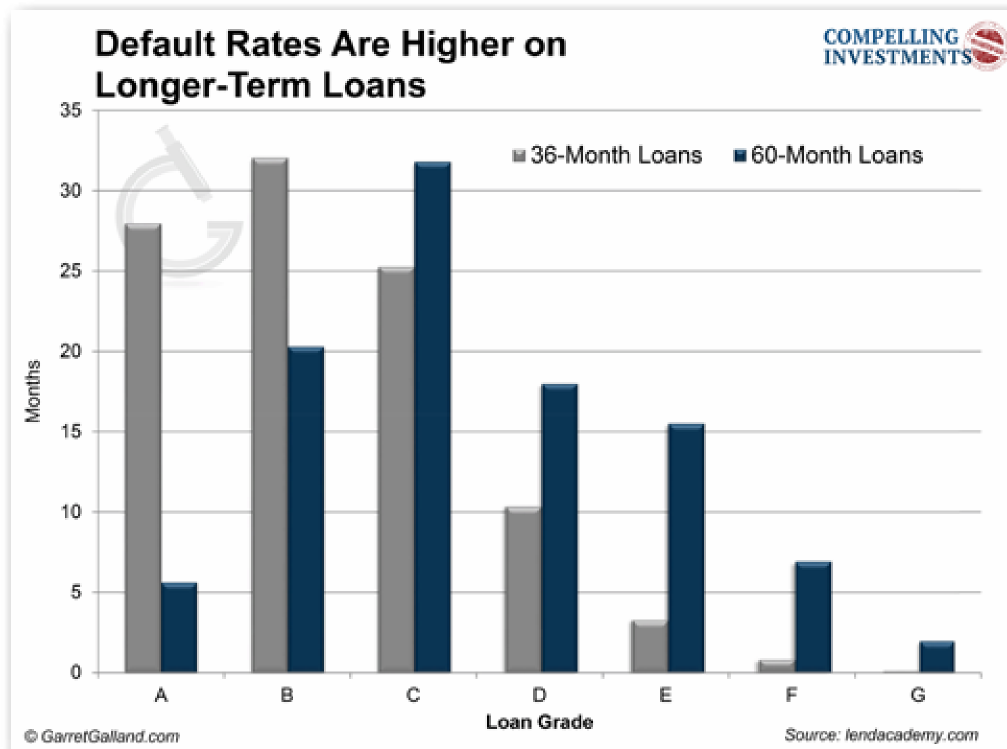
And industry-wide default rates continue to fall as underwriting standards improve.



Some will point to the high 2007–2008 default rate and conclude P2P lending is a risky game in a downturn. But here's the whole picture. Only 600 loans were issued in 2007, too few to be statistically significant. The 2,400 loans in 2008 were made by Lending Club and Prosper, using less sophisticated credit models that have since been replaced.

A Note on 60-Month Loans

There are clear performance gaps between 60-month and 36-month loans. Based on Lending Club and Prosper data, average interest rates and the default rates across all grades (10.5%) are both around five percentage points higher on 60-month loans. This reflects the lower credit quality of a 60-month borrower.



Despite the higher interest rates on 60-month loans, returns are only 1–2% higher than on 36-month loans. This is due to higher default rates and prepayments.

Those are the value propositions of P2P investing. Now let's have a look at the risks.

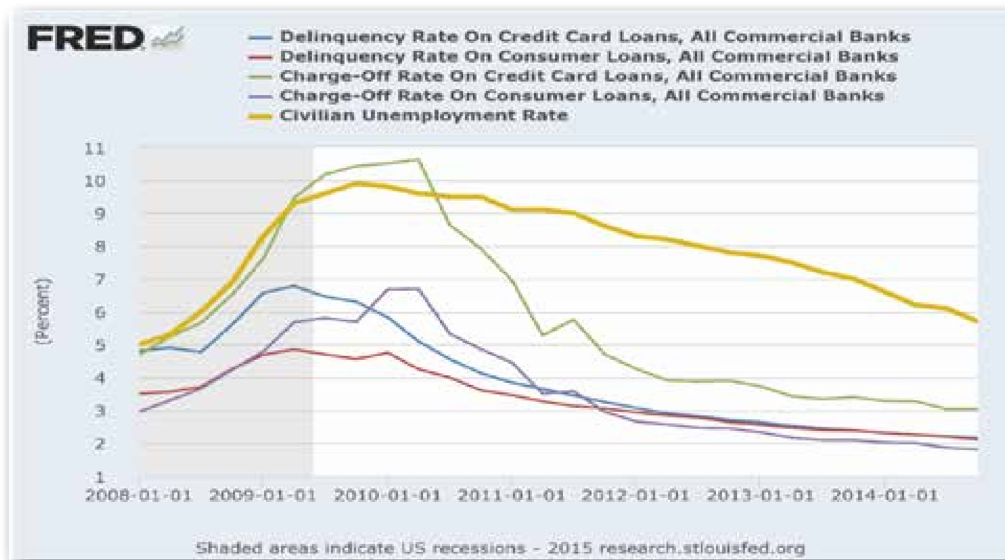
Peer-to-Peer Lending Risks

The unsecured nature of the market means investors must be wary of default rates. Although average FICO scores are lower than those at banks, only 1 in 10 loans are approved, a function of the improved underwriting mentioned above. The grading systems across platforms work as they should; higher yields come with higher default risk.

However, defaults are problematic. If a loan defaults—defined as overdue 120 or more days—the odds that the investor will recoup his principal are very low, and total principal loss happens in many cases. Investors should also track late payments. If a borrower is late by just 16 days, the average outcome is a 59% loss of principal.

Default strategies vary and are discussed in the platform analysis section below.

The industry is untested in a full economic cycle. One way we can estimate how P2P lending might perform in a downturn is to look at credit cards, which have similarities to P2P loans. The graph below shows credit card delinquency rates during the last recession.



The unemployment rate is key. Scott Langmack, founder and managing partner of Incline Fund Management, has stated that the single biggest risk in P2P lending is unemployment. Borrowers with good credit will pay their bills if they can. The main reason they don't is job loss.

As loans are fixed-term contracts, investors are locked into their notes. Secondary markets are in the early stages of development, which creates a liquidity problem for investors. Investors can sell notes on platforms such as FOLIOfn, Orchard, and NSR Invest, but should expect to hold on until maturity.

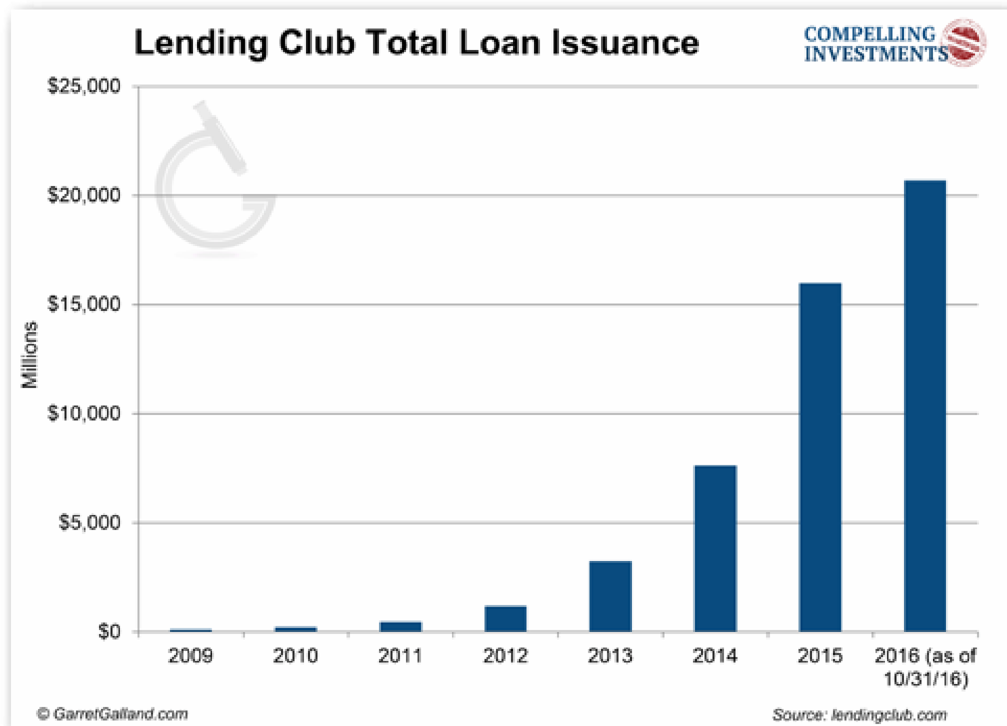
Paradoxically, prepayments are also a risk in P2P lending. If borrowers pay off loans before they mature, it means investors will receive less interest, thus lowering their ROI. It's the nature of the beast as borrowers who prepay are also the least likely to default.

