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Emerging Trends in P2P Lending and Merchant Cash Advance

October 1, 2014

Katten Muchin Rosenman LLP
525 West Monroe Street, Chicago

4:30–5:00 p.m. Registration
5:00–7:00 p.m. Presentation
7:00–8:00 p.m. Cocktail Reception

Panel topics include:

- **Merchant Cash Advance (MCA): Mechanics and Investment**
- **P2P Lending: Mechanics and Investment**
- **Regulatory Checklist for MCA and P2P Business**

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David P. Aidi

Managing Director | Atalaya Capital Management LP

Claudia Callaway

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Brendan Carroll

Partner | Victory Park Capital Advisors, LLC

Chris DiAngelo

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Conor French

Associate General Counsel | Funding Circle

Christina J. Grigorian

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Mark R. Grossmann

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Howie Schickler

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ATALAYA
CAPITAL MANAGEMENT LP

DAVID P. AIDI

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For most of the past 11 years, David Aidi has worked for alternative asset managers focused on private lending, private structured transactions, high yield bonds, bank debt, real estate, private equity, and joint ventures.

Since joining Atalaya in 2010, David has been focused on the origination and secondary purchase of credit assets across multiple asset classes, with an emphasis on specialty finance. Prior to joining Atalaya, David was Portfolio Manager in charge of the Direct Lending Group at Magnetar Capital, an $8+ billion multistrategy hedge fund based in Evanston, Illinois, where he was a member of the firm-wide Investment Committee and a Board of Directors member for numerous portfolio companies. Prior to joining Magnetar, David was a Corporate Analyst at D.B. Zwirn & Co., a spin-off of the Special Opportunities Group of Highbridge Capital Management, a $20+ billion hedge fund based in New York where he began his investing career. David began his professional career at Merrill Lynch, where he initially worked while pursuing his BS degree. He started in the High Yield Capital Markets Group in 1999, and from 2000 to 2003 was a member of the Telecommunications, Media and Technology Investment Banking Group.

David earned a BS in Business Administration, *summa cum laude*, from the Stern School of Business at New York University, where he was the recipient of a merit scholarship. He graduated in the top one percent of his class, received the Jules Backman Economics Award for the top graduating senior in Economics, and was a member of the Beta Gamma Sigma honorary society. David is a current member of the NYU Young Alumni Leadership Council.

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Practices

FOCUS: Consumer Finance Litigation

Financial Services Regulatory and Compliance

Privacy and Data Security

Advertising, Marketing and Promotions

Appellate and Supreme Court Litigation

Class Action and Multidistrict Litigation

Financial Services Litigation

Banking and Finance Litigation

Litigation and Dispute Resolution

Industries

Financial Institutions

Education

JD, Georgetown University Law Center

BA, Bryn Mawr College

Bar Admissions

Maryland

District of Columbia

Claudia Callaway is chair of Katten's Consumer Finance Litigation practice and co-chair of the Class Action and Multidistrict Litigation practice.

She focuses her practice on the defense of state and federal class actions regarding consumer protection and consumer finance laws and representation of clients before the Consumer Financial Protection Board (CFPB), the Federal Trade Commission (FTC) and state banking agencies.

Claudia represents consumer lenders, third-party debt collectors and other consumer financial services clients in class action suits and regulatory actions around the country. She frequently handles cases involving the Dodd-Frank Act, the Truth in Lending Act (TILA), the Equal Credit Opportunity Act (ECOA), the Fair Debt Collection Practices Act (FDCPA), the Fair Credit Reporting Act (FCRA), the Gramm-Leach-Bliley Act and the Federal Trade Commission Act. She advises on state unfair and deceptive trade practices laws, and removal of class actions to federal court under the Class Action Fairness Act (CAFA).

Claudia counsels clients on ways to prevent class action suits before they happen. She provides advice on numerous state and federal banking and consumer protection matters, including privacy, collections, credit reporting and usury issues, and assists clients with the enforcement of arbitration provisions and class action waivers.

In addition to her client responsibilities, Claudia served as an adjunct professor at Georgetown University Law Center and American University Washington College of Law, taught in Georgetown's Criminal Justice Clinic and acted as faculty advisor to the national champion Georgetown Patent & Copyright Moot Court Team.

Memberships

American Bar Association, Business Law and Litigation Sections, Trial Practice Committee

Financial Literacy Project, Co-Founder

Washington Lawyers' Committee for Civil Rights and Urban Affairs, Board of Directors

BRENDAN CARROLL

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Brendan Carroll is a partner at VPC, which he co-founded in 2007. He is responsible for sourcing, evaluating and executing private debt and equity investment opportunities, including assisting portfolio companies with strategic initiatives.

Brendan also manages the co-investment process, fundraising and investor relations. He is a member of the firm's Management and Investment Committees.

Brendan serves as member of the Board of Directors of Victory Park portfolio companies, EMS Holdings I, Inc., Enteris Biopharma, Inc. and VPC Pizza Operating Corp. (Giordano's).

Previously, as a member of the Solutions Group at Magnetar Capital, Brendan specialized in direct financings to lower middle market companies. He has held various investment banking positions at William Blair and Company and Robertson Stephens, specializing in corporate finance and mergers and acquisitions. He has also worked in various capacities for former U.S. Senator Joseph Lieberman (I- CT).

Brendan received a BA with honors in government from Georgetown University and an MBA from Harvard Business School. He speaks frequently on debt and private equity investing issues and has served as a guest lecturer and panelist at the University of Chicago's Booth Global School of Business, Northwestern University's Kellogg School of Management and Harvard Business School. Brendan is also a board member of Loyola Press and Best Buddies Illinois. He is also a member of the Board of Regents at Georgetown University, the Board of Trustees at National Louis University and the Leadership Advisory Council for Cristo Rey Jesuit High School.

CHRIS DIANGELO

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Practices

FOCUS: Structured Finance and Securitization

Structured Products

Commercial Finance

Entrepreneurial Ventures

Affordable Housing and Community Development

Real Estate Finance and Lending

Industries

Automotive

Financial Institutions

Recognition

Chambers Global, 2010, 2012–2014

Chambers USA, 2003–2014

Legal 500, 2013–2014

Super Lawyers, 2007

Best Lawyers in America, 2014–2015

Education

JD, Columbia Law School

MA, The City University of New York

BA, Williams College

Chris DiAngelo is managing partner of Katten's New York office and co-head of the Structured Finance and Securitization practice.

He focuses his practice on structured finance and securitization matters. Chris represents a variety of clients, including issuers, lenders, underwriters and bond insurers, in a wide range of programs and projects involving asset-backed debt, municipal debt, straight corporate debt and equity, warehouse lines, regulatory matters and acquisitions.

Chris's clients describe him as a "significant market player" and say "He has the ability to zero in on the legal and business issues, explain them and then find an appropriate solution," according to *Chambers USA*. Throughout the last decade, he has developed a strong knowledge of housing and mortgage policy reform—including Fannie Mae and Freddie Mac reform—a topic on which he is a frequent speaker. Chris has also spoken on the impact of the Dodd-Frank Act on structured finance.

He is a lead counsel to the Structured Finance Industry Group and outside counsel to a Washington, DC lobbying firm concentrating in financial services matters. Chris has testified before the US House Committee on Financial Services on the issues confronting the commercial real estate market, and frequently appears and provides commentary at industry forums on financial and regulatory matters. He has been recognized in the media as a leader in the field of capital markets and securitization.

Prior to entering private practice, he was on the staff of the New York State Housing Finance Agency, a prominent municipal issuer.

Memberships

Commercial Real Estate Finance Council

Equipment Leasing and Finance Association

New York City Bar Association

Structured Finance Industry Group

CONOR FRENCH

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Conor French is responsible for U.S. legal and regulatory affairs at Funding Circle, the world's largest online marketplace lender exclusively focused on small business.

Funding Circle has raised $123M in equity funding to build an internet-based platform where small businesses can access fast, fair and transparent financing and fixed-income investors can access attractive returns. Prior to joining Funding Circle, Conor served as CEO of Indego Africa, an award-winning social enterprise that creates employment opportunities and sustainable livelihoods for African artisan women through global market access and education. Conor began his career in the corporate department of Latham & Watkins LLP, where he represented public and private companies, investment banks, private equity firms and investors in a wide range of corporate and finance transactions. Conor is a Truman National Security Fellow, a founding member of the *Alliance for Artisan Enterprise*, and a member of the International Institute for Strategic Studies. He serves on the Board of Directors of NYU Law's Alumni Association and on the NYSBA's Committee on Attorney Professionalism. Conor received a JD from NYU Law and a BA from Georgetown. He is admitted to the CA, DC, MA, and NY bars.

CHRISTINA J. GRIGORIAN

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Practices

FOCUS: Financial Services

Banking

Financial Services Regulatory and Compliance

Privacy and Data Security

Consumer Finance Litigation

Industries

Financial Institutions

Education

JD, University of Maryland Francis King Carey School of Law, with honors

MA, The George Washington University, with honors

BA, The George Washington University

Bar Admissions

Maryland

District of Columbia

Memberships

American Bar Association

Bar Association of the District of Columbia

Maryland Bar Association

Christina J. Grigorian works with clients in all matters related to banks, bank holding companies, and state and foreign-licensed consumer and commercial lenders.

She counsels the firm's financial institution clients concerning structural and operational issues, including legislative developments impacting such operations, and has worked with companies and individuals in the establishment of de novo entities, such as national banks, federal savings banks and state-chartered institutions, as well as state-licensed lenders. Christina guides clients with respect to state and foreign licensing regulations and applications. She is experienced in electronic payment networks, network processing and network participation agreements, and innovative uses of electronic funds transfers in areas such as state-funded childcare provider reimbursements. Christina also advises numerous clients in the area of credit card operations, including private label card agreements and consumer documentation, and has extensive experience with issues related to Internet commerce, addressing Internet lending and sales.

Christina counsels clients on issues related to compliance with the USA Patriot Act, the Bank Secrecy Act and the regulations set forth by the US Office of Foreign Assets Control. She has advised clients with respect to regulatory review of financial institutions and has counseled numerous financial entities on compliance issues raised during and after supervisory agency review. She has additionally advised investors in transactions involving Native American tribes.

While attending law school, Christina served as the editor in chief of *The Business Lawyer*, a joint publication of the University of Maryland School of Law and the American Bar Association Section of Business Law. She was also a quarterfinalist in the Morris B. Myerowitz Moot Court Competition in 1996.

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Practices

FOCUS: Corporate

Mergers and Acquisitions

Securities

Entrepreneurial Ventures

Private Equity

Private Funds

Pharmaceutical and Life Sciences Litigation

Landlord Litigation and Counseling

Industries

Automotive

Aviation

Energy

Fashion

Financial Institutions

Health Care

Retail Landlord

Technology

Recognition

Best Lawyers in America, 2014–2015

Legal 500, 2014

Education

D, Loyola University Chicago School of Law, *magna cum laude*

BBA, University of Wisconsin

Mark R. Grossmann is national head of Katten's Corporate practice and a member of the firm's Board of Directors.

He concentrates on mergers and acquisitions, corporate financings and restructuring transactions, representing and counseling private equity funds, as well as institutional and entrepreneurial corporate clients in the technology, manufacturing, consulting, real estate, retail, parking, pharmaceutical, security and health care industries.

Mark represents acquirers and targets in mergers and acquisitions, as well as issuers and investors in equity and debt financings and recapitalizations. Notably, he represented Standard Parking (now SP Plus) in its acquisition of Central Parking in 2012. The transaction conjoined the largest and the second largest parking management companies in the country, more than doubling Standard Parking's holdings.

Mark's clients say he has a "superior knowledge of the legal issues, a keen understanding of the important business points and a direct, firm, yet cooperative approach with the counterparties." They admire his "absolute dedication to getting the deal done correctly."

In addition to mergers and acquisitions and financing transactions, Mark works closely with the management of companies in transactions including the establishment of manufacturing and distribution partnerships and agreements and corporate compliance issues.

Bar Admissions

New York

Illinois

Court Admissions

US District Court, Northern District of Illinois

Memberships

Association for Corporate Growth

Green Acres Country Club Northbrook, Executive Committee

Public Allies Chicago, Board of Directors

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Practices

FOCUS: Structured Finance and Securitization

Structured Products

Private Equity

Private Funds and Investment Management

Industries

Automotive

Financial Institutions

Education

JD, New York University School of Law

BA, The George Washington University, *magna cum laude*

Bar Admissions

New York

Memberships

American Bar Association

New York State Bar Association

Howard Schickler represents a multitude of participants in the structured finance market, including issuers, underwriters, credit enhancers, lenders and borrowers.

With more than 20 years of experience, Howard handles structured finance transactions across a variety of asset classes, including mortgages, home equity loans, auto loans, equipment leases, credit card receivables, franchise loans, health care receivables, trade receivables and royalties. His practice ranges from debt to equity structures, private to public issuances, warehouse lines to residual financings, and domestic to cross-border transactions involving both existing assets and future flows.

Much of Howard's work occurs at the intersection of private equity funds and structured finance and involves assisting private equity funds in securitizing residential mortgage loans, auto loans, equipment leases and other consumer loans. His vast corporate finance experience includes work on public offerings, private and subordinate debt offerings, joint ventures, private equity funds, restructurings and workouts.

THOMAS M. WELCH

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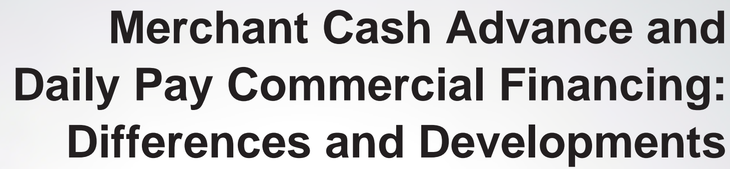
Tom Welch joined VPC in 2009 and is a vice president. He is primarily responsible for sourcing, analyzing, executing and management of direct private debt and equity investments in lower middle market companies in the Specialty Finance and Industrials sectors. Tom also actively works on value creation initiatives and strategic alternatives for VPC's investments.

Previously, Tom served as a credit underwriter in the cash-flow lending group for CapitalSource, concentrating his investment efforts in the industrials, consumer products and business services industries. He also worked in the Global Multi-Industries Investment Banking Group at Merrill Lynch, focusing on mergers and acquisitions, leveraged finance and growth capital transactions.

