

# BANKER & TRADESMAN

THE FINANCIAL SERVICES AND REAL ESTATE WEEKLY FOR MASSACHUSETTS

A Publication of The Warren Group

## MICRO MACHINES

# Micro Lenders Both Boon To, Bain Of Traditional Lenders

How An Industry Built On  
Serving The Desperate  
Can Help Traditional Banks

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**A**n MIT Sloan School of Management professor says while peer-to-peer lending and so-called "crowd funding" have emerged as an alternative to traditional lending, the practice may also enhance banks' own loan returns.



JUANJUAN ZHANG

Juanjuan Zhang, a marketing professor at Sloan, and Cornell University Professor Peng Liu recently analyzed nearly three years of

data on the behavior of borrowers on Prosper, the largest and perhaps oldest micro-lending website in the U.S.

The researchers found a photo negative of the traditional lending market. Online, borrowers with poor credit ratings not only get loans, but are looked upon favorably by investors providing the funds. In fact, loans to borrowers with lower credit ratings tended to perform better than those made to borrowers with higher ratings, the study found.

Zhang said borrowers with poor credit scores find success on Prosper and other online micro-lending sites because of the sites' transparency. Lenders – often called "investors" on these sites – are able to view not only the credit scores of potential borrowers, but also statistics on whether a borrower's loan was paid off on time, as well as endorsements of borrowers' proposals.

"Loan officers at banks can go through your credit file and gauge your credit-worthiness, but they don't always see the decisions of a dozen other banks," Zhang said.

But are peer-to-peer lending websites, where borrowers with bad credit cobble together loans from multiple "investors" to get the money they need, a threat to banks?

That "is a rather delicate matter," Zhang said.

## 'Urgent' Demand

On one hand, micro-loan markets do compete with banks. On the other, they simply help banks keep their lending clientele "homogenous," Zhang said. In other words, they keep the riff raff out. And that "may actually enhance banks' returns on lending."

"Many people's first reaction would be, 'why can't he or she get the money from banks at a lower rate?'" Zhang said. But nearly half of the borrowers on Prosper have credit scores less than 560, making them "high risk" borrowers in the eyes of most traditional lenders.

And the numbers bear that out, Zhang said. Many of the borrowers say what they need is "urgent liquidity" on a "non-recurring" basis.

Zhang's research found the average loan default rate on Prosper to be between 20 percent and 30 percent – and

that's down substantially. Its loan loss rate dropped by 65 percent between 2009 and 2010.

For that "urgent liquidity," borrowers pay a high price. About half the borrowers who take loans through Prosper pay interest rates between 14.57 percent and 26.45 percent on loans that average between about \$4,000 and \$7,500, according to the site. The highest of Prosper's high risk borrowers, which make up about 11 percent of its total clientele, pay more than 33 percent on loans that average less than \$3,000.

Rates charged on personal loans at local banks are notably lower.

For example, at Rockland Trust, personal loans for auto purchases currently carry a maximum interest rate of 7.99 percent. Unsecured personal loans at Rockland max out at \$10,000 and carry an interest rate of 16 percent – the highest charged by the bank.

At Eastern Bank, borrowers can sign up to make automatic payments and get a lower rate. And the bank says it can offer "terms to fit your budget."

## Lessons To Be Learned

But while the peer-to-peer market helps keep the patently unqualified out of banks, while providing a decent return for lenders willing to shoulder the risk of a desperate borrower, there are things banks can learn from the "social" way peer-to-peer lending works, Zhang said.

In the peer-to-peer world, "each lender might not have the credit-discerning capability of banks, but can access a unique source of information: The lending decisions of many other individuals," Zhang said. "In theory, there is no reason why a corporation cannot participate in the social game of borrowing and lending."

Robert Lutts, president and CIO at Salem-based Cabot Money Management, said while the peer-to-peer model can work and "harkens back to the day when 'Joe the Banker' made his decisions on a handshake," overall, it's still a risky proposition.

Combine investors eager to make some money with desperate borrowers in a tattered economy and the ease and convenience of the internet, and it's clear that peer-to-peer lending's time has come. But the question for lenders remains "when am I going to get my money?" Lutts said.

"Just because it's online doesn't mean it's any better than meeting somebody on a street corner," Lutts said. "I think a lot of people are underestimating credit issues."

Lutts is speaking from personal experience, not with online micro-lending sites, but with personal lending.

"I have done some personal lending, and in one case, I lost 98 percent of my money. I had nothing, it was an unsecured loan. It's a lot more risky than many people think, and I seriously doubt they're going to be better than other options. It's going to be a high-risk option, and they're fragile." ■