Platform Analysis

Having covered the key benefits and risks of P2P lending for investors, let's now look at the platforms they can invest through.

Lending Club

Founded in 2007, Lending Club is the world's largest peer-to-peer lending platform with over $20 billion in loan issuance. It offers both consumer and small- and medium-sized enterprise (SME) loans over fixed periods of 36 or 60 months.

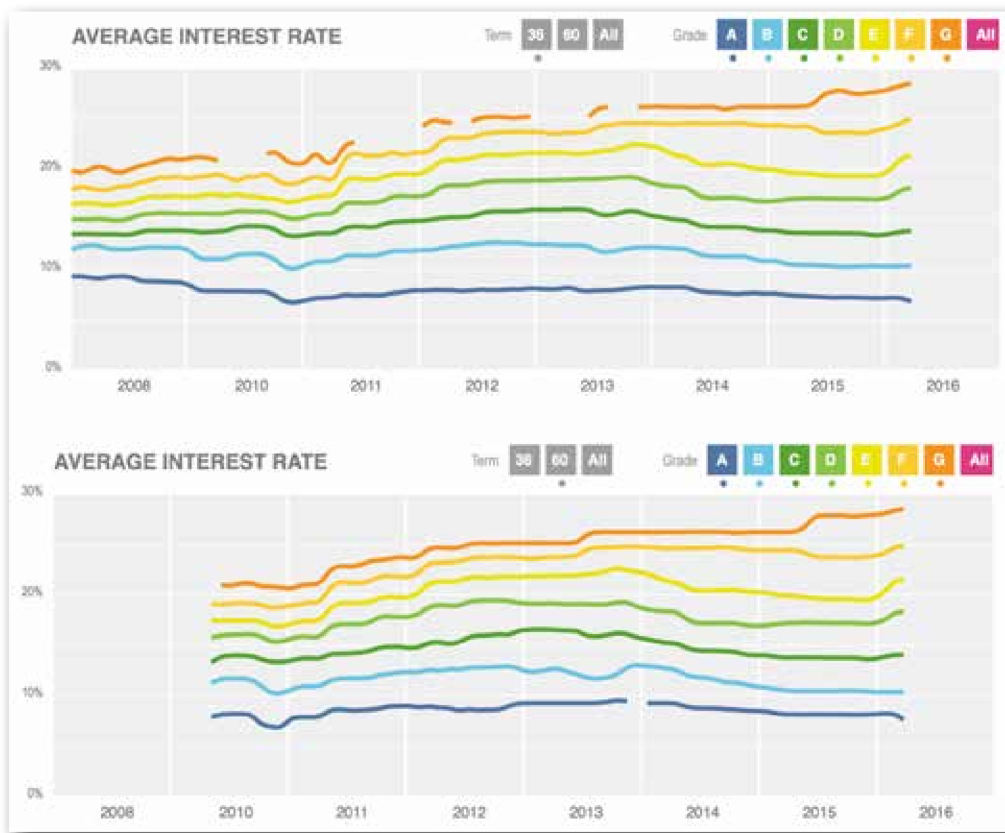


Lending Club has grown exponentially and currently has a 45% market share. It raised over $900 million from its IPO in 2014, but its share price has since fallen 72%.

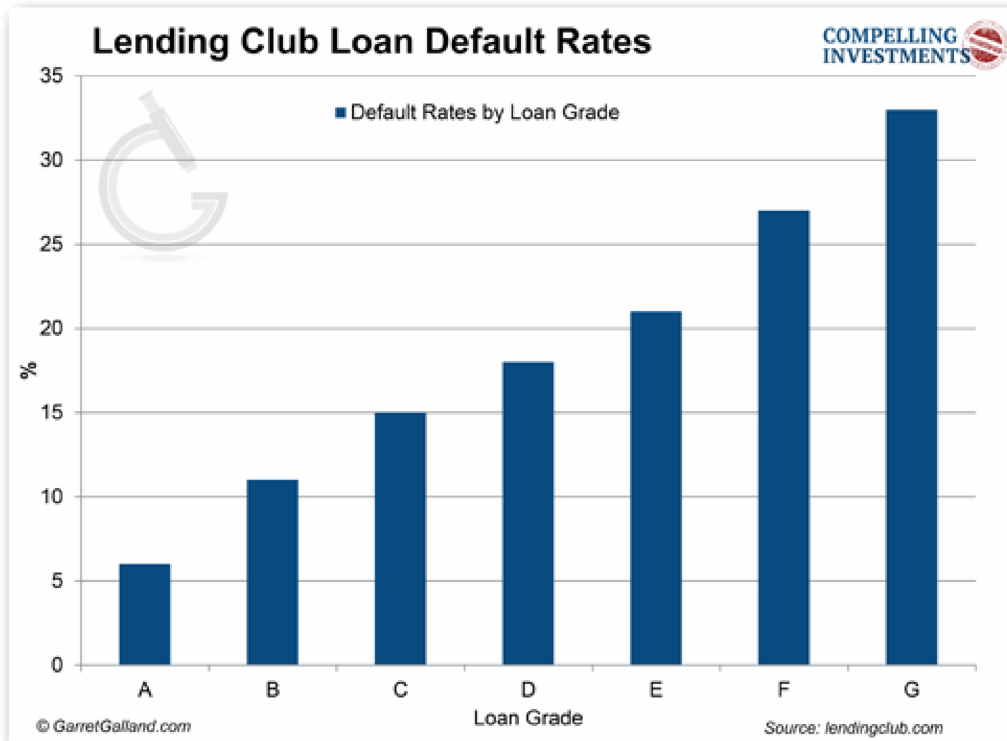
The company was recently embroiled in a scandal surrounding founder Renaud Laplanche. He was forced to resign after an internal investigation found improprieties in the company's lending process, including the altering of millions of dollars' worth of loans. Although the event damaged the reputation of Lending Club and the industry, the company is well capitalized. The company prospectus states that in the event of bankruptcy, a backup system will come online and function as the intermediary.

Lending Club operates on a notary business model, meaning it acts as an intermediary between borrowers and investors. Once a loan has been funded, the money is released to the borrower by a partner bank. Lending Club then issues a note to the investor that is essentially a security. Lending Club and Prosper (reviewed below) both use Utah-based WebBank. Lending Club offers loans from $1,000 to $35,000 for individuals and from $15,000 to $300,000 for businesses.

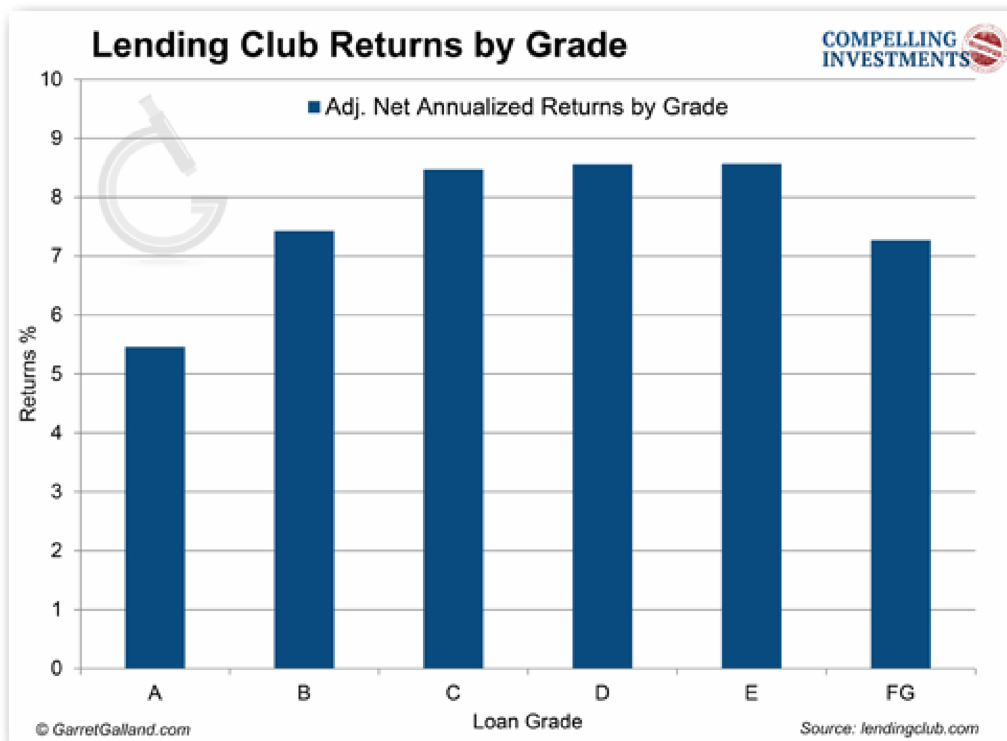
The next charts show the average interest rate charged to borrowers across all credit grades for 36- and 60-month loans.