Tom received a BS in finance with honors from the University of Illinois. He is also a member of Chicago Professionals for Youth, which connects urban scholars with young professionals to provide one-on-one mentorship throughout the college process.



Emerging Trends in P2P Lending
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- Claudia Callaway – Chair, Consumer Finance Practice
- With M&A Group and Securitization Practice, Represent Merchant Cash Advance Providers and their Capital Sources
- *Captain Bounce v. BFS*

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What Is a Merchant Cash Advance?

- Emerged in mid-‘90s
- Financing option for small and mid-sized businesses in need of working capital
- “Not a loan*”
  - No personal guarantee*
  - No liens or collateral*
  - No fixed payment schedule*
  - No absolute obligation to repay (buyer assumes the risk of business failure)*

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How Does a Merchant Cash Advance Work?

- *Business Factoring*
- Merchant cash advance provider purchases specific amount of card receivables from the business at a discount and receives a small percentage of the owner’s daily future credit and/or debit card receivables
- Each time a sales transaction is made, a percentage of the card receivables is forwarded to the cash advance provider or purchaser until all of the purchased receivables are forwarded to advance provider
- Repayment follows the owner’s revenue trend, and is directly related to the success of the owner’s business

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How Is Daily Pay Commercial Financing Different from an MCA?

- *Extremely* different
- Daily Pay Commercial Financing is a loan, repaid on each business day by an agreed upon ACH amount
- Litigation risk differs between models
- Sophisticated capitalization structures for select providers (VCs, Hedge Funds, etc.)

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Litigation: MCA v. Daily Pay Commercial Financing

- "Factor" v. Loan
  - *Contract Language*
  - *"Recourse"*
  - *Practices*
- State Law: License Required?
- Commercial v. Consumer
  - *Who is the Seller/ Borrower?*

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What Is the Current State of MCA v. Daily Pay Commercial Financing?

- Market interest in both products
  - Seeing many traditional MCA companies add loan product to portfolio of offerings
- Fine-tuning of contracts as a result of litigation
- Significant interest from capital sources

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"Peer to Peer" Lending: How It Works in the United States

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- Conor French, Associate General Counsel
- Funding Circle is the world's leading online small business loan marketplace
- $600M lent to date to over 5,000 small businesses
- This year, we plan to lend over $550M globally, with $80M of that lending in the US
- Founded in 2010, we have raised $123M in equity funding
- Growth from 12 employees in our US office this time last year to 70 now

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Benefits of P2P: *Building a Better Financial World*

- P2P platforms allow individuals or small business borrowers to obtain aggregated capital from investors from the platform
- For Borrowers:
  - Improve access to fast, fairly-priced capital for borrowers with few other financing options
  - Enable borrowers to refinance / avoid higher-rate debt
- For Investors:
  - Provide fixed income investors with access to a new asset class
  - Offer attractive, risk-adjusted returns

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“Peer to Peer” in the US … *Isn’t*

- In prior decade, entrepreneurs sought to create “peer to peer” marketplaces in the United States
- Regulators said “not so fast”
  - Who is the lender?
  - Is the lender licensed?
  - Does the interest rate comply with applicable law?
  - Is it a security?

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Current *Commercial* Model

- Lender makes loan directly to a small business
- Lender must comply with all applicable state licensing and lending law*
- Institutional investors may purchase the whole loan
- Accredited investors may (i) purchase a loan payment dependent security or (ii) invest in a pooled vehicle of whole loans and/or securities
- Lender services the loan
- Investor receives P&I (net of servicing fees)

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Current *Consumer* Model: Securitized Bank Loans

- Federally-insured bank can export its home state interest rate on all* consumer loans
- Consumer borrower gets loan from bank
- Bank hires third-party marketer to advertise loans and to find "investors"
- Fund purchases loans
- "Investors" open investment accounts or IRAs with the fund

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How P2P Works

- Lender/marketer screens and scores creditworthy borrowers who list their loan request
- Investors review loan listings and invest in those that meet their criteria
- Borrowers make fixed monthly payments and investors receive their share directly to their investment account

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What Is the Future of P2P?

- Litigation
- Regulatory scrutiny
  - Prudential regulators
  - CFPB (for *consumer* P2P loans)

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Daily Pay Commercial Financing and P2P Lending: Regulatory Considerations

Emerging Trends in P2P Lending and Merchant Cash Advance

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DPCF and P2P: Regulatory Considerations

- MCA v. P2P Lending: Critical Traits and Differences
- Merchant Cash Advance:
  - Regulatory Checklist
- P2P Lending:
  - Regulatory Checklist
- Q & A

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DPCF v. P2P: Critical Traits and Differences

- DPCF
  - Commercial, not consumer
  - MCA: Purchase of receivables (“factor”), not loan/credit; non-recourse
  - Loans: Licensing?
- P2P
  - Consumer loan
  - Usury/interest rate considerations
  - Security law considerations
  - Broker?
  - BSA/AML

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Daily Pay Commercial Financing: Regulatory Checklist

- Contract Language
- Commercial or Consumer?
- UCC Filing?
- Non-Recourse (MCA) or Recourse (Loan)?
- Guaranty / “Bad Actor” Provision?
- Default/Breach of Contract?
- Governing Law?
- Arbitration Provision/Class Action Waiver?
- *Licensing/Model Difference?*

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P2P Lending: Regulatory Checklist

- P2P LENDERS
  - Federally-insured financial institution (bank): interest rate exportation/uniform contract
  - Non-bank: consumer loan licensing/state-by-state contract
  - Arbitration Agreement/Class Waiver
- INVESTORS/CAPITAL SOURCES
  - Securities registration
    - Accredited
    - Disclosures
    - Contract
  - Arbitration Agreement/Class Waiver

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Katten is a full-service law firm with approximately 650 attorneys in locations across the United States and in London and Shanghai. Clients seeking sophisticated, high-value legal services turn to us for counsel locally, nationally and internationally. The firm's core areas of practice are corporate, financial services, insolvency and restructuring, litigation, real estate, environmental, commercial finance, intellectual property and trusts and estates. Katten represents public and private companies in numerous industries, including a third of the Fortune 100, as well as a number of government and nonprofit organizations and individuals.

STRUCTURED FINANCE AND SECURITIZATION

Our Clients

Katten's Structured Finance and Securitization team advises clients in a wide variety of transactions, including securitizations of consumer receivables—such as auto loans and residential mortgages—and commercial receivables—such as equipment leases, corporate loans and commercial mortgages.

We represent all market participants, from issuers, underwriters, placement agents and collateral managers to investors, swap counterparties, trustees, credit enhancers and servicers in industries including aircraft, mortgage, automobile and health care. Our attorneys also provide general corporate and transactional advice to specialty finance companies, government agencies and banks.

Our Services

Katten attorneys structure, negotiate and draft all types of structured finance transactions in most asset classes, from the country's highest-volume programs in the consumer and commercial finance industries to esoteric and one-off transactions, including lottery receivables, municipal receivables, renewable energy, refund anticipation loans, single-family rental programs and timeshares. We work with clients on term and revolving asset-backed facilities, commercial paper conduits, structured product transactions, real estate mortgage investment conduits (REMICs), and correspondent and warehousing transactions. Our experienced team advises on residential mortgage-backed securities (RMBS), collateral loan obligation (CLO) structures, commercial mortgage-backed securities (CMBS), jumbo loans, repurchase agreements, other credit facilities, non-performing loans and rentals, and provides counsel on commercial- and asset-backed representations such as trade receivables, energy finance, purchase facilities and transportation. We guide clients through specialized financing products such as reverse mortgages, non-US mortgages, future flow credits and securities guaranteed by the Overseas Private Investment Corporation (OPIC) and the Federal Deposit Insurance Corporation (FDIC). Clients seek our counsel on transactions outside the United States, in Latin America, the Middle East and Asia.

We address federal and state regulatory matters and issues involving captives, independents and banks. We are well versed in project finance deals, including ship and maritime finance; energy, port, road and airport finance; commodities deals, including the monetization of inventory and creation of hedging instruments for crude, refiners, metals and minerals; and trade finance, including the creation of innovative receivables purchase facilities and loans secured by receivables. By staying informed on regulatory issues such as Regulation AB and the Dodd-Frank Act, and accessing our relationships with key decision makers in Washington, DC, our Structured Finance and Securitization attorneys create groundbreaking solutions to novel business challenges.

Our Experience

- Representation of a captive auto finance company on all of its US securitization and structured finance transactions, including:
  - over 35 publicly registered and Rule 144A issuances of asset-backed securities backed by retail auto loans, retail auto leases and dealer floor-plan finance loans, totaling more than $45 billion;
  - over 25 warehouse or committed finance facilities with financial institutions for retail auto loans, retail auto leases, dealer floor-plan finance loans and dealer mortgage loans;
  - over 15 transactions for the company's single-seller commercial paper conduit, totaling more than $20 billion, together with maintenance of the conduit's liquidity facility with more than 40 financial institutions;
  - over 10 cross-border Rule 144A offerings of asset-backed securities issued by the company's Canadian and German affiliates;
  - a first-of-its-kind program involving the issuance of revolving asset-backed securities that were mandatorily exchangeable into unsecured corporate debt of the company when it achieved an investment grade rating; and
  - a committed purchase facility for dealer floor-plan finance loans in the People's Republic of China for the company's Chinese affiliate.
- Representation of several specialty finance companies on their securitization and structured finance programs involving sub-prime auto loans, including publicly registered and Rule 144A issuances and warehouse and committed finance facilities with financial institutions.
- Representation of a lender and borrowers in multiple "REO to Rental" senior secured facilities, with one of the transactions being only the second of its type to involve a bank financing that required mortgages on all financed properties with a view toward securitization of these assets.
- Representation of a rating agency in the first securitization of "REO to Rental" assets.
- Representation of an investment fund in connection with the creation and operation of an opportunity fund to invest in distressed RMBS.
- Counsel to a government-sponsored enterprise in connection with its REMIC program and related mortgage-backed securities issuances.
- Counsel to a government-sponsored enterprise (GSE) in connection with its credit risk transfer initiative.
- Counsel to a government-sponsored enterprise in connection with a reverse mortgage securitization designed to reduce the GSE's loss exposure and improve liquidity.
- Counsel to a government-sponsored enterprise in connection with a series of transactions in which loans in the GSE's existing securitizations were re-securitized in such a way as to reduce its exposure to losses on the loans.
- Counsel to a specialty finance company in connection with the establishment of a new, small-ticket leasing company and the acquisition by the company of an existing lease portfolio and related assets from a bank exiting the business. The company later securitized the portfolio.
- Counsel to the financial services arm of a multinational automotive corporation in connection with the establishment of an automobile lease origination platform, set-up of the associated lease securitization facility and the issuance of the first asset-backed notes under the facility.
- Representation of a captive finance company in a Rule 144A term securitization backed by construction equipment and heavy duty truck receivables.
- Representation of an asset management company in connection with a performing/non-performing residential mortgage loan securitization of multiple pools of loans. Served as counsel to the sponsor, depositor and issuer.
- Representation of a commercial financial services firm in connection with a series of transactions in which a factoring company was recapitalized and all of its debt facilities with six different groups of lenders were renegotiated to account for accounting and tax changes.
- Representation of an investment bank in connection with the establishment of a new repo platform to finance FHA and VA loans originated by various originators in connection with GNMA securitizations.
- Representation of a specialty life, accident, and health reinsurer in connection with its deployment of state-specific reserves in permitted investments through customized issuances via a Delaware series trust.
- Representation of a Canadian financial institution on multiple cross-border Rule 144A offerings of asset-backed securities backed by credit card receivables.

- Representation of initial purchasers, collateral managers and investors on broadly syndicated and middle-market CLO transactions, both domestically and in the European market.
- Representation of investment banks, corporates and funds on various commodity transactions, including highly structured long-term hedging arrangements, commodity monetization structures and securitizations of commodity repo.
- Representation of initial purchasers, corporates and investor groups on various Latin American securitization/monetization transactions, including project bonds, structured sovereign bond offerings and mortgage-backed securities.
- Representation of investment banks and originators on various structured insurance transactions, including life settlement securitizations, premium finance securitizations, catastrophe bonds, longevity/morality trades and triple-x transactions.

OUR CLIENTS SAY...

"Their turnaround times are amazing and they are always available."

Chambers USA 2013
(Capital Markets: Securitization)

- Representation of private equity funds and hedge funds in connection with asset-backed financings, asset-based financings, acquisition financings, and whole loan sales and acquisitions in both the consumer finance industry and the commercial finance industry.

Our Honors

- *Asset-Backed Alert*
  - Top Five Issuer Counsel – 2014, 2013
- *Chambers Global 2014, 2013*
  - Capital Markets: Securitization (USA)
- *Chambers USA*
  - Capital Markets: Securitization (Nationwide) 2014, 2013
- *The Legal 500 United States*
  - Finance – Structured Finance – 2014, 2013
- *U.S. News – Best Lawyers®* "Best Law Firms"
  - Securitization and Structured Finance Law (National, Chicago, New York) 2014
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LITIGATION AND DISPUTE RESOLUTION

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We represent public and private companies and other business organizations in every major industry in cases ranging from contract disputes and regulatory matters to class action lawsuits, antitrust matters and other complex commercial and criminal litigation.

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CONSUMER FINANCE LITIGATION

Our Clients

Katten litigates in courts and regulatory bodies around the country and provides corporate, regulatory and transaction counseling for all sectors of the consumer finance industry.

Our clients include all types of consumer lenders and their related servicers, including installment lenders, collection agencies, payday lenders, check cashers, credit services organizations (CSOs), state- and federally chartered banks, mortgage servicers, credit card issuers, auto lenders, lead providers, risk assessment and identity verification providers and credit reporting agencies. We also represent members of the health care industry, including service providers, in consumer finance-related litigation.

Our Services

Katten has extensive experience litigating consumer finance class actions in courts around the country. We are deeply involved in the development of new defenses to class claims in light of recent changes in both the law and in industry practices relating to consumer finance documentation, including the proper and effective use of arbitration and class action waiver clauses. Katten is also at the forefront in assisting clients in the development of consumer financial products and in bringing multiple innovative services to market. With extensive experience in corporate, banking, regulatory and tax law and a thorough, real-time understanding of the regulations and consumer protection laws that affect consumer lenders, our Consumer Finance Litigation team guides clients through the state and federal regulatory framework that surrounds them.

