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microNOTE #51
Person-to-Person Lending

Is Financial Democracy a Click Away?

Photo Courtesy of MYC4

"The loans I have received from MYC4 give me the opportunity to become an independent business woman so that I can support my household and pay for the schooling of my children."

--- Catherine Akwir, spare engine part vender and MyC4 borrower in Uganda

Catherine Akwir is an example of one of the many entrepreneurs who has received loans through MYC4, a Danish P2P platform focused on African entrepreneurs. She boasts on MYC4's site that her first loan in 2007 enabled her to increase her monthly income by 30% making it possible to support her household and send her children to school. In May 2008 she received her second loan on MyC4 from 4 individual lenders.

Introduction

Direct lending between friends, family and neighbors has existed since before formal banks, legal agreements and even currencies. These loans were often small, and much like today's "microfinance" loans relied on relationships of trust between individuals. Today, formal banks play a large role in financial intermediation, which has allowed for scale, transparency and efficiency, but has failed to meet the financial needs of the poor. The concept of microfinance stems from this need to extend access to financial services to the poor and other unbanked communities. With the birth of the internet, and the success of online social networking, a new form of non-bank lending has arisen, borrowing from traditional reliance on trust within communities but extending the concept of community beyond geographic boundaries. Beginning with Zopa (www.uk.zopa.com) in the United Kingdom in March 2005, person-to-person (P2P) internet sites are serving as marketplaces for borrowers and lenders in various developed economies. Platforms such as Kiva (www.kiva.org) and MyC4 (www.myc4.com) have expanded P2P lending internationally, linking lenders in developed countries to borrowers in developing countries. For the first time, retail investors have access to investments in microfinance, an asset class previously reserved for institutional investors and high net worth individuals. Although these platforms still represent only a small portion of the financing available to unbanked communities, they are growing rapidly. By reducing, and in some cases, eliminating the role of traditional banks and intermediaries, they have the potential to democratize access to lending and borrowing in the future.

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Overview of the P2P Lending Market

After the launch of Zopa UK in 2005, there has been an impressive growth in the number of domestic, *developed* country P2P lending platforms worldwide. Seven were launched in the first eight months of 2008 alone, bringing the total to 20 to date. P2P investor usage is also booming: as of August 2008, $164 million in loans had been transacted on US-based Prosper (www.prosper.com) and nearly $45 million had been arranged by Zopa UK. Kiva, the first online P2P lending platform geared towards microfinance in *developing* economies was launched in November 2005. Kiva has facilitated nearly US$50 in microloans worldwide and has inspired the launch of six other online platforms dedicated to providing capital to micro, small and medium enterprises in the developing world.

All these online lending sites ultimately connect those with surplus capital to those in need of capital; however the manner in which they do so varies dramatically. There are three general models used to facilitate on-line lending and investing:

"Direct" P2P model: In this model, the platform serves as a virtual marketplace for lenders and borrowers to meet and agree on the terms of a loan. Borrowers may be borrowing for personal or business needs. They post information about themselves, what they plan to use the loan for and their maximum acceptable interest rate. Lenders can browse through the loan "offerings" and chose who they would like to lend to based on their risk appetite and other personal preferences. Generally the interest rate is determined in an open auction by lenders, not by the platform.

"Intermediary" P2P model: Under this model, a website still serves as a marketplace for lenders, who can search for and select their borrowers, but the loan is sourced, verified, posted, disbursed and serviced by an intermediary such as a microfinance institution (MFI) or non-governmental organization (NGO) with a local presence. On some platforms the intermediary sets the terms of the loan, while others allow for lenders to bid on the terms.

The "MicroPlace" model: Microplace (www.microplace.com) offers a different approach to online lending, removing the investor one additional step from the final borrower. On Microplace an individual invests in securities representing a portfolio of loans to MFIs issued by an investment fund such as Calvert Foundation or Oikocredit USA. The MFIs in turn on-lend the funds to micro and small entrepreneurs, but the investor's risk remains with the security issuer. While, MicroPlace cannot really be considered a P2P, it is included here because of its potential for scale and its potential to improve the accessibility of microfinance and other social investments for the retail investor.