We can see from the variance in default rates that Lending Club's grading system works as it should...



...with corresponding increases in returns.

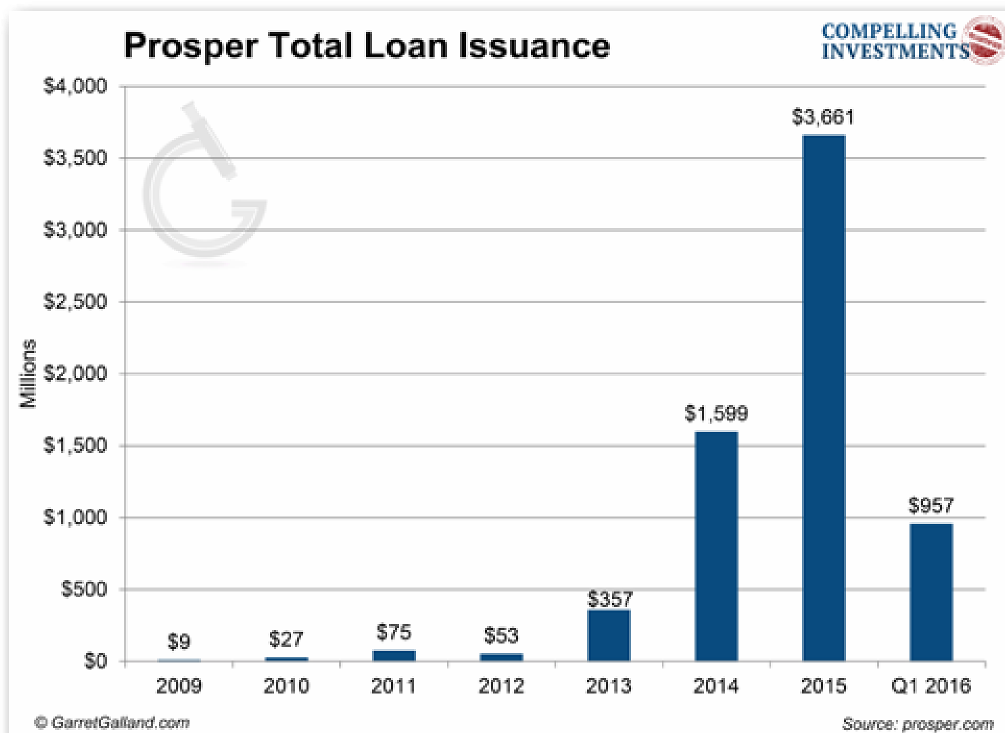


Lending Club charges investors a fee equal to 1% of the amount of borrower payments received within 15 days of the due date. The borrower pays an origination fee that ranges from 1% to 5%, depending on the grade. Investors can get started for as little as $25.

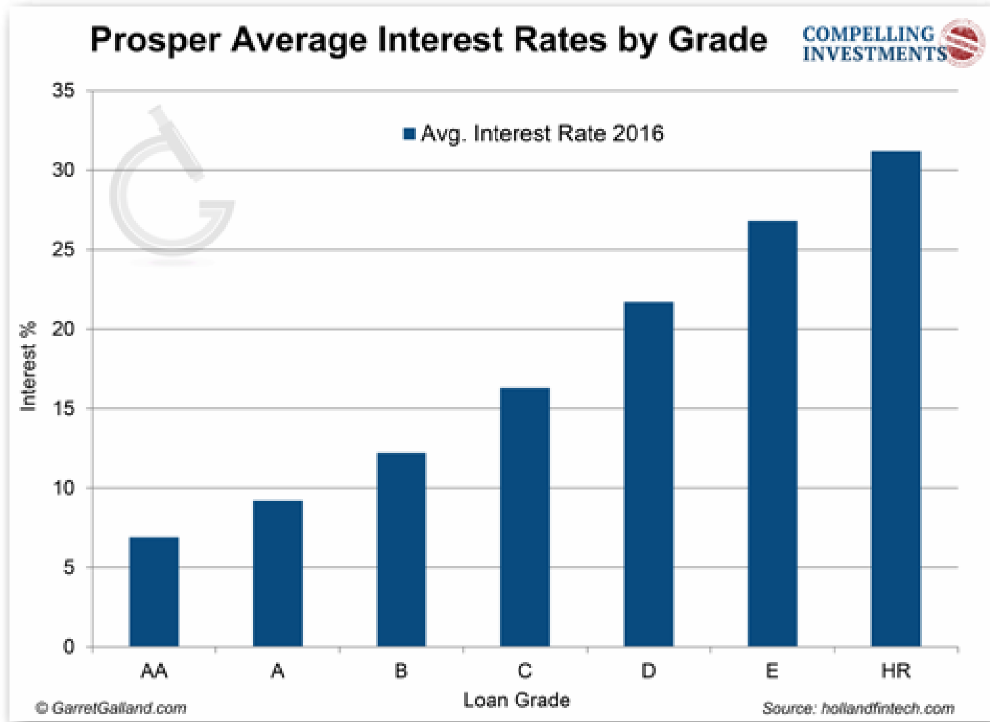
Lending Club uses a model rank system to grade borrowers. The system uses a combination of a proprietary scoring model, FICO score, and other credit features of the applicant. For non-performing loans, Lending Club charges investors 18% of any amount collected if no litigation is involved. If litigation is needed, investors must also pay 30% of hourly attorney fees.

Prosper

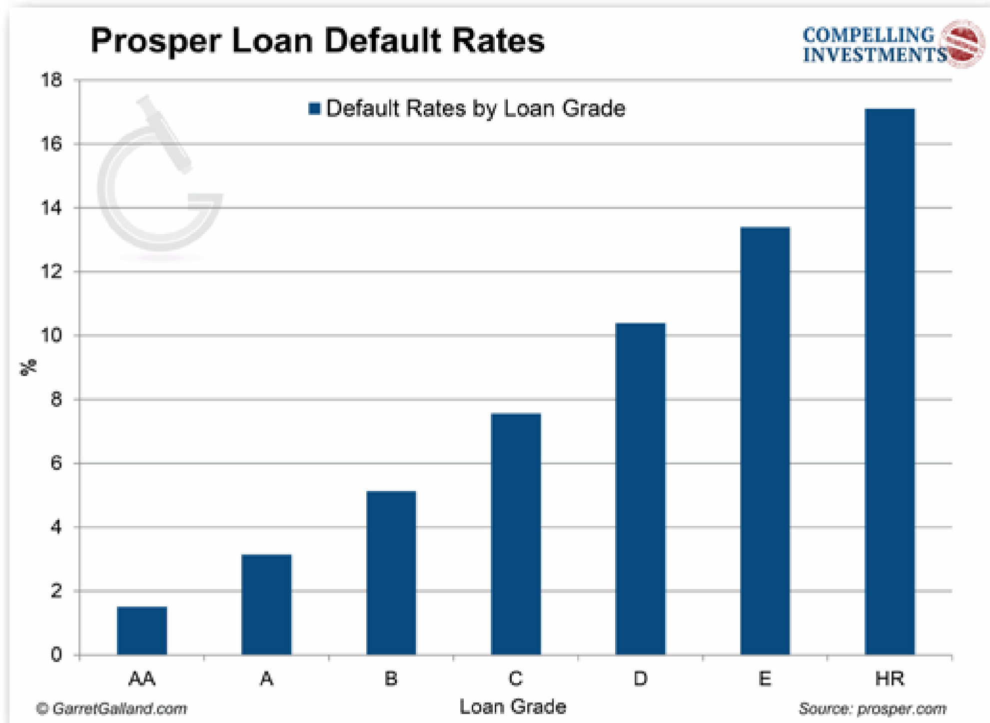
Launched in 2006, Prosper was the first P2P lending platform in the US. It has since funded over $6 billion in loans and serviced over 2 million customers. Prosper only offers unsecured consumer loans and does not make SME loans. Like Lending Club, Prosper offers 36- and 60-month loans with amounts ranging from $2,000 to $35,000. It also operates under the notary business model.