We also regularly defend clients in both state and federal regulatory actions, including matters before the Federal Trade Commission (FTC), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the Consumer Financial Protection Bureau (CFPB). Our Consumer Finance Litigation team includes a former member of the CFPB's general counsel's office. We have successfully represented clients in matters involving unfair and deceptive trade practices, the Fair Debt Collection Practices Act (FDCPA), the Equal Credit Opportunity Act (ECOA), the Truth in Lending Act (TILA), the Telephone Consumer Protection Act (TCPA), exportation of interest rates and questions of jurisdiction over Internet loans.

Whether advising on business formation or handling complex trial work, Katten's Consumer Finance Litigation team collaborates with clients to chart a strategic course that best suits their needs.

Our Experience

- Resolution of consumer class action lawsuits against telecommunications carrier at pleading stages through use of state law demurrers and federal bankruptcy procedures.
- Representation of several large national banks in a series of federal court consumer class actions.
- Representation of Payday Financial, LLC; Western Sky Financial, LLC; and Martin A. Webb in a case of first impression in connection with addressing the question: Where is a loan "made" when a consumer applies for a loan via the Internet from her home state, and the lender is located outside of that state? Here, the US District Court for the District of South Dakota held that the loan was "made" not where the borrower resides, but instead where the lender is located. The case is ongoing; awaiting resolution of remaining issues. *Federal Trade Commission v. Payday Financial, LLC, et al*.
- Representation of Payday Financial, LLC and J. Paul Reddam in a case addressing an issue of first impression. The US District Court for the Northern District of Illinois enforced a forum selection clause designating the courts of the Cheyenne River Sioux Tribe as the exclusive jurisdiction for considering disputes related to a consumer loan agreement where the consumer applied for the loan over the Internet. *Jackson v. Payday Financial, LLC, et al*.
- Representation of Brenda McKenzie and Steve McKenzie in a case of first impression. The Florida Supreme Court sided with Katten's clients, rejecting plaintiffs' argument that an arbitration agreement including a class waiver is unenforceable under Florida law. Reversing the court below, the court determined that Florida law is irrelevant because any such state law rule would be invalid under the US Supreme Court's 2011 decision in *AT&T Mobility v. Concepcion*. In so holding, the court rejected a number of arguments designed to circumvent the Federal Arbitration Act and the *Concepcion* decision. *McKenzie Check Advance of Florida, LLC v. Betts*, Supreme Court of Florida, No. SC11-514 (2013).
- Representation of Title Lenders, Inc. in a putative class action in the Circuit Court for the City of St. Louis, Missouri Plaintiff alleged that although Title Lenders was licensed by the state of Missouri to make small, short-term "payday loans," Title Lenders' practices were nonetheless unconscionable and in violation of the Missouri Merchandising Practices Act. Katten was hired mid-case to try the question of whether the class action waiver contained in Title Lenders' arbitration clause was enforceable. The trial court found that the class waiver itself was inherently unconscionable. On direct appeal, the Supreme Court of Missouri reversed the trial court, and remanded with specific instructions to examine unconscionability again (on grounds that had already been addressed by the trial court).
- Representation of CashCall in a putative class action before the US District Court for the Northern District of Illinois. In a case of first impression, the court dismissed the action in its entirety, and enforced the forum selection clause that designated arbitration by the Cheyenne River Sioux Tribe. In so doing, the court dismissed each of plaintiff's arguments against enforcement of a tribal forum selection clause.

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Divisions of Research & Statistics and Monetary Affairs
Federal Reserve Board, Washington, D.C.

Peer-to-peer lending to small businesses

Traci L. Mach, Courtney M. Carter, and Cailin R. Slattery

2014-10

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Peer-to-peer lending to small businesses

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Abstract

The current paper examines loan-level data from Lending Club to look at peer-to-peer borrowing by small businesses. We begin by looking at characteristics of loan applications that were and were not funded and then take a more in-depth look at funded applications. Summary statistics show an increasing number of small business loan applications over time. Beginning in 2010—when consistent measures of loan purpose were recorded for all applications—loan applications for small businesses were on average less likely than loans for other purposes to have been funded. However, logistic regression results that control for the quality of the application show that, holding all else constant, applications for a loan for a small business were almost twice as likely to have been funded than loans for other purposes. Focusing on funded applications, we note that funded business loans were slightly larger on average than loans funded for other purposes but paid similar interest rates. However, relative to small business loans from traditional sources, peer-to-peer small business borrowers paid an interest rate that was about two times higher. Regression results that control for application quality show that peer-to-peer loans for small businesses were charged almost a percentage point interest rate premium over non-business loans. Logistic regression results that look at loan performance indicate that loans for small businesses were much more likely to be delinquent or charged off.

*The views expressed herein are those of the authors. They do not necessarily reflect the opinions of the Federal Reserve Board or its staff.

Introduction

As distrust and dissatisfaction with commercial banks grew during the recent financial crisis, there was large growth in nonstandard types of borrowing arrangements. One such arrangement that has seen substantial growth in the past five years is crowdfunding —peer-to-peer (P2P) lending, in particular. Crowdfunding arrangements involve groups of individuals, not institutions, providing funding. As the name suggests, P2P loans are generally personal loans. However, small business owners often intermingle their personal and business finances so as overall P2P lending grew, so too did P2P borrowing for small business purposes.

The current paper looks at the individual loan-level data from Lending Club, focusing on those loans that were used by small business owners for their businesses. We begin by looking at the characteristics of loan applications that did and did not get funded. While loan purpose is not one of the criteria taken into account when evaluating loan applications, we find that loans intended for small business purposes were more likely to be funded than loans for other purposes. We then look at the interest rate paid on those loans that did get funded. Again, while loan purpose is not taken into account in assessing the credit quality of the application, loans for business purposes paid nearly one percentage point higher interest rate than other loans, holding borrower characteristics constant. Finally, we look at the loan performance. Our results indicate that loans for small business purposes were more than two-and-a-half times more likely to perform poorly.

The rest of the paper is organized as follows. We begin with a short discussion of crowdfunding and how P2P lending fits into the general crowdfunding framework. Then we look at the small business credit market and examine where small businesses have traditionally gotten their credit and how that may have been more difficult over the recent period. We next take a closer look at the data from Lending Club. The final three sections present our econometric results and the last section concludes.

Crowdfunding

The term crowdfunding has come to represent a spectrum of activities. The underlying idea is that funding that one would typically have to borrow through a bank or other financial institution is gathered from a group of individuals, or "the crowd." This is not a new concept; rotating savings and credit associations (ROSCAs) operate under a similar premise and have been long used in developing countries and within minority communities in the US.[1] However, the growth of the internet has given the concept a boost, allowing for a much larger and diverse "crowd."

[1] A ROSCA is a group of individuals who meet at regular intervals; at each meeting, each member contributes a given sum of money which is then given to a single member at the end of the meeting. Meetings continue until all members have received the lump sum. See Ardener (1964) and Geertz (1962) for a historical perspective on ROSCAs.

There is no longer a need for the individuals in the group to live in close proximity to one another or to actually know each other; crowdfunding sites are proliferating.

Early adopters of the internet for crowdfunding essentially used their websites as fundraisers. In some instances the crowd receives nothing in return, donating the money out of a sense of altruism. This is the model of websites like Kiva and Crowdrise.[2] In other cases, the crowd is essentially pre-buying the good or service being produced. This is the model of websites such as Kickstarter where funders are often given a copy of the book or CD that is being produced.[3] In both models, borrowers do not pay interest to the crowd or specifically repay the funds.

A second form of crowdfunding is equity crowdfunding as laid out in the JOBS Act of 2012.[4] In such cases, rather than receiving interest and principal for their investment, investors receive equity in the business. Prior to the JOBS Act, it was illegal for private companies to publicly solicit investments. It is only recently that the SEC has finalized its ruling making equity crowdfunding legal for accredited borrowers.[5] In an even more recent occurrence, the SEC has proposed rules to allow entrepreneurs to raise capital online with fewer restrictions on who can invest.[6]

The final piece of the crowdfunding pie is debt-based, so-called peer-to-peer (P2P) lending. In P2P lending, the individuals fund small portions of loans and receive their principal plus interest when the borrower repays the loan. The two largest P2P sites are Prosper and Lending Club. Prosper started in 2006 and Lending Club started about a year later.[7] Both websites use a credit score-based model for evaluating investment options. Applicants allow the evaluation of their credit to be translated into a letter grade and investors can then choose how much risk they wish to take on when funding a loan. As in traditional credit markets, higher risk translates into higher interest rates. P2P lending provides funding that might not be available elsewhere and rates are lower than for alternatives, such as payday loans.

Between 2006 and 2008 peer-to-peer lending grew steadily. It hit a snag in 2008 when the SEC determined that their loans should be classified as securities and, thus, regulated.[8] This led both Prosper and Lending Club to put any new loans on hold until they properly registered with the SEC. Both organizations survived the reclassification and moved back onto a path of steady growth.

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[2] For more information, see the individual websites of these companies, http://www.kiva.org/ and http://www.crowdrise.com/.

[3] See http://www.kickstarter.com/.

[4] See http://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act.

[5] See http://www.bizjournals.com/portland/blog/perspectives/2013/09/secs-solicitation-ends-but.html.

[6] http://www.washingtonpost.com/business/on-small-business/sec-introduces-unanimously-approves-crowdfunding-proposals/2013/10/23/f5709630-3bee-11e3-b6a9-da62c264f40e_story.html

[7] See https://www.prosper.com/ and https://www.lendingclub.com/ for more information on the individual companies.

[8] See http://www.sec.gov/litigation/admin/2008/33-8984.pdf

The steady increase in peer-to-peer lending suggests the potential for much more growth. Currently, Lending Club loans are available to borrowers in all but six states while Prosper is available in all but three states. Investors face greater restrictions. Investors in only 29 states plus the District of Columbia are given access to Prosper. Investors in a slightly different set of 28 states have access to Lending Club.[9] If P2P lending were to become available throughout the rest of the U.S., investment dollars and P2P borrowing could grow substantially.

Small Business Credit

Traditionally, small businesses have been thought to face increased difficulties in accessing credit than do larger businesses. Lending to small businesses is generally considered to be riskier and more costly because small firms have higher failure rates and are more vulnerable to downturns in the economy. Lending to small businesses is further complicated by their informational opacity. Most do not have the detailed financial statements and rarely have publicly traded equity so obtaining reliable information on the creditworthiness of small businesses is difficult. Previous research has found that relationship lending provides a way of mitigating the information problem (Petersen and Rajan 1994, 1995; Berger and Udell 1995; Degryse and Cayseele 2000). Because commercial banks typically provide small businesses many products other than loans, commercial banks are able to use information gathered about the business over a longer term to their advantage in assessing the creditworthiness of small businesses. For these reasons, small businesses are thought to be relatively dependent on commercial banks for loans.

During the recent economic crisis, standards on business lending at commercial banks tightened substantially. These tighter credit conditions for small business lending by banks have eased notably since 2010. Results from the Federal Reserve Board's Senior Loan Officer Opinion Survey on Bank Lending Practices (Figure 1) indicate that lending standards for small borrowers tightened substantially in 2008 and 2009 but loosened in 2010 and 2011. The net percentage of National Federation of Independent Business (NFIB) respondents reporting that credit had become more difficult to obtain, which had remained low by historical standards in the years prior to the financial crisis, rose in 2008 and reached its highest levels on record in 2009 (Figure 2). Since then, it has retraced a good portion of its increases during the financial crisis, but still remains well above pre-recessionary levels.

Coincident with the tightening of standards on lending terms, there was also a large drop in commercial lending by banks (Figure 3). Some of the drop is likely a result of the higher

[9] See http://www.prosper.com/help/investing/
http://www.prosper.com/help/borrowing/
http://blog.lendingclub.com/2011/06/10/is-lending-club-available-in-my-state/

standards, but some of it is also likely attributable to diminished demand from small businesses uncertain about their future. In addition, some of the decrease is likely due to deterioration in the financial conditions of many banks during this period.[10]

Small businesses get their credit from many different sources. Statistics from the 2003 Survey of Small Business Finances (SSBF) indicate that while commercial banks are an important source of finances for small businesses, they are not the only source (Table 1).[11] Nearly 60 percent of outstanding credit to small businesses in 2003 was provided by commercial banks, but finance companies provided over 15 percent, and other sources provided just under 10 percent. The median loan outstanding was $20,000, but this varied with the type of provider, ranging from the median $90,000 outstanding loan from mortgage companies to the median $8,000 outstanding loan from a brokerage or mutual company.

There are also differences in the amount and types of credit used according to the size of the firm. For example, the median loan for firms with fewer than 10 employees was less than $18,000 compared to $40,000 for larger firms. This was true across all different types of lenders. The share of outstanding credit provided by each type of lender was similar across firm size for most types of lenders. The exceptions to this were mortgage companies and other providers; nearly 11 percent of funds for small firms were from mortgage companies and about 5 percent of funds were from other sources compared to 2 percent and about 11 percent of funds, respectively, for larger firms.[12]

Given the downturn in the real estate market, the availability of home equity loans to finance the business may have become more difficult in the recent period. Table 2 provides additional insights into this question. In 2003, business owners reported using personal real estate to collateralize—at least in part—loans for their businesses a fair amount: 15.6 percent of total dollars outstanding and 11.0 percent of all loans used personal real estate as collateral. Among loans from mortgage companies, the shares were even higher, with more than a quarter of outstanding dollars and nearly 60 percent of outstanding loans secured by personal real estate.

Overall, commercial bank lending to small businesses is down in the recent period; while much of this may be due to lack of demand, there is also evidence that traditional routes may have been difficult, especially for the smallest small businesses (Figure 4). Such firms often require small amounts of credit which may not be profitable for commercial banks to lend and may be turning

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[10] Kiser, Prager, and Scott (2012) find that the distribution of banks' supervisory ratings shifted towards worse ratings between 2007 and 2010 and those ratings downgrades were associated with significantly lower rates of growth in small business lending over this period.

