Julie Robinson does not consider herself to be a financial innovator. But when the 44-year-old secretary from Hertfordshire left her bank and began borrowing money from an online peer-to-peer lender she became part of an industry intent on disrupting the future of global banking.

After she ran up debt renovating her house in 2009, Ms Robinson took out a £7,500 personal loan at Lloyds Banking Group with a repayment rate of 12.9 per cent. The rate was high, but she was told she could renegotiate later. The renegotiation never happened.

So Ms Robinson went online to look for a new lender. The best deal – at a rate of 10 per cent – came not from a bank, but from Zopa, the UK’s first peer-to-peer lender.

“Anything I can do to make a stand and move my money away from my bank is a good thing,” says Ms Robinson. “I can’t understand why bankers haven’t received prison sentences for what they did in the financial crisis.”

The global credit meltdown may have shattered public faith in mainstream financial institutions by those like her in need of funding, yet it could not have come at a better time for the fledgling and fast-growing P2P loan industry.

In less than a decade a handful of crowdfunding websites around the world have provided billions of dollars’ worth of small loans to individuals and businesses by matching investors with needy borrowers and offering better rates than banks.

Yet as the sector grows, it is attracting the interest of the mainstream financial industry that it professes to undermine. First in the US and now in Europe, P2P is being co-opted by professional investors and even banks themselves.

Ashees Jain and Joseph Marra, two former Lehman Brothers bond traders based in New York, have created a fund to invest in what they see as a new booming asset class. “This year it’s going to be a $3bn origination market. In five years’ time this will be a $25bn-plus market and there will be a large institutional component,” says Mr Marra.

Global regulators are also beginning to scrutinise P2P lending as they explore its potential. Last week, for instance, the Federal Reserve Bank of New York hosted a meeting to discuss the role crowdfunding can play in jump-starting the US economy.
But other organisations are questioning whether the phenomenon is the next evolution of responsible banking or a financial wild west in need of tougher oversight.

The recent surge in interest is a far cry from the early days of the industry. In 2005 a group of British internet bank employees dreamt up Zopa, one of the first examples of P2P lending, as a way for strangers to lend one another small sums of cash.

“In the late 90s there was a lot of innovation about in tech and financial services,” says Dave Nicholson, one of Zopa’s co-founders. “We started to ask the question: why is it that financial services for individuals are so limited compared to corporates? Why can they only go to banks for a loan? Where are the personal bond markets?”

Just like a bank, P2P loan sites check the credit history of borrowers, charging more to those who have a history of defaulting on loans. But unlike banks they use new technology to keep their overheads low, and rates are largely determined by the people who lend the money.

With the permission of a potential borrower, the sites can sweep social media profiles and dive into online bank accounts to approve or reject loans within seconds.

The approach is a canny way to perform the necessary due diligence on loan applicants, and contrasts with the often outdated and creaky information technology systems used by traditional banks.

The use of technology also nets lower rates for borrowers and higher returns for lenders. At a time when average personal loan rates in the UK are hovering at about 6.3 per cent, Zopa advertises a borrowing rate of 4.9 per cent. Lending Club, the world’s largest P2P, offers its most creditworthy borrowers repayment rates of less than 6 per cent.

For borrowers such as Ms Robinson, P2P is an alluring alternative. Although she had never heard of Zopa, she says the decision to use it was easy because it was charging a lower rate.

The appeal has not been lost on Silicon Valley. This month venture capitalists, bankers, traders and investors flocked to San Francisco to mingle with the global P2P industry in the second annual LendIt conference.

“Every banker and most venture capitalists were there – from Goldman Sachs, Credit Suisse to JPMorgan, Barclays, Bank of Montreal and more,” says Ron Suber, president of Prosper, the second-biggest P2P platform.

Hedge funds and large wealth managers have been making loans through US P2P platforms for many months, lured by yields of up to 24 per cent at a time when returns on cash and government bonds are stuck around record lows.

They have been buying at such a fast clip that both Lending Club and Prosper have had to install “speed bumps” in their online software to slow the professionals down and make sure some loans are left for retail lenders to fund.

Investors have also applied one of Wall Street’s most infamous techniques to the sector. Last October a New York-based hedge fund “securitised” about $53m worth of P2P loans from Lending Club, repackaging them into bonds that could be sold to a wider array of investors.

Alongside the potential for slicing and dicing loans, it was the prospect of Lending Club’s much-anticipated initial public offering that caused the most excitement at the San Francisco conference. The company recently reached a valuation of $3.76bn after raising new funds to expand into small business lending and loans for riskier “non-prime” consumers.

The New York Fed’s meeting about P2P is emblematic of the conflicting views of the industry. Regulators want to support competition and think such lending could be useful in helping borrowers who find it difficult to get a loan.

But it also forms part of the “shadow banking” system of non-bank financial intermediaries that authorities fear could pose a risk unless its growth is matched by increasing regulatory oversight.