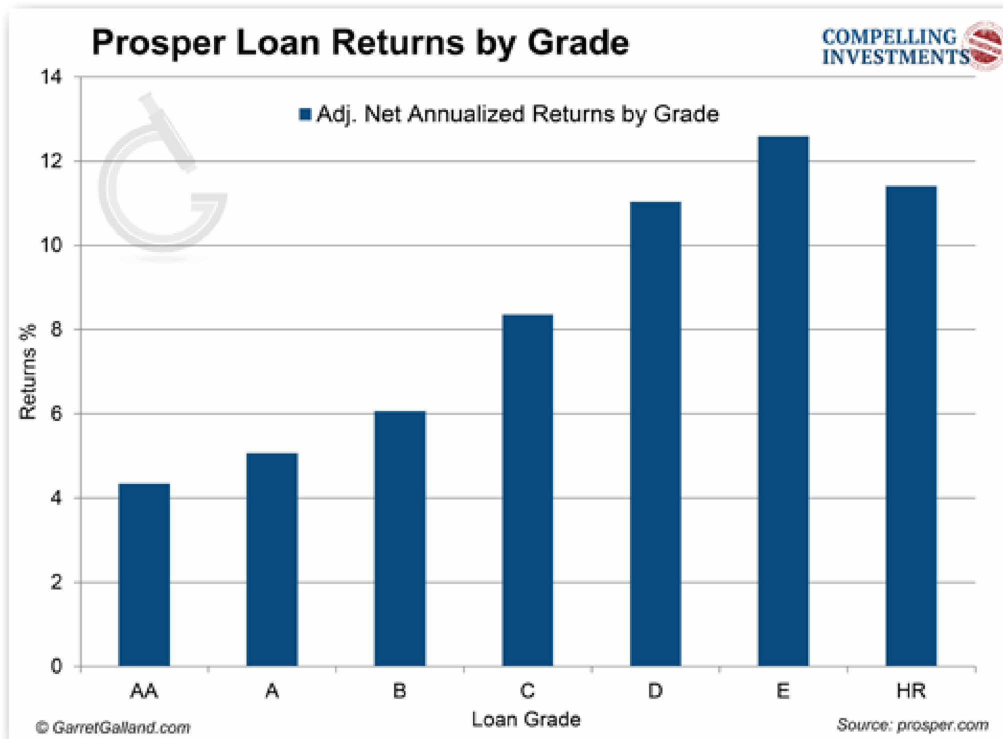
Prosper offers its loans on a grading scale:



Default rates on Prosper loans:



Returns across all grades:



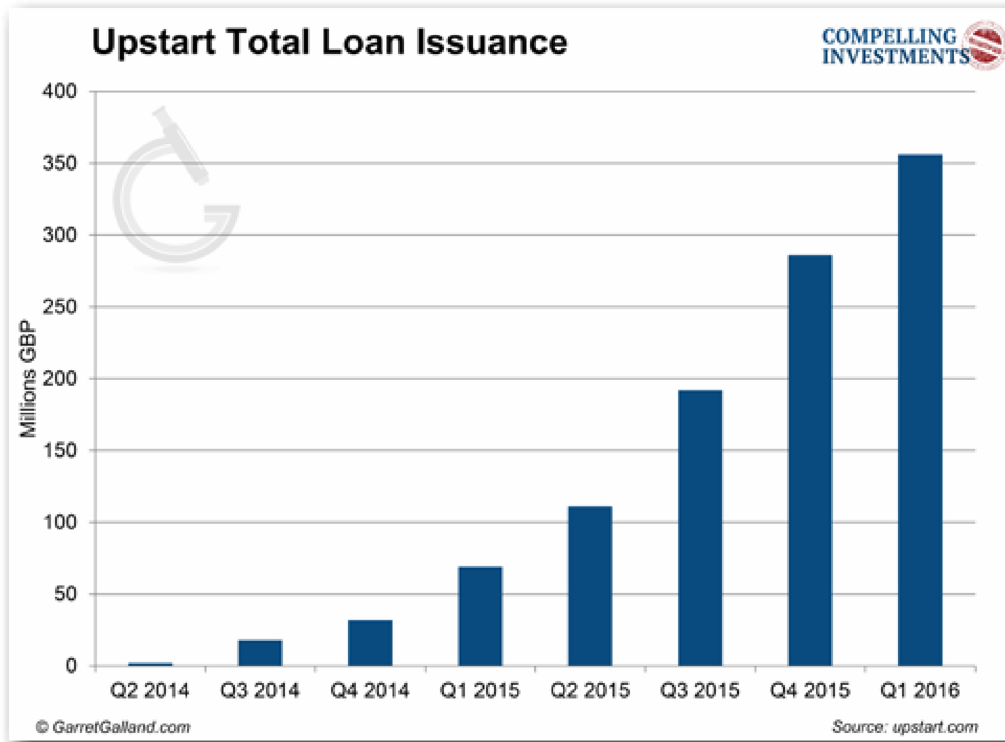
Prosper charges borrowers a "closing fee," which ranges from 0.5% to 5%, depending on the grade. Investors are charged a 1% annual fee based on current outstanding loan principal. The minimum investment is $25.

Prosper grades borrowers through its Prosper Score. This proprietary system focuses on criteria such as debt-to-income ratio and other "soft checks" conducted by credit bureaus. Prosper uses both the custom score and the credit reporting agency score to assign the borrower grade. Prosper bundles all non-performing loans and sells them to a third party. The affected investors then receive an amount proportional to their defaulted loan.

Lending Club and Prosper are the big players in the industry and the only services open to retail investors. The platforms covered below are available to accredited investors only.

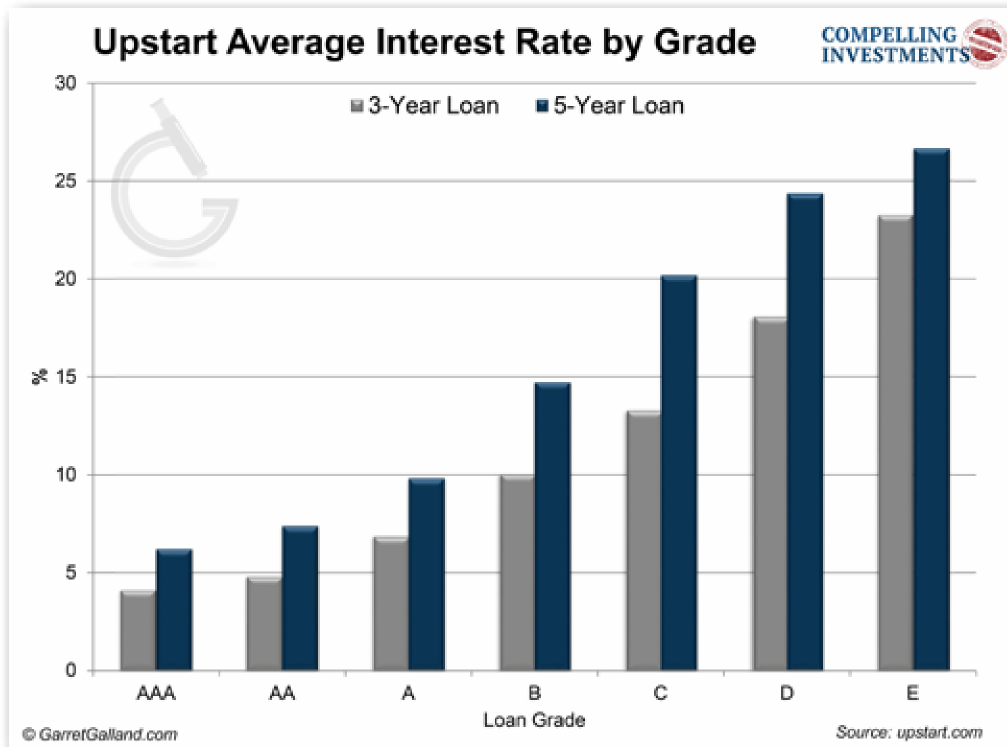
Upstart

Launched in 2014 by a bunch of ex-Googlers, Upstart has originated more than $300 million worth of loans.