[11] While somewhat dated, the data from the 2003 SSBF provide the most current enumeration of small business borrowing from all sources with dollar amounts.

[12] "Other" providers include: venture capital firms, small business investment companies, other business firms, family or other individuals, government agencies, suppliers, credit card processors, check clearing companies, factors, owners, retirement plans and consolidated institutions.

to more alternative sources such as peer-to-peer lending. The impact of such a choice is not clear. Even though such loans may allow the firm to remain in business in the short term the high cost may not be sustainable in the long run.

Data

The current paper is, to our knowledge, the first paper to examine the growing peer-to-peer borrowing among small businesses. In this paper we use data on individual loans and applications from the LendingClub.com website to examine more closely the characteristics of loans that get funded as well as the interest rate paid on those loans. [13] Lending Club makes their data available publicly. The data include borrower characteristics, loan status and payment information of loans that are funded, and details about all of the loan applications that were rejected. Our data set consists of more than 670,000 rejected loan applications and just under 100,000 funded loans.

Both the number of loans and the average dollar amount of loans disbursed through Lending Club has grown tremendously since Lending Club's inception in 2007. Table 3 shows the volume of lending from mid-2007 through 2012. Total loans funded for small businesses grew from about $850,000 in 2007 to over $22 million in 2012. Loans for other purposes grew from just under $4 million in 2007 to nearly $700 million in 2012. The average loan size for small business loans started near $15,000 in 2007 and then fell slightly until 2010. In 2012, the average loan for small business was $16,200. On the other hand, non-business loans grew slowly from 2007 to 2012, from $3,600 to $13,400 for. The interest rate was sometimes higher and sometimes lower for small business loans than loans for other purposes, but they were generally within a percentage point of each other.

Over the entire time span, small business was the sixth most frequently cited loan purpose among funded loans, totaling 3.5 percent of all funded loans. Debt consolidation was the most common loan purpose, accounting for just over half of the total, credit card payoffs follow with about 17 percent, "other" was almost 8, home improvement/purchase is just over 6, and "major purchase" was 3.8 percent. The average amount funded for "other" or "major purchase" is not presented in the table because these categories can encompass a variety of things and is less informative. Comparing small businesses loans to other popular loan purposes, the average amount funded and the interest rates across the groups were comparable, although loans for small businesses were a bit larger on average (Table 4).

Small business and non-business loans had roughly the same rate of rejection, with about 8 percent of all small business loans over the period being funded and about 12 percent of all non-

[13] The data are publicly available at https://www.lendingclub.com/info/download-data.action and are continuously updated. The data used for analysis in this paper were downloaded on August 13, 2013; analysis is restricted to loans issued prior to December 31, 2012.

business loans being funded (Table 5).[14] The rejection rates for small business loans were understated in 2007 - 2009 because it was not until mid-2009 that the rejected and funded loan data sets started to categorize loan purpose in the same way. In order to attempt to correct for this, every rejected entry with a loan description that included the word "business" was designated as a small business loan. Nonetheless, it is likely that many more small business loans than we are counting were rejected in those earlier years. The percent funded in 2012 picked up in both small business and non-business loans, but only by 0.5 percent from 6.8 to 7.3 in terms of small businesses, where it has increased by almost 5 percent for non-businesses, from 9.5 to 14.2.

Figures 5 and 6 break down the number of applications and acceptance rates by state. Not surprisingly, the more populous states had more small business loan applications. However, they did not necessarily have the highest share of small business loan applications that were funded. For example, while Florida was home to more than 4,000 applications for small business loans, fewer than 300 of them were funded. It is interesting to note that funding rates were fairly high in some of the more rural states such as Mississippi and Tennessee, but this may be at least partially explained by the relatively low numbers of applications from these states.

Table 6 provides overall mean and median characteristics of applications according to whether or not the loan was funded. Only 12 percent of all loan applications received by Lending Club over this time period were funded. The applications that were funded were about $1,000 smaller on average than the unfunded requests. The fraction of applicants with less than a year's work experience was quite different in the funded and unfunded applications, with only 10 percent of funded applicants employed for less than a year versus 77 percent of the unfunded applicants. One also saw a sizeable difference in FICO scores, with funded applicants having an average FICO score of 706 versus 636.

As less traditional lending vehicles such as peer-to-peer lending are usually associated with higher interest rates, we are interested to see how the rates that small businesses receive through Lending Club loans differ from those that a small business may receive in a more formal lending setting. Figure 7 and Table 7 explore this by comparing the Lending Club small business lending rate with that reported by National Federation of Independent Business (NFIB) members. NFIB firms are split into two categories, the smallest firms – those with fewer than 10 employees – and larger small businesses, those having 10 or more employees. It is possible that small business owners who are seeking financing through an alternative lending vehicle, such as Lending Club, are less creditworthy and therefore unable to receive financing through a traditional lending institution, such as a commercial bank. As mentioned in the previous section, assessing the creditworthiness of small businesses is difficult, particularly among the smallest businesses. For

[14] The total number of funded small business loans is slightly larger in Table 5 than in Table 3. This is because Table 3 is split by the year or issuance of the loan whereas Table 5 is by year of loan application. There is some lag between application and issuance.

this reason we would expect that the rates for the smallest NFIB firms would be more comparable to the Lending Club small business rates. Although it is the case that the NFIB firms with fewer than 10 employees paid about a 0.5 to 1.5 percentage point higher rate than those with 10 or more employees, the NFIB reported rates were much lower than the Lending Club rates, with the smallest NFIB firms averaging about 7 percent over the period, and the Lending Club small businesses averaging over 5 percent more. Also, the NFIB firms did not experience the spike in late 2009 that the Lending Club small businesses did, which is evident in both the table and the figure.

Figure 5 tracks the mean interest rates on a monthly basis, and although there is volatility from month to month, the Lending Club small business rate fluctuated much more than the NFIB rate. This can be partially explained by the fact that there were fewer observations in the Lending Club data. Also, the NFIB rate has trended slightly downward since mid-2007, when the series began, ending with a 2012 mean rate that is about 3 percent lower than the 2007 mean. The Lending Club rate did not experience this decline, and the small business loan rate averaged about 0.9 percent higher in 2012 than 2007, and about 1.9 percent higher in 2012 than 2007 for non-business loans.[15]

Funded vs. unfunded loan applications

Because some of the variables are analogous between the rejected loan applications and funded loans data sets we are able to do some regression analysis in order to discern some of the determinants of loans being funded, and if small business loan applications were more or less likely to be funded. We estimate a logistic regression, using the following variables:

$$Funded_{i\{0,1\}} = f(SmallBusiness_i, Amount_i, Employment_i, HPI_i, Fico_i, Year_i)$$

Where *i* refers to the individual application. SmallBusiness is a dummy which equals 1 if the application was for a small business loan, and 0 if not. Amount is the amount of money requested in the application, in thousands of dollars, and Employment is a dummy indicating that the applicant had been employed less than a year at the time of application. HPI is the mean of the Corelogic house price index in the state where the applicant resided, indexed such that 100=1, and averaged over the previous year. Fico is the Fico credit scores of the potential borrower at the time of application. Finally, Year represents the year of application, and we include state fixed effects. We estimate the model initially with all time periods. Because the identification of loan purpose is not consistent until 2010 and we are likely to underestimate the share of loans for small business purposes, we estimate the model again using only applications from 2010 forward. Despite the incomplete information in the early years, the results from both models are quite similar.

[15] There are several months in 2008 when there were no peer-to-peer loans for small business when Lending Club was coming into compliance with SEC regulations.

Table 8 presents our results from the model described above, displayed as odds ratios. When controlling for quality of the application, loans were about two times as likely to be funded when they were designated for small businesses. As expected, requesting greater amounts of money decreased the likelihood of a loan being funded; each additional $1,000 requested decreased the likelihood of funding by about 4 percent. Having worked less than a year decreased the likelihood by about 97 percent. Having a higher FICO score positively affected the likelihood of acceptance, with each additional point increasing the odds by about 2 percent. We also see a positive relationship between higher home prices and the likelihood of having one's application accepted.

Interest Rate Paid

Turning to funded loans, we estimate a linear regression on the interest rate paid on the loans.[16]

$$InterestRate_i = f\begin{pmatrix} SmallBusiness_i, Amount_i, Employment_i, HPI_i, Fico_i, \\ Year_i, Population_i, Income_i, Long_i, Home_i \end{pmatrix}$$

SmallBusiness, Amount, Employment, Fico, and Year are defined as in the previous model. HPI is the Corelogic house price index, averaged over the previous 12 months in the county where the applicant resided.[17] Long indicates that the loan agreement was for 60 rather than 36 months, and Home indicates that the borrower owned his/her own home at the time of the application. Population and Income are the population, in thousands of people, and the per capita income, in thousands of dollars in the county where the borrower lived. These county level controls are gathered from data provided by the U.S. Bureau of Economic Analysis.[18] We also control for state level fixed-effects in the regression.

The results of this regression are displayed in Table 9. The results indicate that, all else equal, loans that were for small businesses were charged an interest rate nearly a full percentage point higher than loans for other purposes. Each additional $1,000 requested increased the interest rate by 0.14 percentage points. Having a higher FICO score negatively affected the interest rate paid by borrowers; for each additional FICO score point, the interest rate was 0.09 percentage points lower. The year with the highest interest rates, as seen in the descriptive statistics, was 2009.

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[16] In doing our research, we noticed that interest rate downloaded on different days was not identical for a handful of observations. For the 21 observations that did not have the same value across the two time periods, we compared the rate paid and the credit grade of other loans issued at the same time and used the reported rate that mostly closely fit with other loans from that period. For example, one loan on the data downloaded in August 2013 had an interest rate of 6.00 percent; that same loan had an interest rate of 14.91 on the data downloaded in December 2012. Because the 14.91 rate was more in line with the other loans made at the same time with a D2 rating, we used the 14.91 interest rate in the analysis.

[17] The location data for the denied loans is of much lower quality than for the funded loans. For the denied loans, the state is the finest level of geography that we are able to ascertain for most of the applications. For the funded loans, we are able to ascertain the county from the city and state for most loans. Thus, we use state-level controls in the logistic model, but county-level controls in the regression.

[18] The data used is the "Local Area Personal Income accounts CA1-3" series, downloadable from http://www.bea.gov/regional/downloadzip.cfm.

Relative to the omitted category of 2007, all the years had positive coefficients, or higher interest rates, but at over a 2 percentage point increase, 2009 was the highest. Living in a county with a higher per capita income slightly decreased the interest rate charged. There was no statistically significant relationship between either the county population or the local house price index on the interest rate charged.

Loan Performance

Our finding that loans for small businesses were charged a premium over other types of loans despite controlling for the credit quality of the borrower is interesting. In order to explain this finding, we investigate whether such loans perform differently than other types of loans. We estimate the following logistic regression:

$$Delinq_i = f\begin{pmatrix} SmallBusiness_i, Amount_i, Employment_i, HPI_i, Fico_i, \\ Year_i, Population_i, Income_i, Long_i, Home_i \end{pmatrix}$$

All covariates are as defined in the interest paid regression and the dependent variable is a dummy variable equal to one if the loan was charged off, in default, or 31 to 90 days delinquent.[19] In addition, the model included state fixed effects.

Results from estimation are in Table 10. The results indicate that after controlling for observable differences in the quality of the borrowers, loans for small businesses were more than 250 times more likely to perform poorly than loans for other purposes, which may give some insights into why such loans are charged a higher rate. The other covariates in the model behave as one would expect.

Conclusions

Peer-to-peer lending has grown substantially since its inception in 2007 and has shown no signs of slowing. To the contrary, Prosper, the largest competitor in the peer-to-peer space, recently received a $20 million equity injection and may considerably expand its lending in the very near future. In addition Lending Club received $125 million dollar investment led by Google.[20] Shortly thereafter, Lending Club announced that they had plans to launch a separate platform to make small business loans.[21] Unlike the personal loans to business owners on the traditional Lending Club platform which are underwritten based on the characteristics of the owner, loans on the small business platform would be based on the characteristics of the firm. The other large difference that is likely to occur is an increase in the size of the loans available. While final details are not yet available, there is an expectation that loans as large as $250,000 may be available on the new platform.

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[19] While we cut off applications at December 31, 2012, we pulled data on all these loans on August 14, 2013 to get updated performance data.
[20] See http://dealbook.nytimes.com/2013/05/02/google-to-invest-in-lending-club/?_r=0.
[21] See http://news.cnet.com/8301-1023_3-57588175-93/with-rising-revenues-lending-club-ceo-plans-expansion-q-a/.

While a relatively small fraction of peer-to-peer lending in the US currently goes to businesses, one might expect this to grow rapidly with a platform dedicated to small business lending based on two factors. First, beginning in June, community banks Titan Bank and Congressional Bank began purchasing loans through the Lending Club platform and Titan Bank started to offer personal loans to their customers through Lending Club.[22] With nearly 7,000 community banks in the US, the potential for additional partnering with Lending Club as it expands into the small business space is substantial. The passage of the SEC crowdfunding rules will certainly expand the pool of individuals eligible to provide funding to small businesses but it is unclear what the overall impact will be on P2P lending.

Second, consider the experience in the UK. UK-based Funding Circle is a peer-to-peer platform dedicated solely to making loans between £5,000 and £1 million to small businesses for 6 months to 5 years. It was founded in August 2010; as of August 2013, it had already made loans to nearly 2,500 businesses totaling more than £135 million.[23] This information is particularly relevant now that Funding Circle has merged with Endurance Lending Network in the US and are providing loans to businesses in the United States.[24]

As small business owners are increasingly turning to this alternative source of money to fund their businesses, policy makers may wish to keep a close eye on both levels and terms of such lending. Because such loans require less paperwork than traditional loans, they may be considered relatively attractive. However, given the relatively higher rate paid on such loans, it may be in the best interest of the business owner to pursue more formal options. More research is required to understand the long-term impact of such loans on the longevity of the firm and more education to potential borrowers is likely in order.