One of the major differences between the P2P lending platforms in developed economies and those which target developing countries is the use of intermediaries to identify, verify and register borrower information and to handle repayment and collection efforts. The use of intermediaries has been necessary, in part because potential borrowers do not have access to the internet and/or do not have the financial, computer or even alphanumeric literacy necessary to apply for a loan. Additionally, there is a need for a local presence to ensure credit quality and to facilitate disbursement because of limited available information and cross-border restrictions for financial transactions. For example, in developing countries, credit bureaus are not always available, accessible or reliable, whereas in developed economies, lenders can use credit history, credit scores and some of their own local knowledge to make lending decisions.

Democratizing Investor Access to Finance

P2P marketplaces have the potential to democratize asset management and financial intermediation, one of the few professions that remains reserved for "elite" bankers and professional asset managers. The main benefit that online P2P lending platforms offer retail investors is that they provide easy access to investments in loans to micro, small and medium sized businesses, an investment class previously reserved for institutional investors or very high net worth individuals. Developed country P2Ps allow investors to play the role of a small bank. Investors use their own "deposits" to build individualized loan portfolios according to their personal risk preferences, and social and financial criteria. Developing country P2P's offer investors the chance to invest directly in international micro, small and medium businesses, a sector which has not been accessible in the past, and most provide some level of discretion over which borrower an investor is financing. As investment minimums are so small (as little as $10 to $20), investors are able to diversify their portfolios significantly, especially on sites with high volumes of transactions and large numbers of borrowers. Some sites such as Prosper, Zopa UK, LendingClub (www.lendingclub.com) and soon MyC4 even have mechanisms which allow investors to delegate their investment choices to automated tools on these sites based on a set of pre-established criteria. In addition, many sites also offer higher expected rates of return than investors might receive when trusting a bank to make similar investments with their savings accounts or CDs, albeit at what is arguably a greater risk.

Democratizing Borrower Access to Finance

Both domestic and international P2P lending platforms provide borrowers with new sources of financing. Direct P2Ps allow borrowers to directly appeal to individual lenders and hopefully receive a loan that better meets their financial needs, while Intermediary P2Ps and MicroPlace increase their partners' ability to serve their local communities, populations traditionally ignored by the formal banking sector. Increasing access to finance is one of the main goals of P2Ps in developing countries and anecdotal evidence indicates that there has been progress towards reaching this goal. For example, RangDe (www.rangde.org) boasts that one of its partners in India has expanded into rural areas previously thought to be unsustainable because of high costs of funds. In addition platforms such as MyC4 and Investors Without Borders (www.investorswithout borders.wordpress.com) are providing access to finance to small and medium-sized enterprises in developing countries, which are often considered to fall into the "missing middle" in financing.[1] They are largely excluded from the formal financial sector because they are informal or too risky for banks, yet MFIs generally do not offer products or services appropriate for their greater financing needs. Given much of economic growth and job creation in developing economies comes from the SME sector, improving access to finance for these businesses can help not only the individual entrepreneurs but overall development and poverty alleviation goals in a country.

For developed country oriented platforms it is less clear to what extent P2Ps are "democratizing" access to finance rather than just providing alternative sources of finance. There are surely some individuals who are able to borrow through a P2P who would not be able to take out a loan from a bank or credit card company, but because most of these platforms require a minimum credit score of borrowers, they exclude many potentially credit worthy individuals who lack a credit history. The current credit crisis in the United States could potentially lead a greater number of people with good credit histories to the P2P marketplace as banks close their doors to all but the strongest clients.

P2P platforms also have the potential to benefit borrowers by reducing interest rates on loans. Direct P2P sites, which directly connect lenders and borrowers are cutting out the role of the middle man and avoid costly fees to intermediaries. The auction system used by many models to determine borrower interest rates further encourages rate reductions. In the Intermediary P2P Model which is prevalent in developing countries, however, we have yet to see a significant impact on borrowers in the form of cheaper funds. One of the main reasons for this is that many such platforms do not monitor or limit the spreads between funding and lending rates charged by their local partners. Intermediaries end up with large margins ranging broadly from 20% to over 50% per annum, which seem excessive even to cover the high cost of making microfinance loans. For those intermediary platforms that allow borrowers and investors to bid on interest rates, there appears to be room for a greater rate reduction. A market study conducted by MyC4, revealed that despite the often high fees charged by its local

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[1] Sanders, Theirry and Wegener, Carolien. "MESO Finance: filling the financial service gap for small businesses in developing countries", NDCO, September 2006, available at http://www.bidnetwork.org/artefact-40006-en.html.

partners, loans originated on MyC4 usually offered the cheapest or second cheapest funding available to these types of business in the countries.