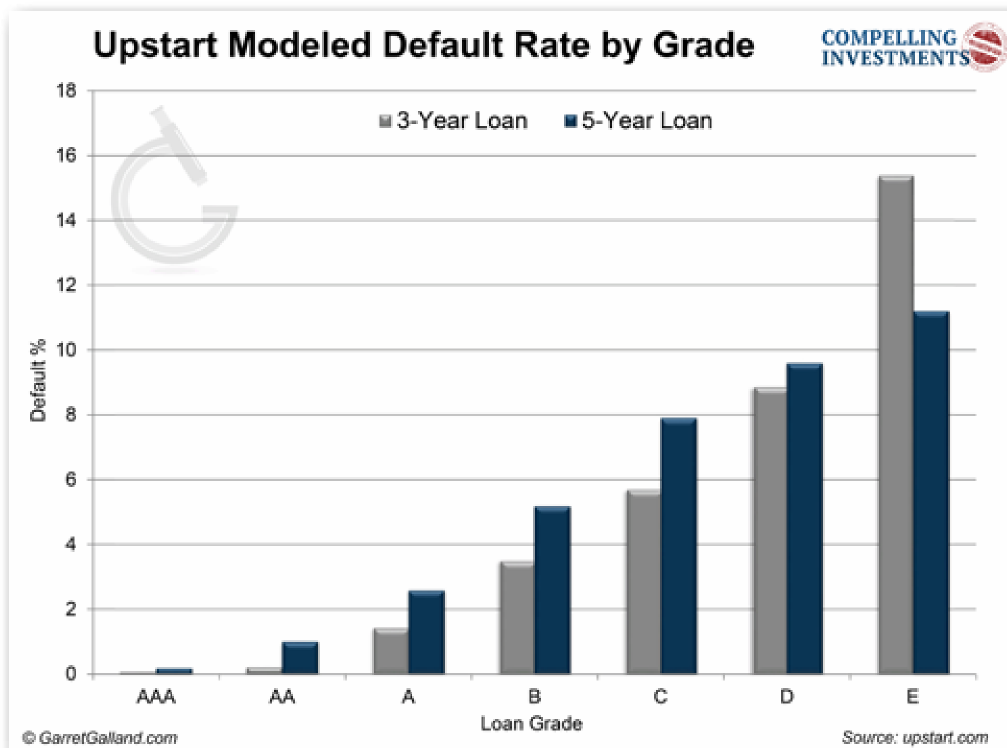


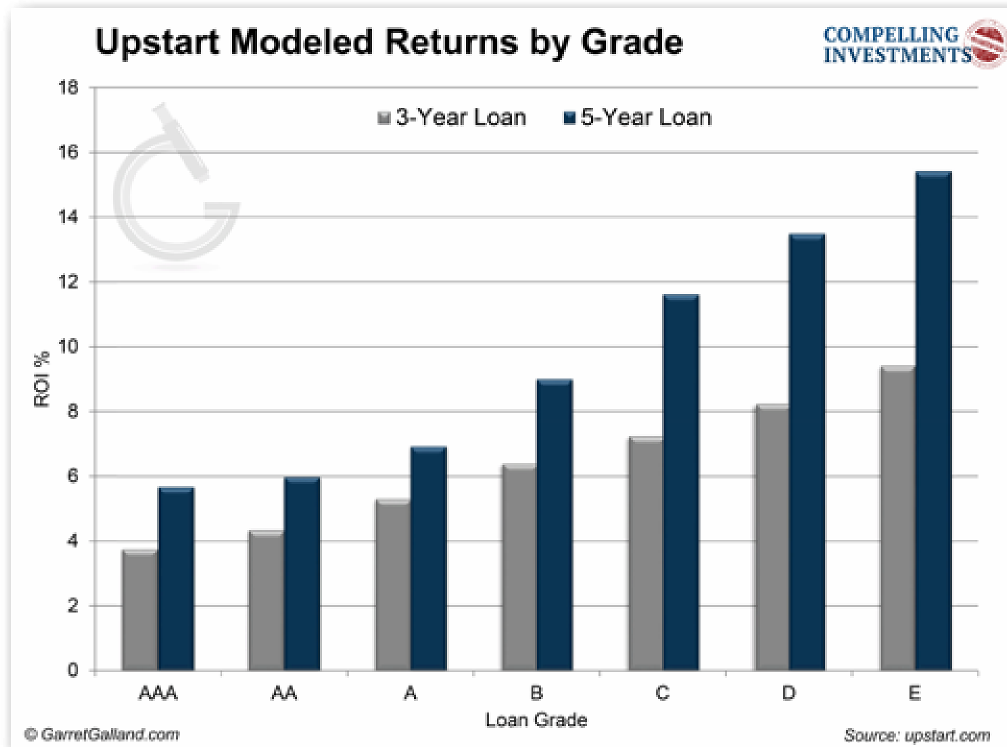
Upstart uses unique grading criteria. It looks at FICO scores but also considers educational background. The firm has the lowest default rates across the industry thus far. Over 94% of loans are on track to be repaid in full.

Upstart's target niche is young professionals—over 90% of borrowers are college graduates—and small-business start-ups. It offers loans between $3,000 and $35,000 for fixed periods of three to five years. Interest rates range from 4% to 26%, depending on grade.



Upstart employs a modeling system that has so far been remarkably accurate at predicting future defaults and returns.



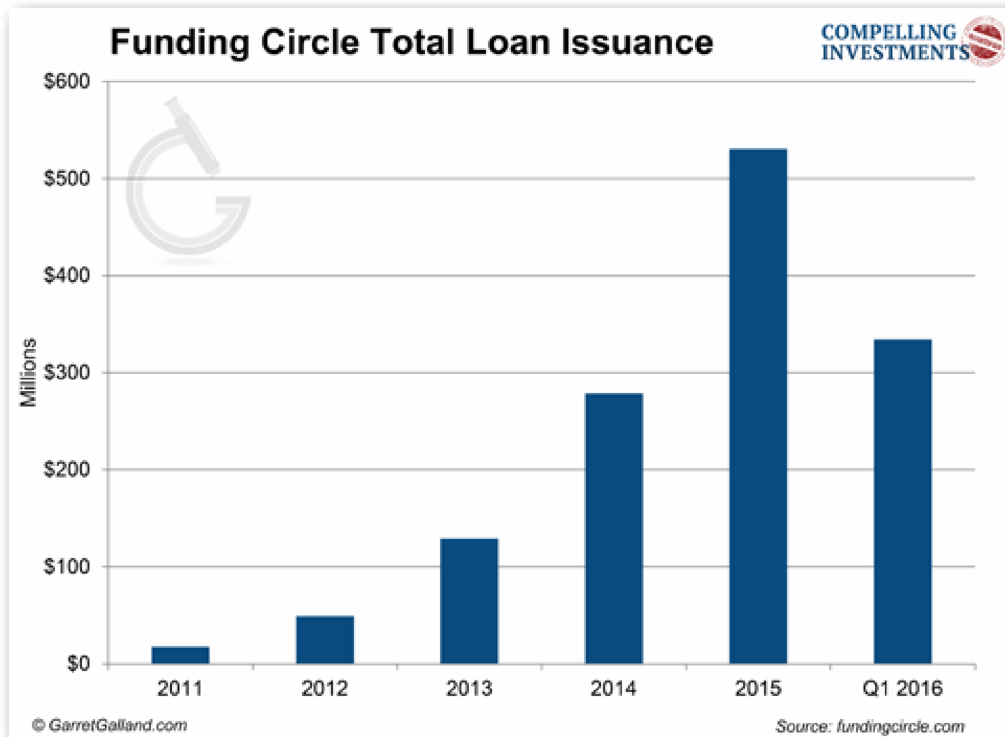


The way Upstart operates differs in many ways from other P2P lenders. To start, investors do not pay fees. The company makes its money solely on origination fees from the borrower. If a loan defaults, Upstart refunds the investors using the origination fee. This means if loans go bad, Upstart loses. It has skin in the game.

Loan selection also differs in that investors cannot cherry-pick individual loans. Instead, they choose to invest in a specific grade or loans with set criteria. The minimum investment is $100.

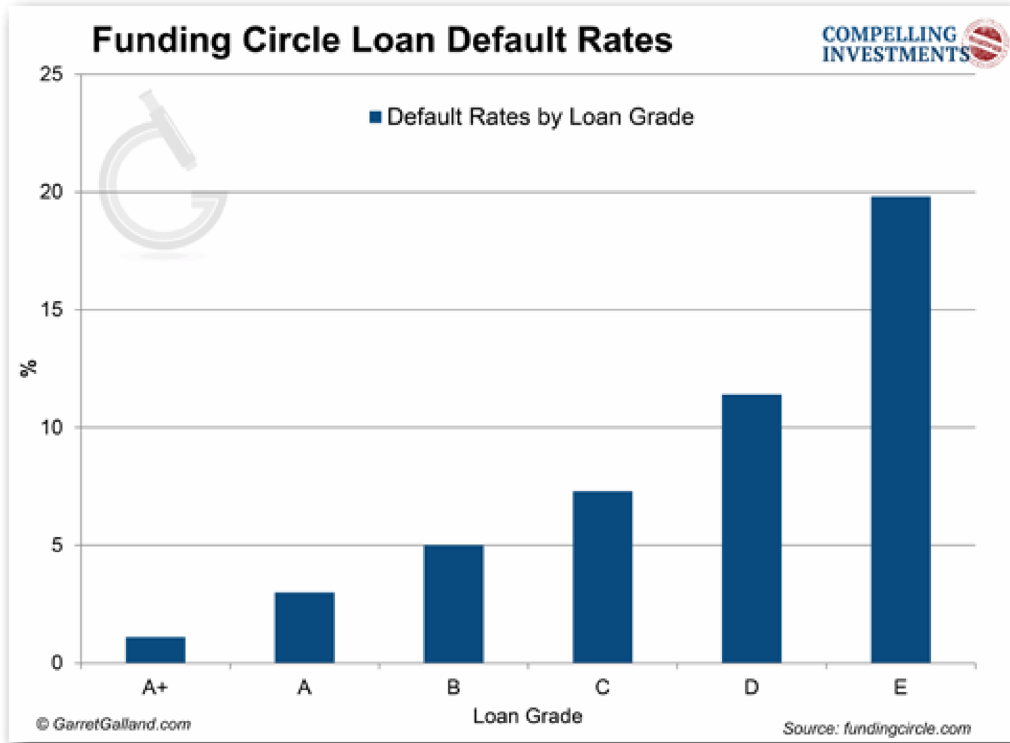
Funding Circle

Sam Hodges is the Co-Founder and U.S. Managing Director. The company only makes business loans and operates in the US, UK, Germany, and the Netherlands.