[22] See http://banklesstimes.com/2013/08/11/community-banks-partner-with-lending-club-as-p2p-continues-to-evolve/.
[23] Statistics were pulled from the Funding Circle page on August 7, 2013.
[24] http://blog.enduranceln.com/2013/10/announcing-funding-circle-usa/

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Table 1: Balance on loans to small business with any outstanding debt, by number of employees of firm

	All small businesses			Fewer than 10 employees			10 or more employees		
	Share of total	Mean per loan	Median per loan	Share of total	Mean per loan	Median per loan	Share of total	Mean per loan	Median per loan
All firms	**100.0**	**182,288**	**20,000**	**100.0**	**97,999**	**17,149**	**100.0**	**359,096**	**40,000**
Commercial bank	56.8	221,241	25,000	54.7	116,414	20,000	58.0	430,685	60,000
Savings bank	5.3	212,533	37,000	6.8	139,046	34,000	4.4	393,789	90,000
Savings and loan association	1.0	243,238	35,000	1.0	115,862	9,959	1.0	600,116	130,000
Credit union	0.5	27,720	15,000	1.1	23,978	13,000	0.3	43,918	30,000
Finance company	16.2	114,050	18,000	15.9	62,206	15,000	16.4	213,064	26,079
Insurance company	2.2	694,474	21,000	2.0	268,761	14,000	2.3	2,899,123	38,000
Brokerage or mutual fund company	1.0	246,251	8,000	0.7	96,853	8,000	1.1	550,066	55,000
Leasing company	3.1	126,893	9,200	2.6	60,314	8,500	3.5	238,794	14,839
Mortgage company	5.3	587,029	90,000	10.7	566,467	84,000	2.2	652,478	245,000
Other	8.5	141,832	20,000	4.6	39,503	15,000	10.8	392,207	80,000

Note: Weighted statistics from the 2003 Survey of Small Business Finances. Balances include loans include outstanding balances on lines of credit, capital leases, mortgages, motor vehicle loans, equipment loans, loans from owners, and other loans.

Table 2: Share of loans to small businesses secured by personal real estate, by number of employees of firm

	All Institutions		Fewer than 10 employees		10 or more employees	
	Share of dollars	Share of loans	Share of dollars	Share of loans	Share of dollars	Share of loans
All firms	15.6	11.0	18.5	14.7	13.9	8.8
Commercial bank	18.7	17.1	24.0	22.1	15.8	14.0
Savings bank	23.9	29.7	32.9	34.3	16.0	25.5
Savings and loan association	19.5	24.2	53.2	36.8	1.2	7.1
Credit union	27.9	13.4	20.3	10.7	45.8	18.1
Finance company	8.5	1.7	3.8	2.4	11.1	1.3
Insurance company	2.2	5.7	0.8	5.9	2.9	5.6
Brokerage or mutual fund company	4.9	7.5	0.0	0.0	6.6	10.3
Leasing company	0.0	0.0	0.0	0.0	0.0	0.0
Mortgage company	25.5	57.8	11.5	58.1	64.3	57.1
Other	5.9	5.5	11.5	5.1	4.5	5.8

Note: Weighted statistics from the 2003 Survey of Small Business Finances. Balances include loans include outstanding balances on lines of credit, capital leases, mortgages, motor vehicle loans, equipment loans, loans from owners, and other loans.

Table 3: Peer-to-peer lending volume and interest rate by Lending Club, by loan purpose and year of issue

Year	Non-business loans				Small business loans			
	Number of Loans	Dollar amount funded	Average dollar amount funded	Average interest rate	Number of Loans	Dollar amount funded	Average dollar amount funded	Average interest rate
2007	547	3,946,350	7,215	11.75	56	845,200	15,093	12.54
2008	2,266	18,291,776	8,072	12.07	127	1,683,250	13,254	11.95
2009	4,913	47,422,624	9,652	12.27	368	4,392,125	11,935	14.63
2010	12,071	120,966,304	10,021	11.97	466	5,384,875	11,556	12.45
2011	20,746	243,501,696	11,737	12.18	975	13,861,950	14,217	13.13
2012	51,981	695,395,520	13,378	13.65	1,386	22,547,076	16,268	13.39
Total	92,524	1,129,524,352	12,208	12.98	3,378	48,714,476	14,421	13.25

Note: Statistics are calculated from LendingClub.com loan issue data through December 31, 2012. Year is based on the year the loan was issued.

Table 4: Peer-to-peer lending volume and interest rate by LendingClub.com, by loan purpose and year of issue

Year	Loans to pay off credit card		Loans to pay off debt		Loans for home improvement/ home purchase		Loans for small businesses	
	Average $ amount funded	Average interest rate	Average $ amount funded	Average interest rate	Average $ amount funded	Average interest rate	Average $ amount funded	Average interest rate
2007	8,065	12.05	8,680	12.65	6,358	10.99	15,093	12.54
2008	7,994	12.02	9,198	12.61	8,267	11.63	13,254	11.95
2009	10,155	12.01	11,072	12.74	9,652	11.78	11,935	14.63
2010	11,242	11.63	11,476	12.34	9,356	11.72	11,556	12.45
2011	12,222	11.90	13,268	12.72	11,707	11.69	14,217	13.13
2012	13,067	13.33	14,438	14.11	12,995	12.51	16,268	13.39
Total	12,468	12.82	13,585	13.52	11,671	12.08	14,421	13.25

Note: Statistics are calculated from LendingClub.com loan issue data through December 31, 2012. Year is based on the year the loan was issued.

Table 5: Denied and funded applications from Lending Club, by application year

	Non-Business Loans			Small Business Loans*		
Year	Rejected	Funded	% funded	Rejected	Funded	% funded
2007	5,298	630	10.63%	8	65	89.04%
2008	25,319	2,254	8.17%	450	124	21.60%
2009	55,805	4,936	8.13%	1,393	370	20.99%
2010	106,602	12,245	10.30%	6,472	468	6.74%
2011	204,571	21,370	9.46%	13,875	1,018	6.84%
2012	319,335	52,955	14.22%	17,366	1,360	7.26%
Total	716,930	94,390	11.63%	39,564	3,405	7.92%

Note: Statistics are calculated from LendingClub.com loan data and declined loan data up to December 31, 2012. Year is based on when the application was received. * The rejected loan data set does not start identifying "loantitle" with categories that are comparable to the funded loans data set until 2009. Business loan applications are identified as any application containing the word "business" in the "loantitle."

Table 6: Mean characteristics of Lending Club loan applications by whether or not the application was funded[1]

	All Applications		**Funded**		**Not funded**	
	Mean	Median	Mean	Median	Mean	Median
Funded	0.12	0	1.00	1	0.00	0
Small Business Loan	0.05	0	0.04	0	0.05	0
Amount Requested ($1,000's)	13.16	10.00	12.56	10.40	13.25	10.00
Employed less than 1 year	0.68	1	0.10	0	0.77	1
Mean state house price index[2]	1.42	1.39	1.44	1.43	1.42	1.38
Fico Score (lower range, nonmissing)	644.63	658	706.12	700	635.97	649
<680	0.64	1	0.23	0	0.70	1
680-714	0.21	0	0.41	0	0.18	0
715-749	0.10	0	0.23	0	0.08	0
750-779	0.03	0	0.09	0	0.02	0
780+	0.02	0	0.04	0	0.01	0
Year of Application	2011.07	2011	2011.21	2012	2011.05	2011
Number of Observations	766,761		94,688		672,073	

Notes: 1. Standards for loans have changed over time; the statistics reflect whether or not the loan applications met the standard at the time the application was submitted. 2. Due to the volatility and seasonality of the house price index, we use the moving average of the previous 12 months in the state where the application was submitted.

Table 7: Interest rate for Lending Club loan compared to other interest rates for NFIB members, by year

Year	LC Non-Business Loans	LC Small Business Loans	NFIB Firms with 10+ employees	NFIB Firms with <10 employees
2007	11.75	12.54	8.67	9.23
2008	12.07	11.95	6.92	7.74
2009	12.27	14.63	5.54	6.92
2010	11.97	12.45	5.55	6.77
2011	12.18	13.13	5.47	6.56
2012	13.65	13.39	5.29	6.09
Total	12.98	13.25	6.06	7.03

Note: Lending Club statistics are calculated from LendingClub.com loan issue data through December 31, 2012. Year is based on when the loan was issued.

NFIB statistics are calculated from monthly membership surveys done by the National Federation of Independent Business through the December 2012 survey.

Table 8: Logit estimates of whether or not the loan application gets funded

	Odds Ratios (May 2007 - Dec 2012)	Odds Ratios (Jan 2010 - Dec 2012)
Small Business Dummy	1.969***	1.796***
	[27.01]	[20.90]
Amount Requested	0.955***	0.957***
($1,000's)	[-90.23]	[-82.43]
State House Price Index	1.348***	1.318***
(1 year lag, 1=100)	[17.69]	[14.70]
Fico Score	1.018***	1.017***
	[175.28]	[147.88]
Employed less than 1 year	0.035***	0.028***
	[-276.65]	[-274.02]
Application year (2007 is omitted)		
2008	0.504***	
	[-13.06]	
2009	0.430***	
	[-16.98]	
2010*	0.803***	
	[-4.52]	
2011	1.272***	1.610***
	[4.99]	[32.68]
2012	2.574***	3.249***
	[19.78]	[88.62]
Constant	0.000***	0.000***
	[-149.78]	[-148.08]
Pseudo R2	0.415	0.445
N	766,761	683,599

Note: t-statistics in brackets. *** indicates significance at the 1% level; ** indicates significance at the 5% level; and * indicates significance at the 10% level. Applications from prior to 2010 do not fully identify all business loans.

Table 9: Regression results for interest rate paid on loan

	Linear Reg
Small Business Dummy	0.893***
	[24.06]
Amount Requested	0.141***
($1,000's)	[136.43]
Treasury Rate	-0.152***
	[-2.68]
Fico Score	-0.088***
	[-422.52]
Annual Income ($1,000's)	0.000
	[0.60]
County Population	-0.000
(1 year lag, in 1,000's)	[-0.00]
County Per Capita Income	-0.000
(1 year lag, in $1,000's)	[-0.84]
Home Owner	-0.118***
	[-7.86]
County House Price Index	-0.075*
(1 year m. avg lag, 1=100)	[-1.70]
Loan Length	3.630***
(0 is 36 months, 1 is 60 months)	[193.46]
Employed less than 1 year	0.101***
	[4.38]
Application year (2007 is omitted)	
2008	0.552***
	[3.53]
2009	2.110***
	[9.70]
2010	0.417*
	[1.86]
2011	0.292
	[1.27]
2012	0.942***
	[4.10]
Constant	71.795***
	[251.26]
Adjusted R2	0.769
N	84,342

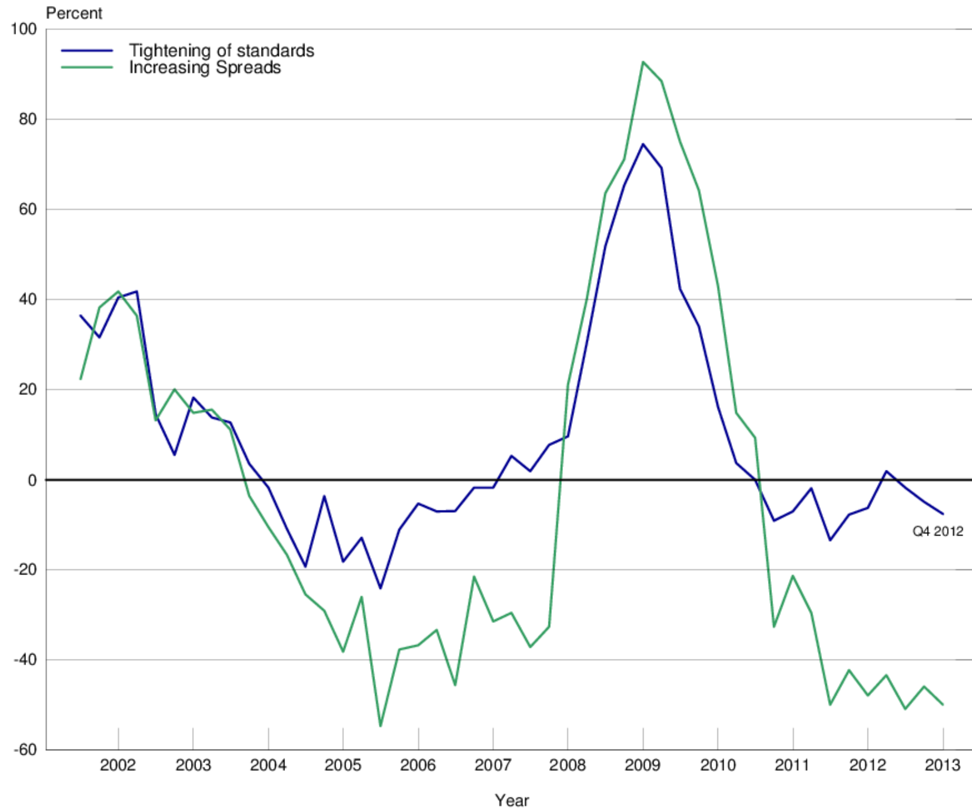
Note: t-statistics in brackets. *** indicates significance at the 1% level; ** indicates significance at the 5% level; and * indicates significance at the 10% level. State fixed effects included in estimation.