“We want to ensure that consumers are appropriately protected – but not prevented from investing,” says Christopher Woolard, director of policy at the Financial Conduct Authority, which began regulating the UK P2P industry in April.
The automated due-diligence process that allows platforms to keep their costs low can also be manipulated by fraudsters. In its first few years of operation, Prosper’s default rate exceeded 20 per cent. Now, as a result of its enhanced systems to weed out manipulation, it has been able to reduce it to just over 3 per cent.

When UK consumer group Which? investigated the sector by lending £100 on Funding Circle, another UK-based P2P platform, it lost £10 when one borrower defaulted on a loan.

“Peer-to-peer lending has brought a new element of competition to the saving and loans market,” says Richard Lloyd, executive director at Which? “But it is riskier.”

As it grows, crowdfunded lending faces a fundamental choice between remaining selective about its borrowers to keep default rates low or relaxing criteria and accepting the risk of more bad loans.

The International Organisation of Securities Commissions, which has carried out a detailed analysis of the risks posed by such lending, points out that there have been cases of platforms closing, leaving lenders facing total losses on their loans.

In China, where nearly 1,000 P2P companies operate, dozens have collapsed in recent months as borrowers struggle with debts in the midst of an economic slowdown, according to research by Celent consultancy.

Across the world, unfettered P2P loan markets are rare. The sector is approached differently by various regulators, treated as banking by some countries and an intermediary in others. In Israel and Japan activity is prohibited altogether.

“The primary issue that regulators have generally is when finance touches the individual. If an institution [corporate client] is somehow taken advantage of, it’s kind of like, yes, ‘big boys’, that’s the way it works,” says Dan Zwirn, a hedge fund manager who had his own encounter with the US securities watchdog several years ago. “But when you touch a depositor, when you touch an insurance premium payer, a taxpayer, that’s what costs you your job.”

Regulation of P2P is likely to evolve as institutional investors take a bigger role in the sector

More than 60 per cent of the loans facilitated by Prosper and Lending Club are now thought to be funded by big institutional investors such as hedge funds and wealth management firms.

Even in the UK, where the crowdfunded lending landscape remains dominated by retail investors, the British arm of Santander is in talks with Funding Circle.

The industry’s partnership with bankers is viewed with suspicion by many. There is disbelief that an industry that once claimed to want to avoid large financial institutions is now teaming up with them. Some have suggested that investment through P2P lending might be a way for institutions such as banks to circumvent regulatory requirements.

Mr Suber from Prosper says that it is not the purported iniquity of big banks that people should focus on but rather their inefficiencies. He says big banks can use P2P platforms to facilitate their own lending at a cheaper rate or to help them more easily source loans.

Lending Club and Prosper have struck deals with a clutch of smaller banks for just these types of arrangements.

There was little actual reference to P2P lending in San Francisco this month. Executives are moving away from the term in favour of “direct consumer lending”. Now, as the sector booms, it is time for another rebranding: “marketplace lending”.

It is a catch-all term that perhaps better reflects the growing aspirations of the industry, says Mr Suber. He sees P2P as a software solution for big banks, one they can use to power their lending systems just like the microprocessor chips made by well known computer companies.

“Marketplace lending will become this ‘Intel Inside’-like component that plugs in to banks, where we can help banks satisfy their customers who want personal loans and enable banks to buy loans from us to hold on their balance sheets.”

Despite the sentiments of borrowers such as Ms Robinson, far from shunning the banking industry, P2P’s future may ultimately be tightly entwined with it.
Global network: Expansion sought across frontiers

Peer-to-peer lending is a highly concentrated industry dominated by a small number of websites in the US, UK and China.

Across the rest of the world in countries such as Argentina, South Korea, Italy, Estonia and India, online P2P lending remains a tiny sector, hampered by local lending laws and a lack of public awareness.

“There is perhaps more anti-bank sentiment in the US and UK than elsewhere, and other lenders haven’t received the same level of media attention,” says Claus Lehmann, who runs the analysis website p2p-banking.com. “Plus in some countries it is harder for the lenders to beat banks on rates.”

Even in Europe, where borrowers were left stranded by banks that withdrew credit following the eurozone crisis, P2P websites have struggled to facilitate a large number of loans.

The solution, according to the region’s established platforms, is cross-border lending.

Loan volumes in Spain provided by domestic platform Communitae are low, but Estonian lender Isepankur and German company Lendico have both moved into the country in recent months and say interest from borrowers has been strong. German lender Auxmoney says that it is also planning international expansion in Europe in the near future.

The snag is that regulation of cross-border loans is untested and could prove complicated. There is no common European framework for oversight of crowdfunding, and the European Commission is still in the process of carrying out research into the sector. Some commentators think regulation for borrowers and lenders could be split between different countries, others say a single point of contact is needed. Until regulation is agreed or something goes wrong, no one knows for sure how it will work.

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