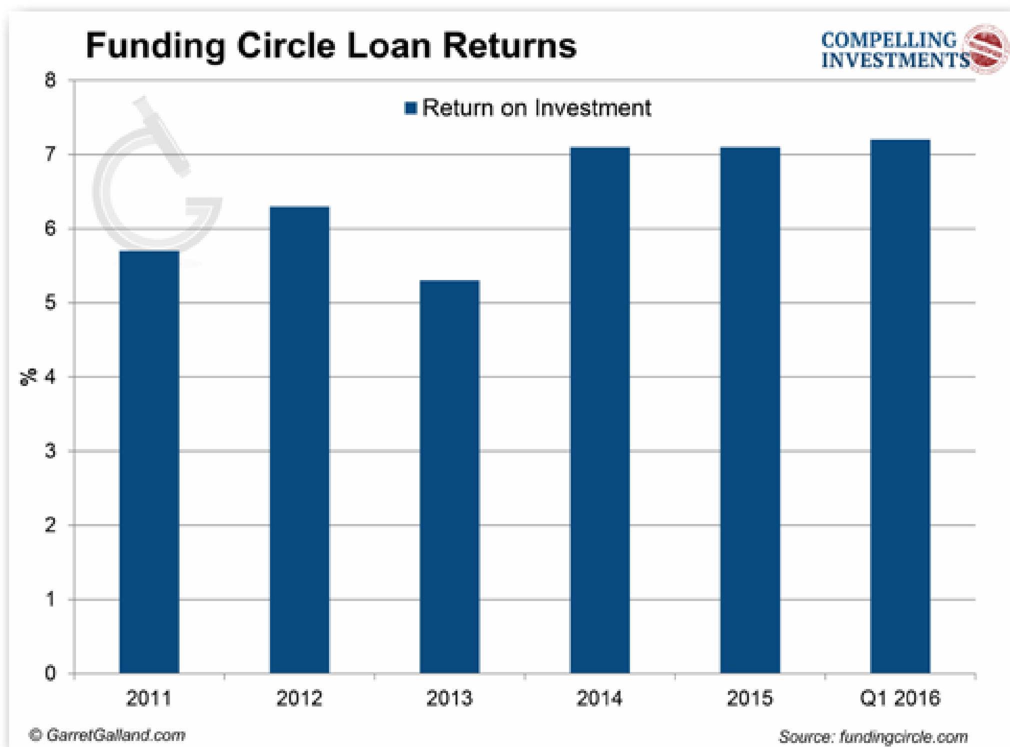


The company has originated more than $3 billion in loans by offering loans from $25,000 to $500,000 in the U.S. Rates range from 5.5% to 27.8%, depending on grade.

Investors are charged a 1% monthly service fee on all payments received within the month. The minimum investment is $50,000.



Investor returns also continue to improve:



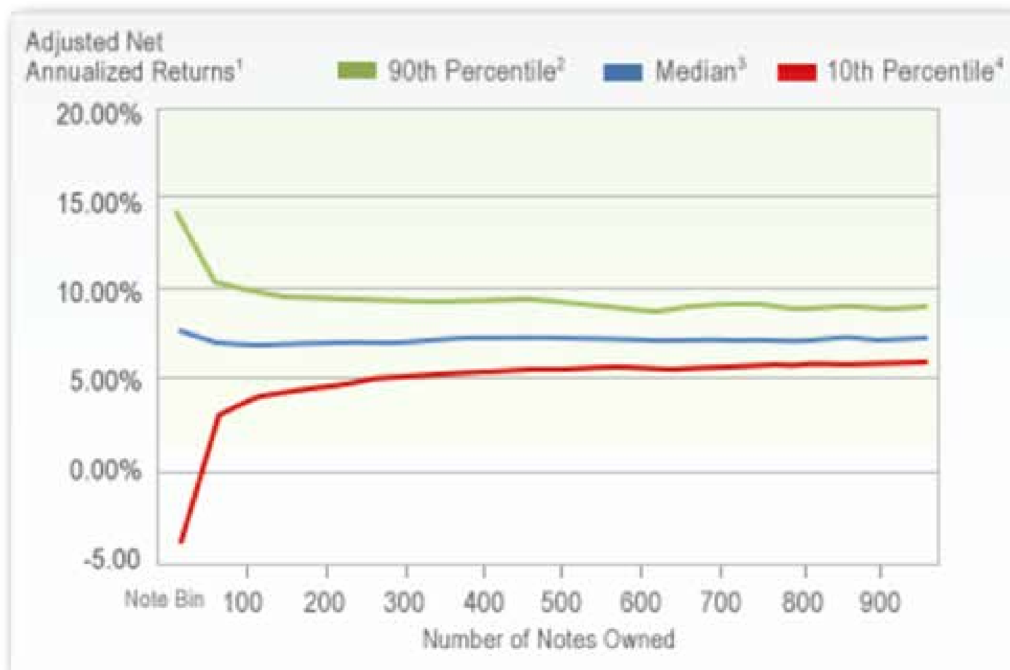
Strategies for Successful P2P Investing

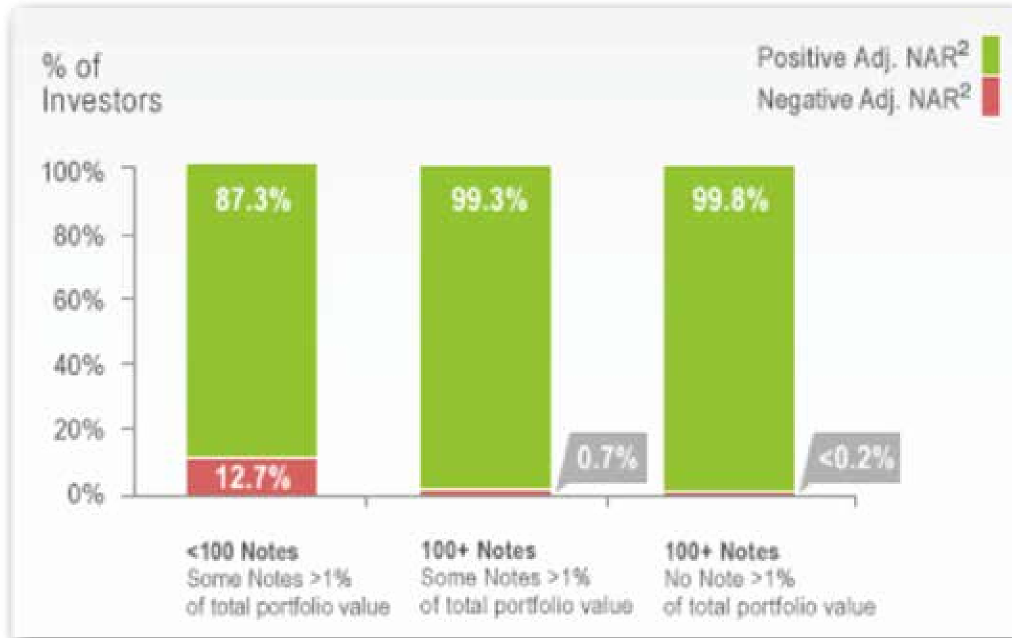
We discussed P2P investing with several industry experts, and a few key factors to success emerged. The first among them is **diversification**.

The unsecured nature of P2P lending means the investor must build a portfolio of hundreds of loans where each loan is a fraction of the total portfolio. And this is not an asset basket into which you put too many of your investment eggs.