Table 10: Odds Ratio from logit estimates of whether or not the loan performs poorly

	(May 2007- Dec 2012)
Small Business Dummy	2.710***
	[19.61]
Amount Requested	1.017***
(In Thousands)	[8.42]
Fico Score	0.988***
	[-27.31]
Annual Income ($1,000)	0.995***
	[-11.58]
County Population	1.000
(1 yr lag, in 1,000's)	[1.40]
County Per Capita Income	0.996***
(1 yr lag, in $1,000's)	[-3.70]
Home Owner	0.956
	[-1.57]
County House Price Index	1.173**
(1 yr m.avg lag, 1=100)	[2.09]
60 month loan	1.621***
	[14.64]
Employed less than 1 year	1.042
	[0.99]
Application year (2007 is omitted)	
2008	0.993
	[-0.06]
2009	0.758**
	[-2.34]
2010	0.583***
	[-4.64]
2011	0.435***
	[-7.13]
2012	0.190***
	[-14.25]
Constant	486.619***
	[12.24]
Pseudo R2	0.076
N*	84,333

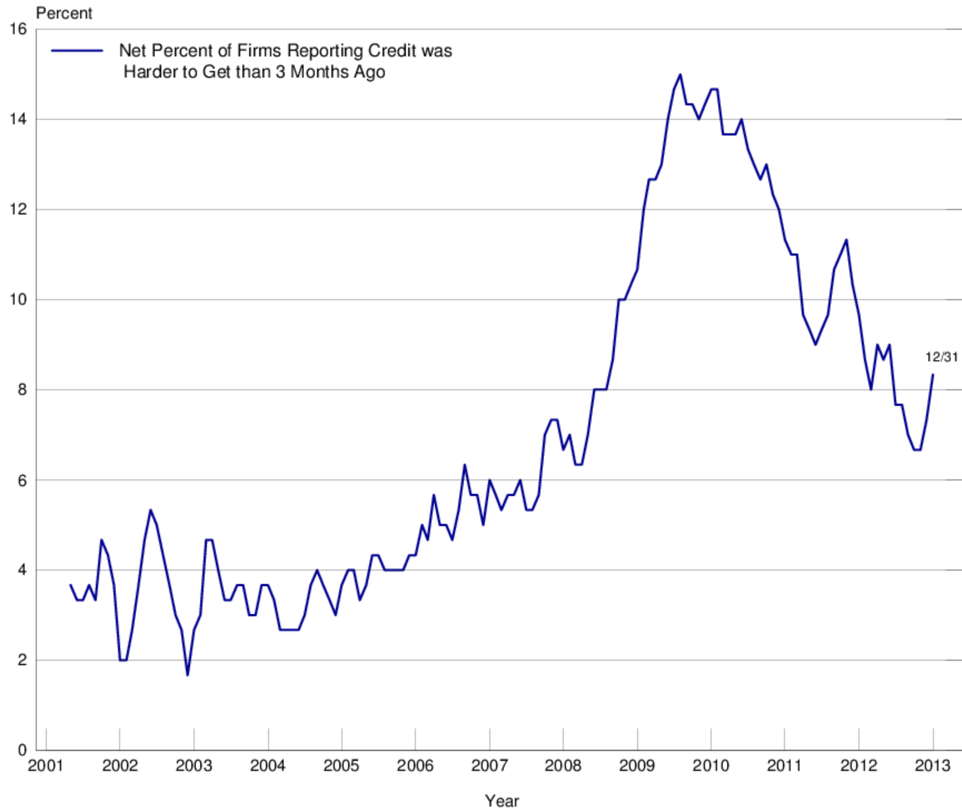
Note: Poor performance is defined as having a loan status of "charged off," "default," or "late (31-120 days); t-statistics in brackets. *** indicates significance at the 1% level; ** indicates significance at the 5% level; and * indicates significance at the 10% level. State fixed effects included in estimation.

Figure 1: Net percent of domestic banks reporting a tightening of standards or terms on loans to small businesses



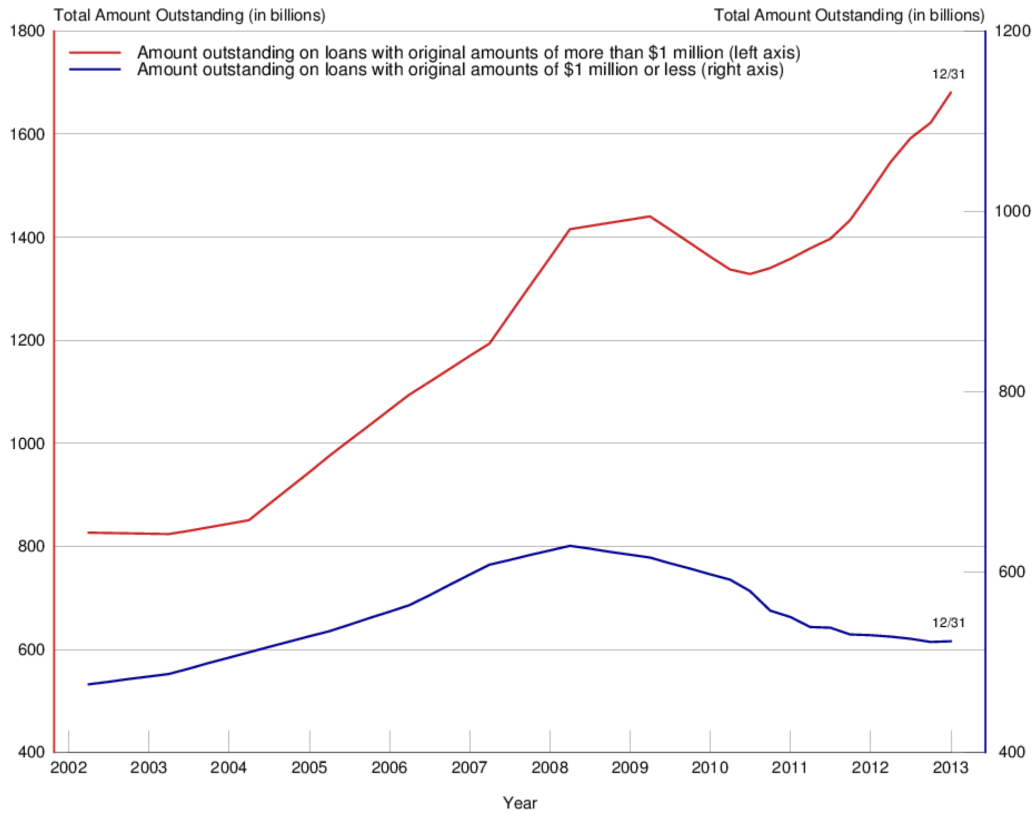
Note: Data are quarterly; not seasonally adjusted.
Source: Federal Reserve Board, Senior Loan Officer Opinion Survey on Bank Lending Practices www.federalreserve.gov/boarddocs/SnLoanSurvey/.

Figure 2: Net percent of firms reporting that credit was harder to get compared to 3 months ago



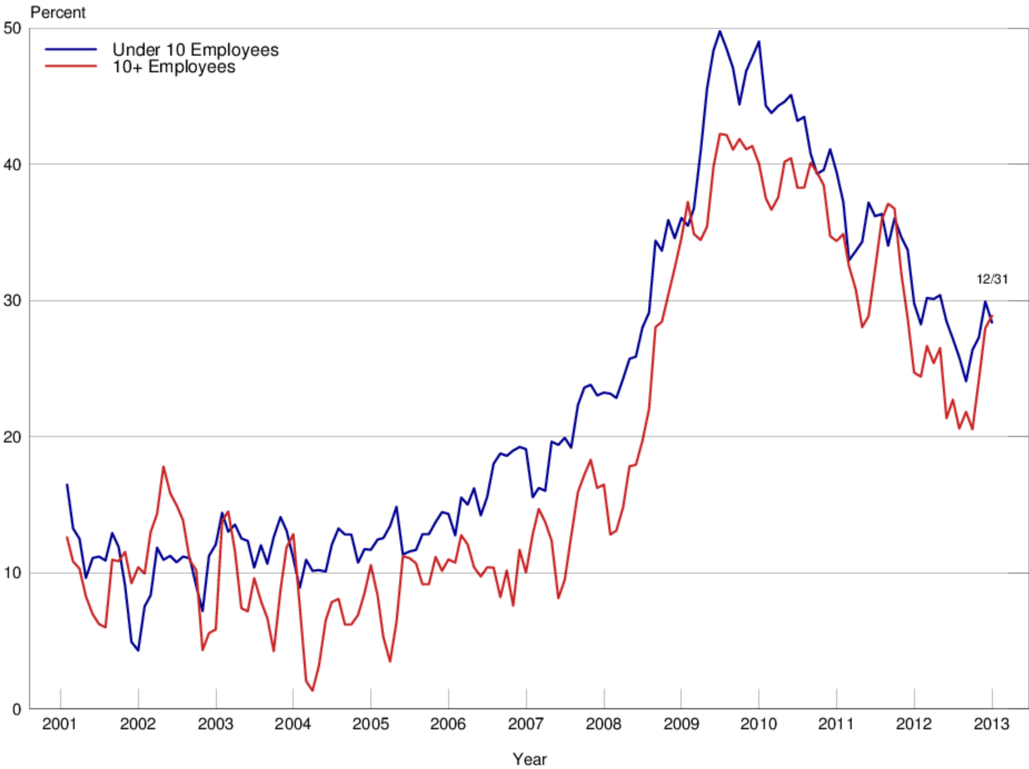
Note: This question is only asked of firms reporting that they regularly borrow; data are monthly; 3 month moving average is reported; not seasonally adjusted.
Source: National Federation of Independent Businesses (NFIB) Survey, Small Business Economic Trends Data http://www.nfib.com/research-foundation/surveys/small-business-economic-trends.

Figure 3: Amount outstanding on loans to businesses



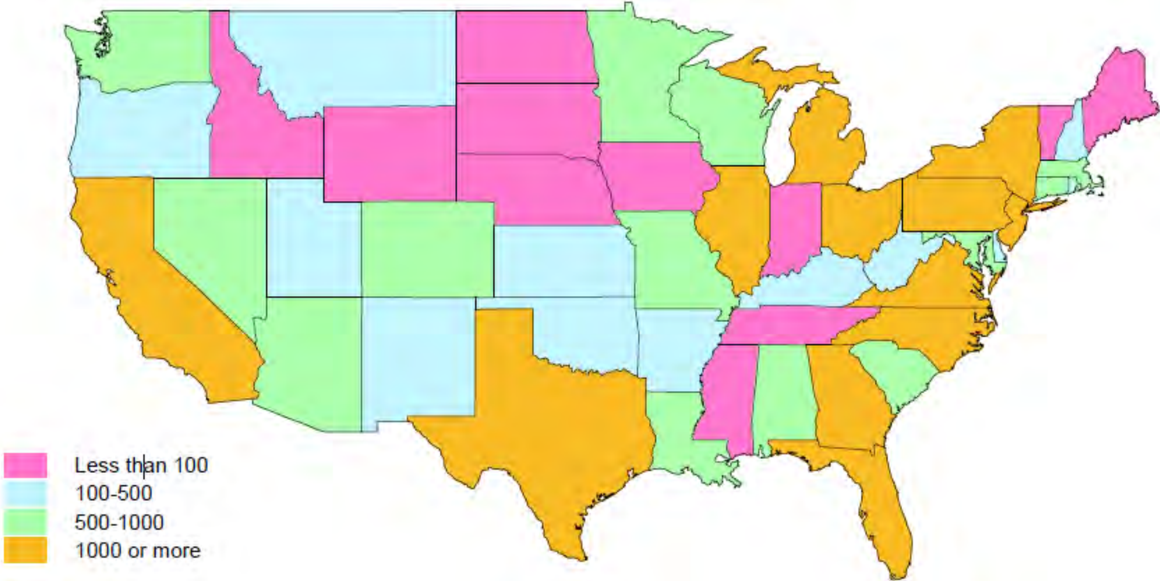
Source: These data are constructed from special tabulations of the June 30, 2002 to September 30, 2012 Call Reports (Consolidated Reports of Condition and Income for U.S. Banks).
Note: Beginning March 2010, the data reporting frequency changed from annual to quarterly.

Figure 4: Net percent of firms reporting that credit was harder to get compared to 3 months ago, by number of employees



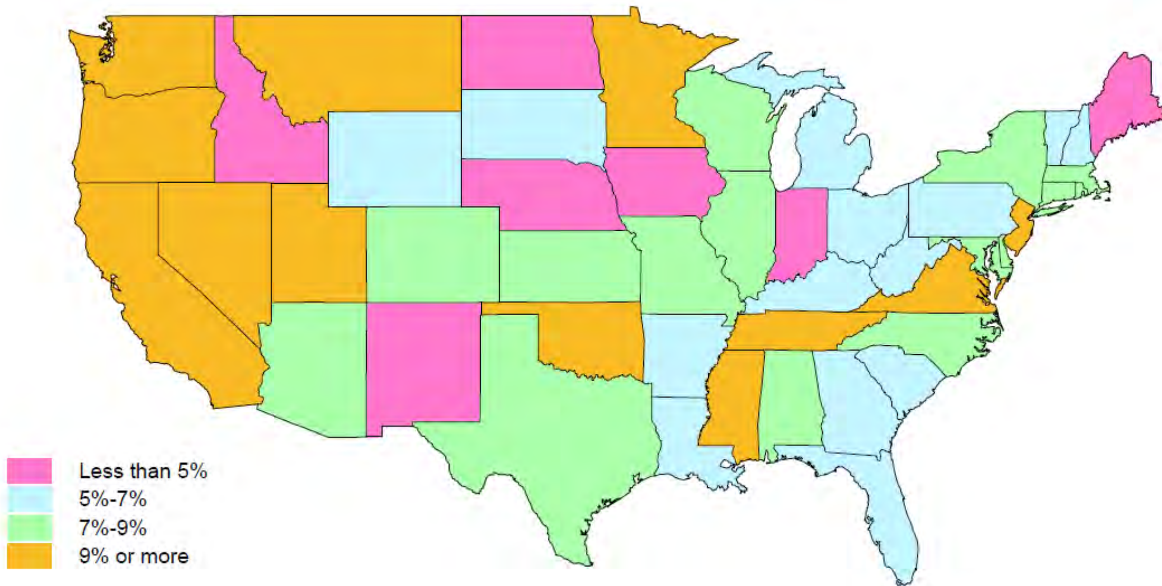
Note: This question is only asked of firms reporting that they regularly borrow; data are monthly; 3 month moving average is reported; not seasonally adjusted.
Source: National Federation of Independent Businesses (NFIB) Survey, Small Business Economic Trends Data http://www.nfib.com/research-foundation/surveys/small-business-economic-trends.