Impact on the Microfinance Industry

Perhaps one of the greatest benefits of P2P platforms for the microfinance industry has been their ability to reach out to new and diverse demographics to raise not only funds, but awareness of microfinance and its need to strive for universal access to finance. P2P platforms such as Kiva, MicroPlace and MyC4 have been featured on shows like Oprah and CNN and in publications like the Financial Times and Time magazine. For MFIs and other MSME lenders the growing success of the P2P marketplace offers an opportunity to increase access to capital and diversify funding sources by attracting a new investor class of small, socially motivated investors. Combined, Kiva, MyC4, and MicroPlace have channeled nearly $60 million towards the microfinance industry. Funds from P2P platforms may also prove to be more inelastic during financial and credit crises, as retail platforms tap into a different investor base, that balances social and financial return objectives. In addition, the availability of lower cost funds through P2P sites may allow mission driven MFIs that lend to poorer clients to continue their efforts without needing to drift toward more profitable larger loans and larger clients. Their ability to tap into new socially oriented funds including P2P platforms may be the difference between success and failure over time.

However, the sustainability of P2P platforms as a consistent and long term funding source for microfinance institutions has yet to be proven. P2P lenders often base their decisions on personal preferences and can be fickle. As funding from P2P platforms match the short-term tenor of the underlying client loans, changes in investor preferences can present liquidity challenges for MFIs whose P2P funding represents a large percentage of their portfolio. In addition, it is important to note that there are often hidden costs to MFIs of P2P funding which are not always taken into consideration, such as the time spent posting loans and creating specialized reporting and monitoring processes. One Kiva client estimated that these non-direct costs amount to approximately 5% of the total amount of loans funds. While still cheaper than most commercial microfinance investment funds, these costs should not be overlooked.

Issues and Constraints to Scalability

Reaching scale in a nascent industry is never easy and both the domestic and the international P2P markets face substantial challenges to their growth. Despite the rapid growth posted by many of the P2P platforms interviewed for this research, none have yet reached sustainability or break-even. Non-profit platforms such as Kiva and RangDe have based their business plans on the assumption that donations will grow, but face the risk that donors will grow tired of these platforms as their novelty wanes. They have yet to develop a model to ensure a reliable revenue or donation stream. Both non-profit and for-profit P2P platforms also face challenges in finding the right message and breadth of product offering for investors, creating the necessary local partnerships, dealing with complex regulatory environments, and ensuring transparency at the borrower, investor and public levels. In addition, platforms that cross international borders face additional political and currency risks.

Marketing has been a constraint to growth for younger P2P platforms which have not yet gotten the traction they need with investors to quickly fund loans. Access to affordable marketing channels and finding the right message for the targeted investor segment are important. MicroPlace's model, for example, does not provide the same kind of personal connection between investors and borrowers as those sites where investors lend directly to borrowers; thus the message used to attract investors must also be different. By offering real returns on investments versus zero-interest loans, platforms like MicroPlace, will attract a different type of investor, one focused on the social return but also attracted to the diversification potential of the platform. Platforms are also realizing that one key to achieving greater scale is to offer a greater variety of products. Many platforms are considering offering shorter-term or more liquid products; others are considering a greater range of potential returns or investments in complementary new sectors. While most platforms continue to have greater demand for loans than supply of investor capital, many Intermediary P2Ps also expressed supply side concerns to growth, specifically finding and screening the right local partners. More than once, Kiva has completely sold out the loans on its site because of unexpected increases in investor demand and the time require for partners to post new, relatively small, loans.

Transparency is a major issue which threatens the growth of the P2P lending industry, specifically finding a balance between protecting the privacy of borrowers and the interests of lenders. There is an inherent asymmetry of information in any lending relationship, only the borrower truly knows whether or not they plan to repay the loan. This asymmetry is amplified in P2P lending where borrower and lender do not meet in person and where information provided by the borrower is often not checked. P2P platforms also have a need and perhaps an obligation to be as transparent as possible themselves. Specifically, they need to be transparent about the interest rates charged to end borrowers in order to avoid borrower or investor outrage in the future. The majority of platforms charge origination and facilitation fees to borrowers, which increases the real cost of their loan, and when intermediaries are involved, they often also charge high fees for sourcing, posting and managing the loan. Thus a 0% interest loan on Kiva may ultimately cost the borrower 30%, 40% or even 50% annually.