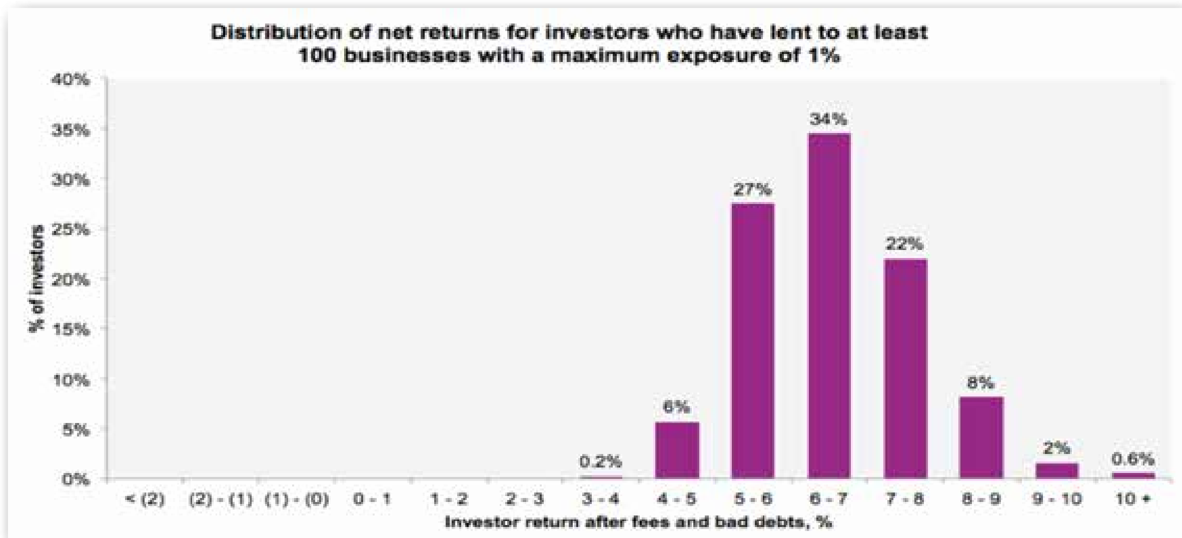
Lending Club, Prosper, and Funding Circle have all released statistics that show diversified portfolios give the greatest return and minimize risk.

Diversification at Lending Club:





Diversification at Funding Circle:



Prosper also has statistics that show since July 2009, every portfolio of 100 notes or more has had positive returns.

The low minimum investment at these services makes diversification easy. However, loan selection takes time, and speed is key to getting the best loans.

With the recent influx of institutional money, P2P lending has become much more competitive. The best-quality loans can be snapped up within minutes of being posted. This is why investors must use third-party peer-to-peer tools, which we detail next.

Tools for Success

The fast pace of loan purchases on platforms requires that investors use automated filtering and selection tools.

NSRInvest.com is a registered investment advisor that offers managed accounts to P2P investors. Investors can link their Lending Club, Prosper, and Funding Circle accounts to the website and have NSR experts invest for them based on their loan selection criteria. Loan filtering can help investors consistently outperform the market. Based on back testing from NSR, the most effective filters are: loan grade, credit inquiries in the last six months, and loan purpose.

Although default rates are higher on grades D–G at Lending Club, and grades D–HR at Prosper, the ROI is higher too. Loan filtering can mean successful investing in these lower grades.

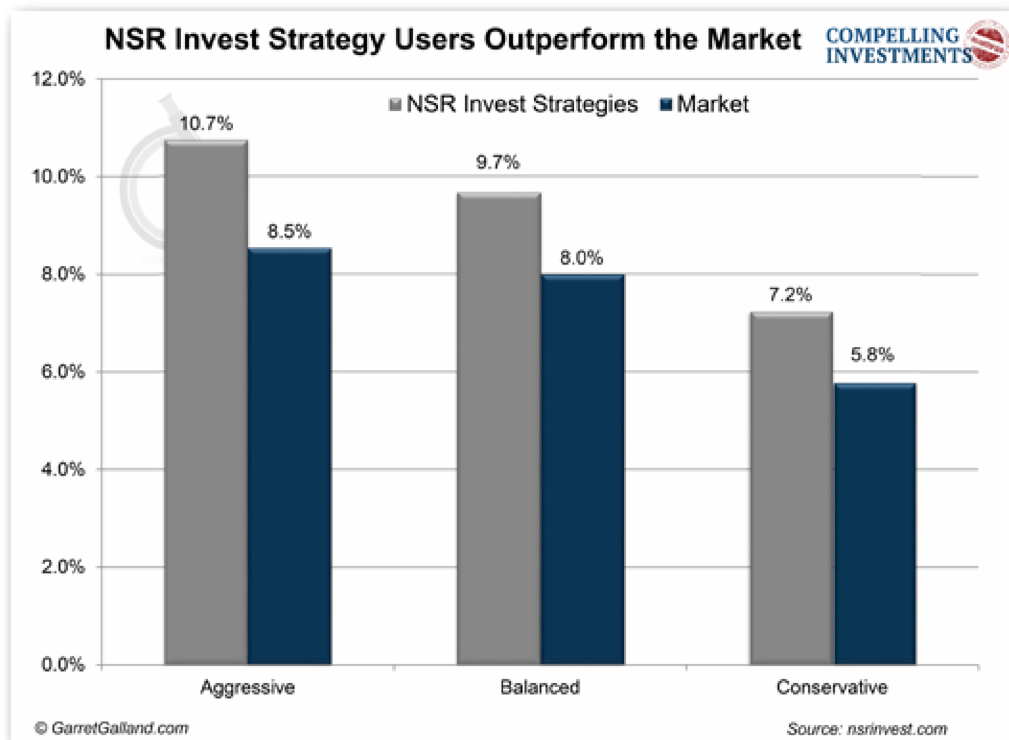
This table shows how filtering for the number of credit inquiries in the last six months can effect returns on D- to HR-graded loans on Prosper.

	ROI	AVG RATE	Loss
<=0	16.85%	22.50%	4.85%
1	15.46%	22.56%	6.44%

In the next table, you see how the annual income filter can effect returns on D- to HR-rated loans on Prosper.

	ROI	AVG RATE	Loss
$1-249,990	14.47%	23.87%	8.46%
$25,000-49,999	16.64%	23.26%	5.78%
$50,000- 74,999	15.19%	22.63%	6.69%
$75,000-99,999	14.06%	22.21%	7.51%
$100,000	16.47%	22.09%	4.86%

NSR also offers investors access to liquidity with automated secondary-market trading plus detailed loan selection algorithms. Users pay a fee of between 0.45% and 0.60% of the total value of all notes purchased on NSR Invest (excluding charged-off loans) plus your average daily idle cash balance during the billing period. Depending on the strategy selected, NSR users outperform the market by as much as 2.2% (average is 1.7%).



NSR recently partnered with MonJa, an P2P investment tool that provides loan selection strategies and portfolio analytics. The MonJa platform offers investors a user-friendly interface that breaks down portfolios to explain performance and understand what is driving returns. Its analytics can be used for back testing so investors can enhance their current investment strategy based on past performance.

Another great tool is LendingRobot, a registered investment advisor offering fully automated P2P investing for individuals. Investors can link their Lending Club, Prosper, and Funding Circle accounts to the website. Users then select from several criteria, which determines their individual strategy, and have LendingRobot execute the investments.

LendingRobot is extremely fast, executing investments in less than one second after loans have been listed on a platform. The first $5,000 is managed for free. After that, users pay a 0.45% monthly fee on assets under management.

BlueVestment and PeerCube are two other automated P2P investing platforms that can help users. Both platforms perform the same function as LendingRobot.

Peer-to-Peer Lending Future

P2P lending has gone from zero to an estimated $35 billion industry in 10 short years. However, it still accounts for less than 2% of the market for US unsecured consumer credit. Morgan Stanley estimates this market is $450 billion per annum.

Morgan Stanley expects P2P lending to achieve a 47% compounded annual growth rate until 2020, with P2P lending platforms accounting for 8.4% of the total unsecured consumer credit market in four years. It also forecasts that P2P lending will capture a larger share of SME lending, jumping from 2% to 16% by 2020.

The other growth area will be student loans. Morgan Stanley projects the P2P share of this market to grow from 2% currently to 14% by 2020. Although P2P lending has broken into the mortgage and auto industries, they are more complex, and Morgan Stanley does not see P2P lending playing a major role.

In the current economic and interest rate environment, P2P lending has a couple of advantages over the general equity markets we'll mention again: lower volatility and higher expected returns.