Figure 5: Number of loan applications for small business



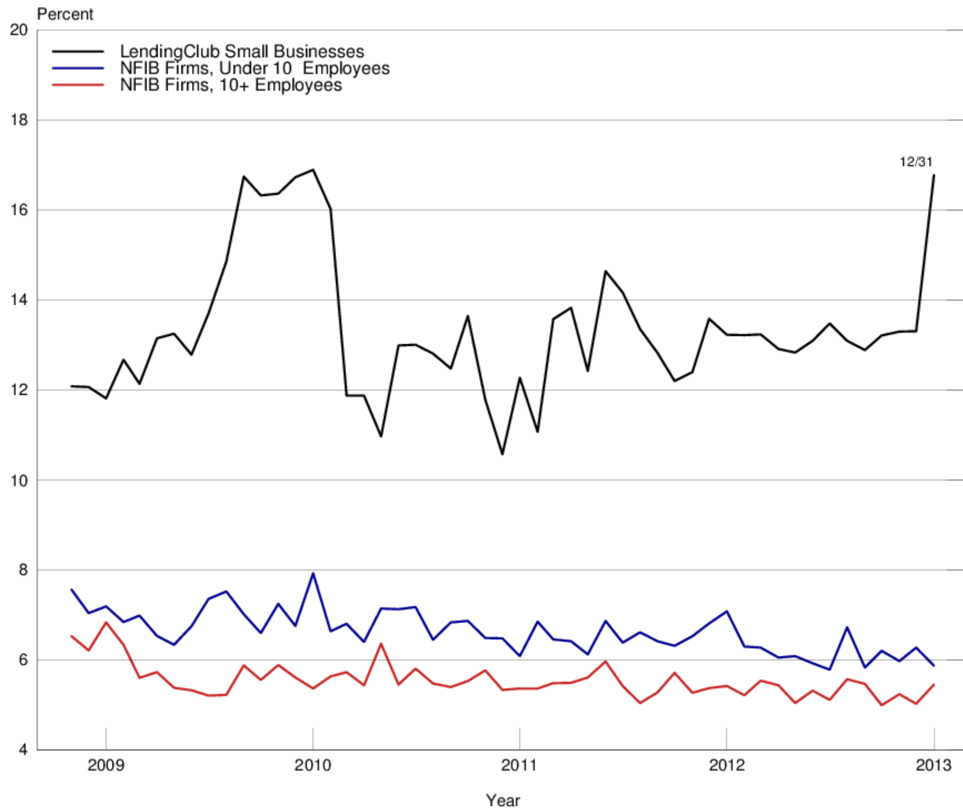
Note: Statistics are calculated from LendingClub.com loan data and declined loan data up to December 31, 2012. Year is based on when the application was received. The declined loan data set does not start identifying "loantitle" with categories that are comparable to the funded loans data set until 2009; business loans are identified as any application containing the word "business" in the "loantitle."

Figure 6: Share of loan applications for small business that were funded

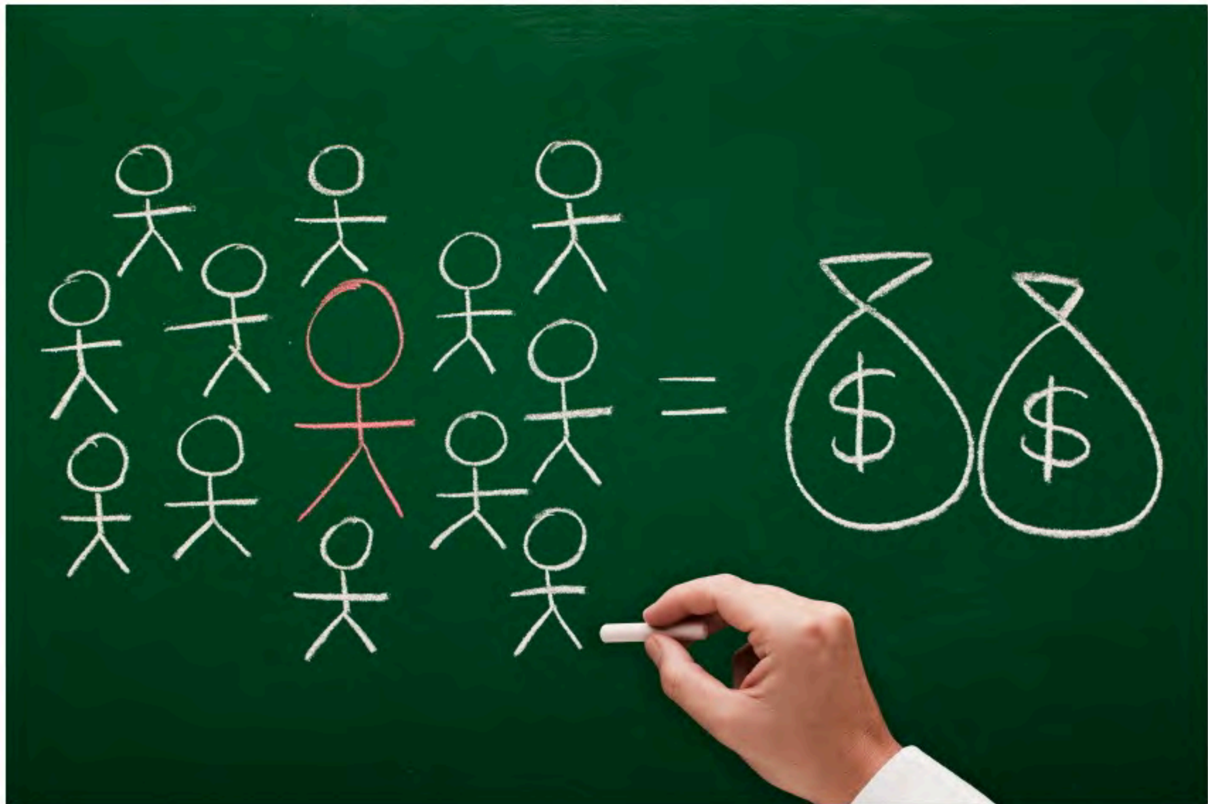


Note: Statistics are calculated from LendingClub.com loan data and declined loan data up to December 31, 2012. Year is based on when the application was received. The declined loan data set does not start identifying "loantitle" with categories that are comparable to the funded loans data set until 2009; business loans are identified as any application containing the word "business" in the "loantitle."

Figure 7: Interest rate paid by small business borrowers from LendingClub.com compared to NFIB borrowers



Understanding Peer to Peer Lending



by Peter Renton

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Introduction

This free e-book introduces the concept of peer to peer lending to everyone. It provides some background and history as well as describes how the process works for both investors and borrowers. While peer to peer lending is now a global phenomenon this book will be focusing on the U.S. market in particular and how it works here.

If you have been curious about peer to peer lending but don't really know where to begin then this e-book is for you. This e-book will describe in detail how peer to peer lending works and the requirements for borrowers and investors to participate in peer to peer lending in the U.S.

Peer to peer lending is an idea whose time has come. We live in a highly sophisticated and interconnected world yet the banking system is still based on a centuries old model. There is no need for borrowers to obtain loans from a bank any more when they can turn to their peers, often with a lower interest rate. Borrowers can save money by taking out peer to peer loans and investors can earn great returns on their money.

All the data in this e-book is current as of April 2014.

What is Peer to Peer Lending?

Peer to peer lending goes by many names. It is also called social lending, person-to-person lending or p2p lending. It can be defined in this simple way: individuals lending money to other individuals without a banking intermediary.

The official definition from Wikipedia is "a certain breed of financial transaction (primarily lending and borrowing, though other more complicated transactions can be facilitated) which occurs directly between individuals or 'peers' without the intermediation of a traditional financial institution." Basically, it involves people with money (investors) lending to people who need money (borrowers). Obviously this is something that has taken place since the invention of money thousands of years ago.

Today, with the explosive growth of the Internet and online social networks, this concept has been brought online. So now, borrowers can borrow money from people they have never met and investors can lend money to many anonymous borrowers just based on their credit information. There are dozens of companies all over the world enabling peer to peer lending, and in the United States there are two established companies: Lending Club and Prosper.

There are also many companies that do what I call direct peer to peer lending (direct p2p). These are primarily for people who want to formalize a loan arrangement between friends and family. Companies in the U.S. doing this today are ZimpleMoney, LendingKarma, National Family Mortgage and many more. They help setup loan agreements and manage the funding process for you. While these companies provide a valuable service the focus of this e-book will be on the mass-market p2p lending sites, Lending Club and Prosper.

I also want to make a distinction between peer to peer lending and microfinance. Microfinance typically deals with very small loans sizes (under $1,000) and are usually run by non-profit organizations. I am a big fan of microfinance organizations like Kiva (I loan money on Kiva) but they serve a different purpose and have different goals from peer to peer lending organizations like Lending Club and Prosper.

A Short History of Online P2P Lending

It wasn't until well after the new millennium began that for profit p2p lending began to emerge online. In 2005, Zopa launched in the U.K. as the world's first online p2p lender, and they are still going strong today as the number one company in the U.K. market.

In the U.S., Prosper began operations in February 2006 and within 9 months they had garnered 100,000 members and funded $20 million in loans. They had the market to themselves in the US until Lending Club launched in May 2007 as a Facebook application. Within a few months they emerged as a standalone website to compete directly against Prosper.

Quiet Periods

Both Prosper and Lending Club spent some time in "quiet periods" in 2008 and 2009. By a quiet period we mean that the companies still operated but they didn't allow new money to come in from investors. This was necessary because the Securities and Exchange Commission (SEC) demanded that they register all the loans on their platform as promissory notes with the government. Lending Club spent about six months in their quiet period from April to October 2008 and Prosper spent a little longer from October 2008 through July 2009. Now, all notes are registered with the SEC and all financial results for both companies are publicly available. The notes for both companies are now offered by a prospectus filed with the SEC.

Peer to Peer Lending 2.0

With the emergence from their quiet periods, both Lending Club and Prosper became more focused on risk management. The early loans made on Prosper in 2006 and 2007 didn't perform well for investors at all. Most investors lost money, caused by the high default rates. According to Prosper's own statistics page, just under 40% of loans issued in 2006 and 2007 defaulted. With Lending Club the numbers are slightly better, but still not good. Of loans issued before their quiet period, around 24% of them have defaulted.

Now, if you look at loans made in the first year after their quiet period, the default rates and the returns for investors are much better. As of this writing (most of these loans are still outstanding), the default rate for Prosper loans issued from July 2009 through June 2010 is just over 5%. For Lending Club during the same period, their default rate is around 4%. This is much better than they did before their quiet period.

Both companies have added to the attractiveness of p2p lending by adding additional "products" recently. You can now invest in both one year and five year loans on Prosper, along with the original three year loans. Lending Club gives you the choice of three year and five year loans and with loan amounts now up to $35,000.

Why is Peer to Peer Lending Becoming Popular?

Peer to peer lending is a rapidly growing industry. In the 12 months ended March 31, 2014 the total amount of money loaned by Lending Club and Prosper was just over $3 billion. That is around 171% growth over the preceding 12 months. Clearly, it is becoming more popular all the time.

To understand why peer to peer lending is growing so fast, we need to look at the advantages it provides for both borrowers and investors.

Borrowers

The financial crisis in 2008 had a huge impact on banks and financial institutions that is still being felt. Many individuals who had found it easy to get loans from banks before suddenly found themselves cut off.

Many people had used the equity in their home to borrow money in the past couple of decades, but with homes across the country dropping in value, banks became much more cautious with this kind of lending. Unsecured personal loans from banks became almost non-existent.

Many people who needed money found themselves resorting to credit cards with high interest rates. Clearly, there was a void in consumer financing and peer to peer lending helped fill that void. Borrowers found that their 28% credit card interest rate could be cut in half with a loan through Prosper or Lending Club. The fixed loan term, typically three or five years, is also appealing because borrowers can see how they can pay off their debt completely in a relatively short time period.

Investors

There are several advantages for investors. The biggest and most important one is the higher rate of return. Many Lending Club and Prosper investors are averaging at least a 10% annualized return, and the vast majority are earning more than 6%.

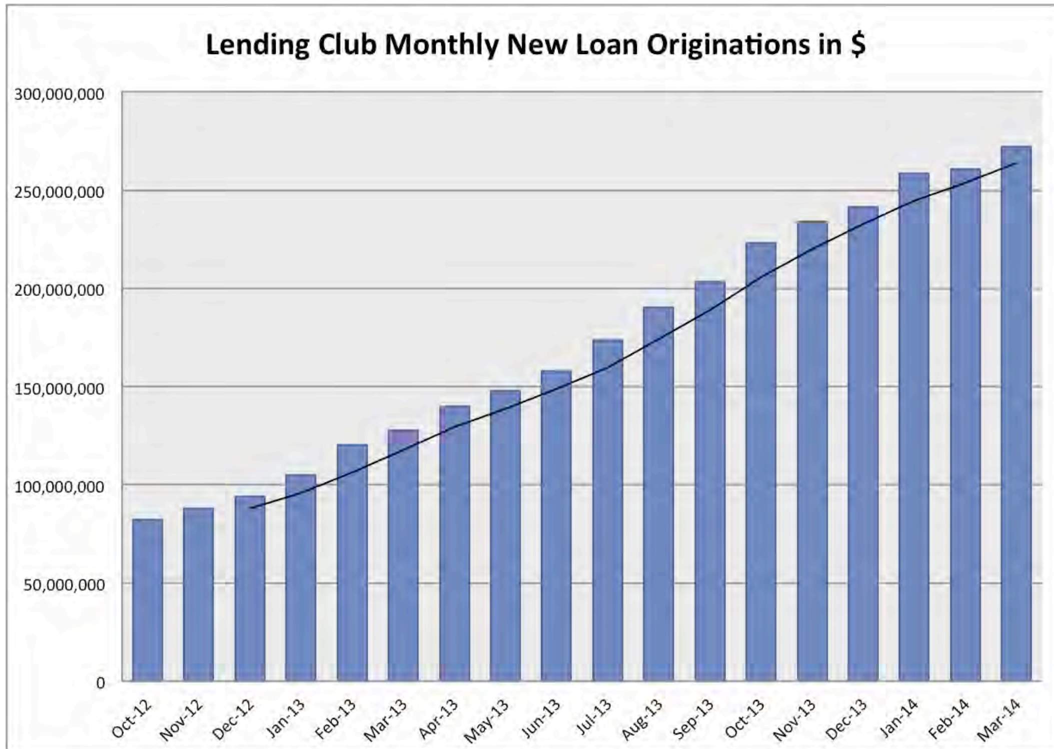
You can choose your level of risk with p2p lending. You can choose to invest in A grade loans where every borrower has excellent credit, where the likelihood of defaults are low. Or you can invest in higher risk, higher interest loans. Alternatively, you could choose some combination of these high risk and low risk loans.