Regulatory issues are a constraint for nearly all of the P2P platforms interviewed for this study. While P2P lending is not a new phenomenon, the formalization of P2P lending is, and most countries have not determined the government's role in regulating this industry. Because the regulatory environment differs in each country, it is also difficult to replicate a given model exactly in other countries. For international P2P platforms, the regulatory environment can be even more complicated. Platforms must abide by lending regulations within their home countries as well as in those countries where they have borrowers or lenders. In addition, platforms must comply with restrictions on capital flows between countries and withholding taxes where applicable. The complexity of these regulations requires significant spending in legal counsel and if not addressed could drastically inhibit the international P2P industry's ability to achieve scale.

Conclusion

The potential for scale and growth of the P2P model is immense. Many of the platforms have been designed in such a way that they allow for a multitude of products and services to be transacted through the sites. Prosper is working on a shorter maturity product to make payday loans a feasible product for the site. MyC4, the Denmark based platform targeting MSMEs in Africa, is considering opening a secondary market for loans which would make the sector more liquid and more appealing to a larger range of investors. They are also considering expanding into a marketplace for equity in the future. Such a product would open up and democratize a whole new asset class-private equity- that was previously reserved for the "elite" , and has the potential to put much needed seed capital into the hands of entrepreneurs, reinvigorating the SME sector. The MicroPlace platform is already being used for other social finance sectors such as low-income housing, and because of the model it employs, it would be easy to leverage for other asset classes such as equity and for other sectors such as renewable energy and healthcare. New online platforms have also recognized the potential of using the concept of social networking to make markets more efficient. PeerFX (www.peerfx.com) in the US and Canada provides travelers with a venue for exchanging currencies. Partizipa (www.partizipa.com) in Spain and Valuna (www.valuna.de) in Germany offer retail investors the opportunity to invest directly in businesses, or peer-to-company investing. P2P platforms can also provide a valuable venue through which borrowers and lenders can interact. Such interaction not only facilitates loans or investments, it can also lead to the creation of business relationships and opportunities.

While the P2P lending space has shown signs of quickly adapting to market changes and to broadening access to financial intermediation for both borrowers and lenders, it is still a nascent industry and has yet to demonstrate fully its potential for scalability. Constraints including regulatory hurdles, limited and inconsistent transparency of information, and marketing challenges are significant, and could stifle industry growth. The current credit crunch and complex environment for financial services worldwide will likely test these models and provide greater clues as to whether the democratization of financial intermediation is really a click away. Three years ago, borrowers in many countries had relatively easy access to credit, and as the recent credit crisis has shown, it was more than they could handle. The ensuing credit crunch and the burden of existing debt on families in the United States, for example, have likely attracted many borrowers to the P2P marketplace. Nonetheless, lenders have adjusted to the credit crisis, even on P2P platforms, where many lenders are now favoring less risky, higher rated borrowers. While the P2P market has not completely shut out riskier borrowers, lenders are demanding higher interest rates. It is not clear whether this marketplace will provide any relief for some of the casualties of the credit crisis. However, it is encouraging to see signs that the model incents prudent lending behavior that adapts to market conditions and risk perceptions.

Microfinance Oriented Platforms

dhanaX (India)
www.dhanax.com

Globefunder (India)
www.globefunder.in

Investors Without Borders
www.investorswithoutborders.wordpress.com

Kiva (Global)
www.kiva.org

MicroPlace (Global)
www.microplace.com

MyC4 (Africa)
www.myc4.com

RangDe (India)
www.rangde.org

Selected Developed Country Platforms

Boober (Netherlands)
www.boober.nl

Cashare (Switzerland)
www.cashare.ch

Igrin (Australia)
www.smava.de

LendingClub (United States)
www.lendingclub.com

Prosper (United States)
www.prosper.com

Smava (Germany)
www.smava.de

Zopa (United Kingdom)
www.uk.zopa.com

Zopa (United States)
www.us.zopa.com