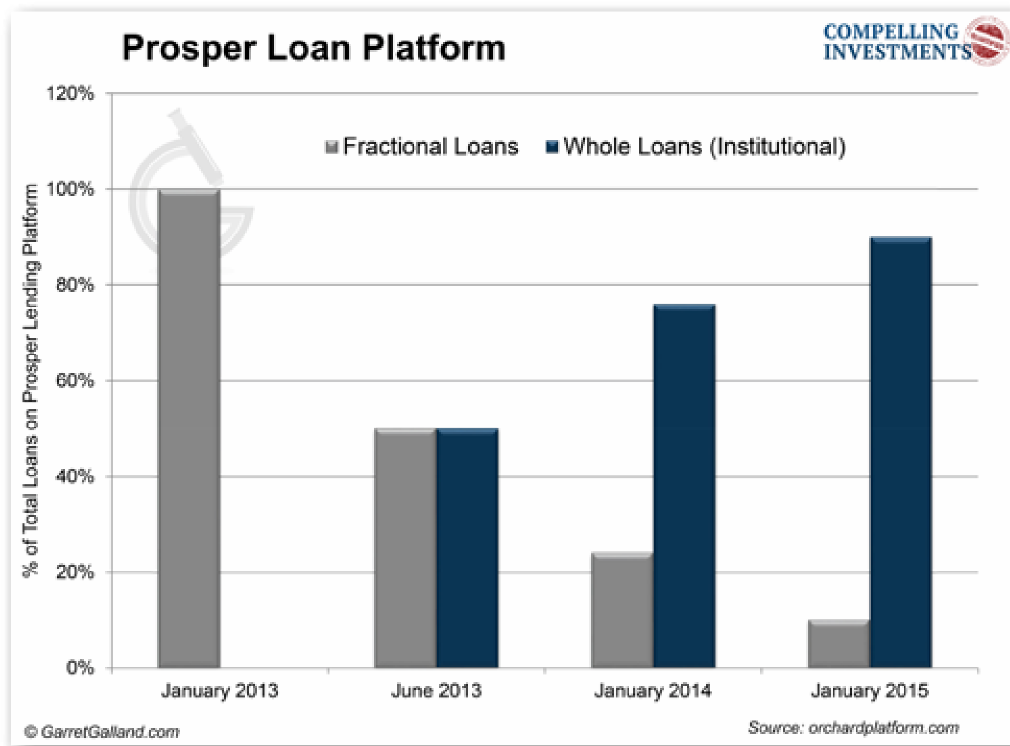
There are challenges ahead, too. P2P lending is untested in a full economic cycle with rising unemployment and delinquency rates. Although the industry was created to counteract this exact phenomenon, a recession may hinder platform lending. If delinquency rates did begin to rise, we could begin to see investor capital dry up.

So far, banks have collaborated with P2P lending platforms by purchasing loans and forming alliances with lenders.

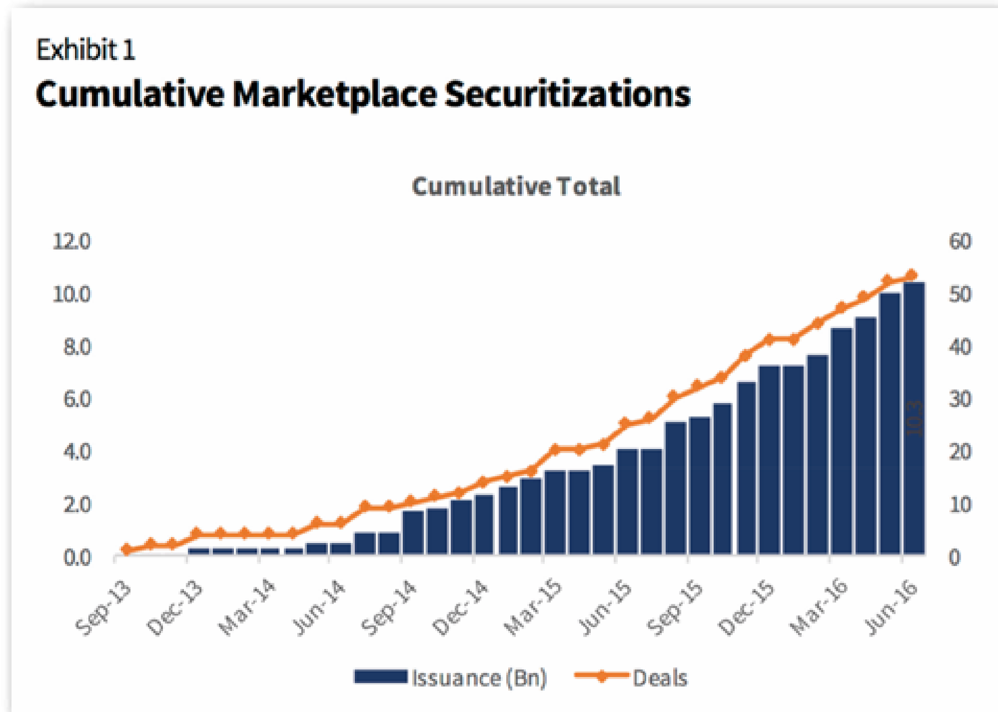
However, we have now entered the competition phase. Goldman Sachs recently announced it will be the first major bank to launch its own P2P lending platform, Marcus. It is only available for US customers and offers unsecured personal loans ranging from $3,500 to $30,000. The rates on Marcus range from 5.99% to 22.99% APR, with terms running from 24 to 72 months. Marcus also has no fees, a major plus for P2P lending participants.

Institutional Involvement

Marketplace lending may have started as peer-to-peer, but with over 65% of capital now coming from institutional sources, it has grown into a marketplace. Institutional involvement has supercharged growth, prompting Prosper to create a separate platform for institutions to fund "whole" loans.



Institutional participation has also greatly increased securitization in the industry. There was approximately $3.2 billion worth of securitized issuance in 2016, a 77% increase on 2015.



Although securitization has been good for growth, we see a few issues. As mentioned above, P2P lending is untested during a full economic cycle. Given its similarities to credit cards, we will see defaults rise during a downturn.

Of the $10.3 billion in securitized marketplace loans, $4.6 billion is consumer credit and $4 billion is student loans. This table shows the top financiers of securitized marketplace loans.

Rank	Bookrunner/Lead Dealer	Deal Value (Mn)	Deals	%Share
1	Citi	1,857	7	19%
2	Morgan Stanley	1,633	7	16%
3	Credit Suisse	1,426	8	14%
4	Goldman Sachs	1,332	4	13%
5	Jefferies	1,266	11	13%
6	Guggenheim Securities	956	2	10%
7	Deutsche Bank	675	2	7%

Rank	Bookrunner/Lead Dealer	Deal Value (Mn)	Deals	%Share
8	JP Morgan	250	1	3%
9	DBS	250	1	3%
10	Barclays	189	1	2%
11	Bonwick Capital	121	1	1%

Regulation

Contrary to popular belief, the P2P lending industry is heavily regulated. Although P2P lending has benefited by avoiding the burdensome regulation placed on financial institutions post-2008, the industry now finds itself under regulatory scrutiny.

P2P lending complies with regulatory regimes in both consumer credit and securities transactions. The Consumer Financial Protection Bureau and the Securities and Exchange Commission began regulating the industry in 2011 and 2008, respectively. SEC regulation prevents retail investors from investing in platforms like Funding Circle that haven't registered their securities with the SEC.

Enhance Your IRA with Peer-to-Peer Investing

Investors can link their self-directed IRA to both Lending Club and Prosper to take advantage of tax-deferred earnings and enhance their retirement.

How to Get Started

Based on our research, here is our recommendation on the best way to get started in peer-to-peer lending.

While Lending Club offers higher returns on high-grade loans, Prosper offers much lower default rates across all grades. Each platform can earn investors outsized returns, so you should follow a key principal of P2P lending and diversify your investments across both platforms.

Accounts on Lending Club and Prosper can be set up in just a few minutes. If you want a representative to walk you through the process, both platforms have helplines that are open Monday to Saturday, 8am–5pm PT.

Another key to success is using investment automation tools like NSR Invest.

NSR users have consistently outperformed the market, as we showed in an earlier chart above. Once the NSR account is set up, it can be linked to your Lending Club and/or Prosper accounts. You then select specific filters so that you only invest in notes that match your desired levels of risk and returns. You can also back-test your NSR filters, which can help with loan criteria selection.

Besides delivering higher returns, NSR will save you a lot of time and energy by automating the execution.

Lending Club and Prosper also offer built-in automation investing services. While they do not give users the same depth of customization as NSR, their services are free. These integrated automation tools may meet the needs of investors with less-detailed selection criteria, such as simply filtering notes by grade. After users have entered their filtering criteria, they can then sit back and let the algorithms do the work.

P2P investing is a classic example of balancing risk and reward—higher returns versus greater default rates. It is vital that investors who enter this arena know their risk tolerance and stay within those limits.

Peer-to-peer lending has become a viable option for fixed-income investors. The opportunity to earn 5–7% annualized returns on high-grade P2P loans vs. 3% on 30-year US government bonds is a meaningful difference.

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