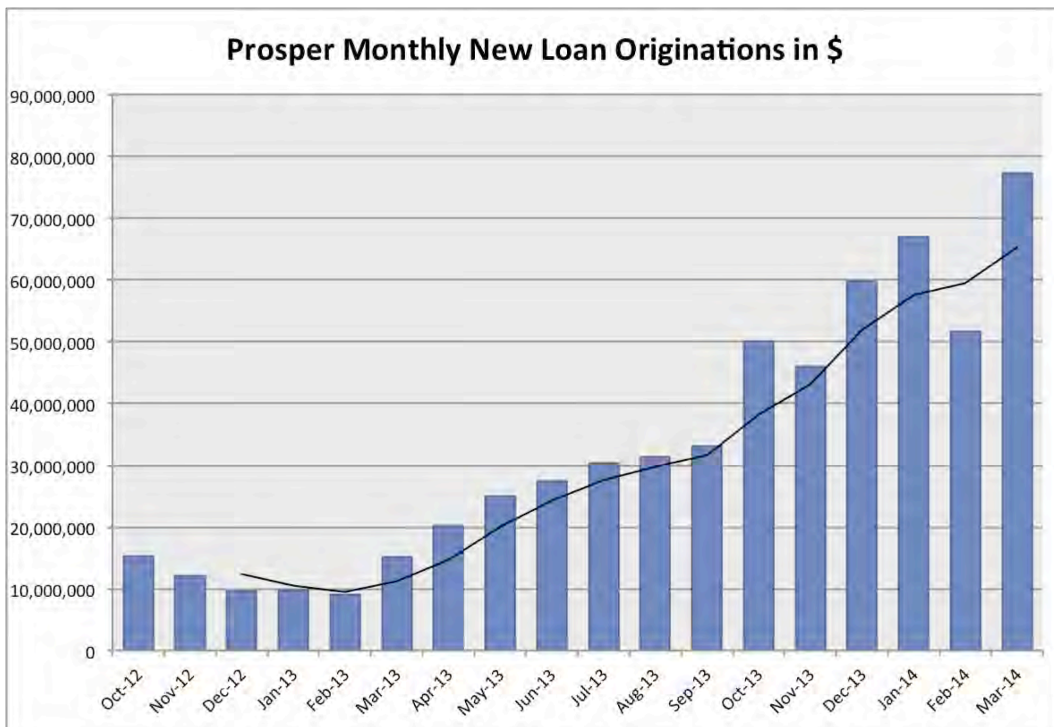
Many people are drawn to peer to peer lending because you are investing in real people, not some faceless bank or mutual fund.

Peer to peer lending also adds diversification to an investor’s overall portfolio. You are investing in consumer credit, which is a different asset class from other investments.

The Growth of Peer to Peer Lending in the U.S.

The two charts below demonstrate the growth of peer to peer lending in the last 18 months. Here are charts showing the total dollar amounts in new loans from both Lending Club and Prosper. Lending Club has been growing steadily and Prosper is starting to see some strong growth in recent months. The black line is the three-month moving average.





How Peer to Peer Lending Works

The basic premise of p2p lending is this: people sign up on either Lending Club or Prosper as a borrower or an investor. A borrower submits an application for a loan, and if approved the loan is placed on the website for investors to fund. Investors typically invest in a small portion of many different loans, thereby spreading their risk.

Borrowers

A borrower's loan will remain on the web site for a short amount of time, up to two weeks. During that time investors can ask the borrower questions in order to decide whether or not to invest in the loan. While no personal information is displayed, information from the borrower's credit report is provided for the investors, many of who screen these loans based on different criteria.

A number of things can happen while the loan is being funded:

1. The loan can be pulled off the platform because it fails some part of the verification process.
2. The loan can become fully funded, in which case it is taken off the platform and the borrower will receive their money less an origination fee (detailed in the table on the next page).
3. The borrower may cancel their loan and delete it from the platform.
4. The loan fails to obtain funding after 14 days. Although if investors fund only part of the loan it can still be issued if it funds above a certain percentage.

Investors

From an investor perspective, peer to peer lending allows you to directly invest in other people, thereby completely bypassing the banking system. Investors simply sign-up at Lending Club or Prosper, link to their bank account and then transfer money in.

Typically, there will be hundreds of loans to choose from for investors. Both Lending Club and Prosper allow investors an easy way to invest by providing automated plans. Prosper provides several different automated plans based on credit risk or you can build a customized plan based on your own selection criteria. Lending Club provides you with three automated options (low, medium and high risk), or you can use their slider tool to choose an average interest rate. Then you just choose the total amount you want to invest and your money will be allocated automatically among many different loans.

The other alternative for investors is to choose loans individually. You can use the filters that Lending Club and Prosper provide, and then browse through each loan one by one. While this method is more time consuming, many successful investors will only invest this way.

Borrowing Money

Who Can Borrow Money?

To borrow money on Prosper or Lending Club you must be a US resident, at least 18 years old, have a bank account and social security number. But even if you meet that criteria, not all states allow people to borrow money through peer to peer lending platforms. You must also have a decent credit score and have a good credit history. Lending Club and Prosper have slightly different requirements, which are detailed in the table below.

	Lending Club	Prosper
Minimum credit score	660	640
States Not Available for Borrowers	IA, ID, ME, MS, ND, NE	IA, ME, ND
Loan amount range	$1,000 - $35,000	$2,000 - $35,000
Origination fee range	1.11% - 5% varies by loan grade	1.95% - 4.95% varies by loan grade
Loan Terms	3 and 5 year loans	3 and 5 year loans
Interest Rate range	6.03%% to 26.06%	6.05% to 30.59%
Average loan size (2013)	$14,505	$10,118

You should check the websites for Lending Club: http://www.lendingclub.com/ and Prosper: http://www.prosper.com/ for the most up to date requirements.

Interest Rates

Both Lending Club and Prosper will assign each loan a grade or rating, and the interest rate will depend on that rating. They base this rating on a number of factors such as the borrower's FICO score and other information obtained from the credit report. Both Lending Club and Prosper use their own formula in determining the loan grade.

Borrower Fees

All borrowers will pay an origination or closing fee when their loan has been funded. For both Lending Club and Prosper, this fee varies depending on the loan rating. Lending Club will charge between a 1.11% and 5% loan origination fee (1.11% for three year loans rated A1). Prosper's fees range from 0.5% for AA rated loans up to 4.95%. The origination fee is subtracted from the loan proceeds, so it is important to ask for slightly more money than you need.

There are no pre-payment penalties, so borrowers can pay off their loan at any time without penalty. There are also no hidden fees. The only other fee a borrower may pay is a late fee, which is assessed if a loan payment is more than 15 days late.

Investing Money

Who Can Invest Money?

Investing with both Lending Club and Prosper is much more restrictive than borrowing. Only about half the states allow investors to open a peer to peer lending investment account.

Prosper allows investors in the following 31 states: Alaska, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New York, Oregon, Rhode Island, South Carolina, South Dakota, Utah, Virginia, Washington, West Virginia, Wisconsin and Wyoming. There are additional requirements for residents of California, Idaho, New Hampshire, Oregon, Virginia and Washington detailed on Prosper's website.

Lending Club allows investors in the following 28 states: California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Kentucky, Louisiana, Maine, Minnesota, Missouri, Mississippi, Montana, New Hampshire, Nevada, New York, Rhode Island, South Carolina, South Dakota, Utah, Virginia, Washington, Wisconsin, West Virginia, and Wyoming.

However, even if you reside in these states Lending Club imposes additional criteria on all investors. To be eligible, an investor must have an annual gross income of at least $70,000 and a net worth of at least $70,000, or just a net worth of more than $250,000. There are different requirements for California and Kentucky residents explained on Lending Club's website.

Getting Started With Investing

Assuming you meet the above requirements then you can become an investor. Getting started with peer to peer lending can be a bit daunting for new investors. Lending Club and Prosper offer hundreds of loans to choose from and a myriad of ways for you to invest your money. Some people that are eager to get started jump out of the gate without thinking through their options and end up disappointed with their investment returns. The shrewd investor does some initial planning and research in order to get off to a great start.

Here are a seven points to consider that will help you do just that.

1. Cherry Pick or Auto Plans

The first decision you need to make is whether you are going to invest in loans individually or go with one of the automated plans offered by Lending Club and Prosper. If you have a large amount to invest ($10,000 or more) I recommend you consider starting with an automatic plan or you can look at Lending Club PRIME (a special account with Lending Club that offers a completely hands off approach). If you choose to invest in loans individually, and this is really the only way to obtain above average returns, then you need to pay close attention to the points below.

2. Diversify

If there was only one word of advice I could give to all new p2p investors it would be this one: diversify. Don't make the mistake I made and spread your initial investment between two loans. What you want to do is diversify your initial investment as widely as possible. Both Lending Club and Prosper allow a $25 minimum investment in each loan. Take advantage of it. If you are starting off with $1,000 then fund 40 different loans with this money. Only if you are starting with more than $2,500 do I recommend you going over the $25 minimum. Then, I would still make sure that no loan is more than 1% (and preferably less) of your total p2p investing portfolio.

3. Don't Shoot for the Moon

You have a choice to invest in A grade loans that earn in the mid single digits in interest to loans of over 20%. Sure, you might think, a 20% return sounds much better. But keep in mind these are higher risk borrowers that historically have had a higher default rate. So a portfolio of loans that are earning over 20% could easily end up with a real world return under 10% once all the defaults have been taken into consideration. Whatever your risk tolerance, for new investors I would recommend a broad portfolio with a range of different loan grades. Having said that, I tend to avoid A grade loans, I think they are risky for a different reason. We are in a historically very low interest rate environment right now and it is highly likely that in two or three years interest rates will be much higher than they are now. If you can get 6% in an FDIC insured CD, it makes 7% in a p2p lending investment a poor choice. I personally prefer to invest in loan grades of B and below.

4. Use Some Simple Filters

So you have transferred your money in and have decided you want to invest in individual loans. You would login to your Lending Club or Prosper account and start browsing through the dozens, or even hundreds of loans. You suddenly realize you are going to be here all day unless you can narrow down your selections somehow. This is where filtering comes in. Both Prosper and Lending Club allow you to filter loan selections on their site. Prosper's filtering is much better than Lending Club, so what I do for Lending Club is download the CSV file of all available loans and filter them in Excel.

You can spend hours (or even days) playing around with filtering on a p2p lending statistics site. For Lending Club investors sites such as Nickel Steamroller: http://www.nickelsteamroller.com/, Interest Radar: http://www.interestradar.com/ or Lendstats: http://www.lendstats.com/ provide excellent tools for analysis. For Prosper investors the go to site is Prosper Stats: http://www.prosper-stats.com/.

You can slice and dice previous loan ROI data in many different ways, but there is one filter I always use: Inquiries = 0. Inquiries means number of credit inquiries this person has undertaken in the last six months. It is recorded on a borrower's credit report. I like to invest in someone who has not been shopping around in many places for more credit. I use other filters, such as no recent delinquencies, but this one seems to have the biggest impact on ROI based on

previous loans. We need to state here that past performance is no guarantee of future returns. This filter may not produce superior returns in the future, but for past loans on both Prosper and Lending Club, if you had chosen that filter and nothing else you would have increased your ROI considerably.

5. Read the Details of Each Loan

I believe that it is useful to spend some time reading the details of each loan. If nothing else, this will give you a feel for the different kinds of borrowers on the platform. I tend to avoid someone who hasn't bothered to give a good loan description (or any description) and if they have failed to answer investor questions then that is a red flag, too. You can always ask your own questions, keeping in mind of course, that people may not always tell the complete truth.

6. Start Slowly

As a new investor, you are probably all excited to get started and want to get all your money to work quickly. But if you have done the work of the other steps above you will likely only have a relatively small number of loans to choose from. For example, you might have $2,000 to invest and have narrowed your search down to 40 loans to invest in. So, you think you should just invest $50 in each loan. That is not what I would recommend. Stick with my diversification point above and stay with $25 per loan. Invest half your money now and then wait a week or two. There will be an entirely new batch of loans on the platform by then, and you can repeat the process. I know some investors with very strict investing criteria who have repeated this process many times before all their money was invested.

7. Avoid Taxes if You Can

Interest earned on your investments at Lending Club and Prosper are taxed at the standard income tax rate. They do not get the favorable tax treatment of stock dividends. So, if you are in the 28% federal tax bracket then you will likely pay 28% in federal taxes on all of your interest income earned from p2p lending. You can avoid this tax burden completely by putting your investment in an IRA. Both Lending Club and Prosper offer a no-fee IRA (with a minimum $5,000 investment) where all your interest can accrue tax-free. You can open a new Traditional IRA, Roth IRA or a SEP-IRA or you can roll over an existing retirement account.

Where to go from here?

This e-book has only covered the very basics of peer to peer lending. It is a young and very dynamic industry that is changing all the time. Serious borrowers and investors need to keep up to date with all the changes. There are many resources online that can help you with this.

Of course, if you haven't already I recommend you subscribe to my blog, Lend Academy: http://www.lendacademy.com/.

The blog is updated several times a week and any important developments are discussed in depth there. Other sites updated regularly with useful content for investors are LendingMemo: http://www.lendingmemo.com/ and Nickel Steamroller: http://nickelsteamroller.com/.

The Lend Academy forum is a gathering place where investors and borrowers come to discuss p2p lending. You can register and join the conversation or just follow along as a guest. There are hundreds of active members there where your questions can be answered very quickly. You can go to the forum here: http://www.lendacademy.com/forum/index.php.

Also, Lend Academy is the co-founder of the only conference for the p2p lending community called LendIt. In 2013 LendIt was held in New York City on June 20th. The second LendIt Conference will be held in San Francisco on May 4-6, 2014. You can find out details and sign up here: http://www.lendit.co/2014/.

We have only just scratched the surface of the world of peer to peer lending in this e-book. But hopefully now you will have a feel for what it is all about and why it is becoming so popular. I will be updating this free e-book every quarter and providing the new edition to all my email subscribers. So, if you have received a copy of this book from a friend then I encourage you to subscribe to the Lend Academy email list.

Whether you are a borrower or investor, peer to peer lending is the wave of the future. It is just getting started. One day in the not too distant future, I expect that most people will invest and borrow money this way. So come and join the 21st century way of lending money.

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