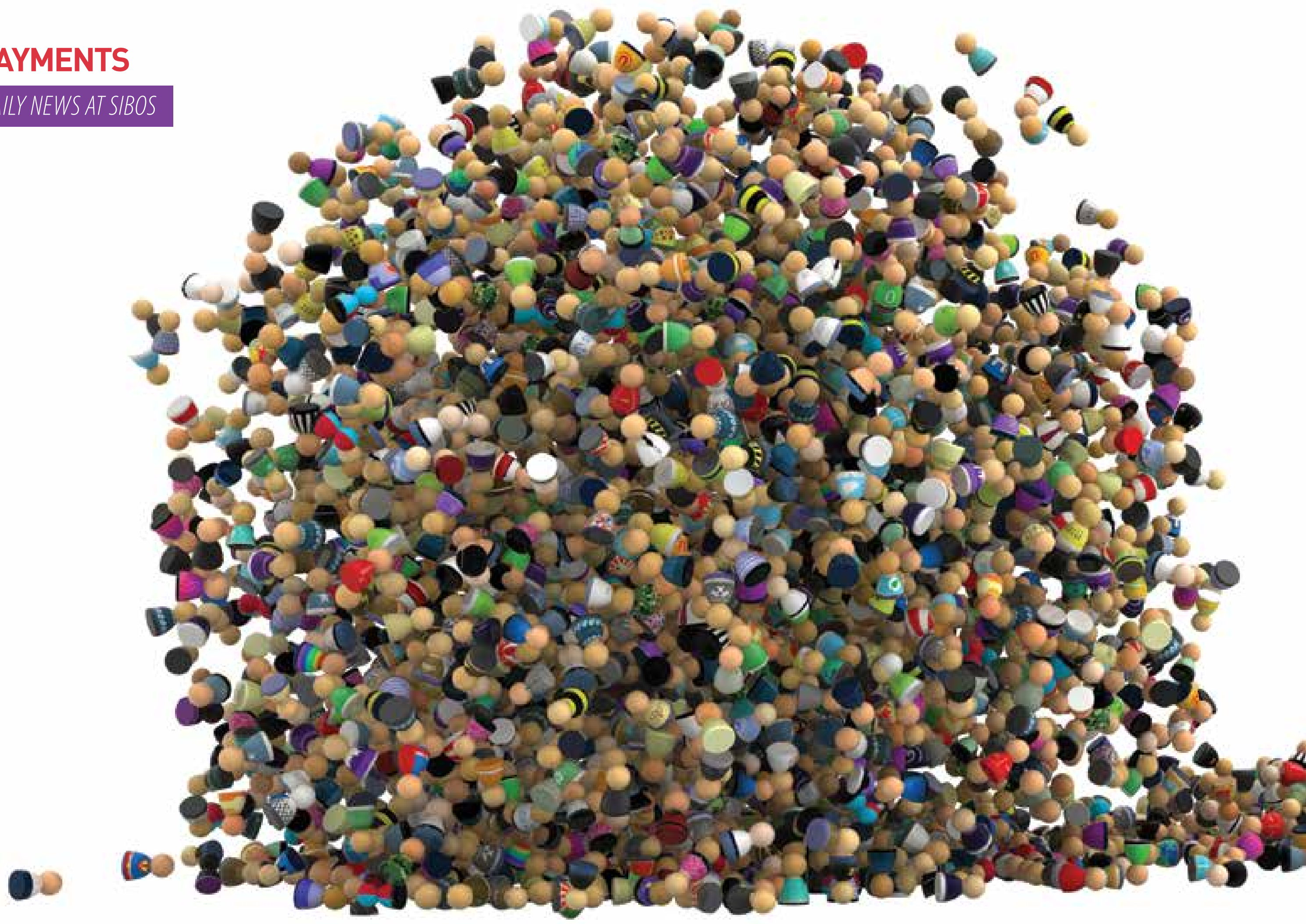
POWER TO THE PEOPLE?

The growth of peer-to-peer (P2P) lending has shown there is an alternative to the traditional lending model of banks. But can crowdfunders ever replace the incumbents, and do they enjoy long-run advantages or face being co-opted? Neil Ainger investigates

The potential disintermediation threat to traditional banks from peer-to-peer (P2P) lenders was illustrated in August when the pioneer Zopa burst through the $1bn (£602m) mark in the total amount lent since its formation in 2005. Many of its successors, such as Prosper and Lending Club in the US, long ago passed that milestone, and other new P2P lenders are springing up around the globe, all the time eating into the market share of banks' loan books.

Prosper spokesperson Sarah Cain says the US small business lender originated $153.8 million in July 2014 on its online platform, which is more than quadruple the amount lent in the same month last year. Prosper "continues to set monthly records", with the $369.9 million for Q2 2014 more than the whole of last year. Rival US firm Lending Club lent $1 billion in the same quarter alone.

The strength of the sector is illustrated by Lending Club announcing a $500 million initial public offering (IPO) in »



August. Google paid $125 million for a minority stake in the firm last year and is one of many set to benefit from the IPO, including hedge funds. This reflects how P2P online operators are increasingly coming into the mainstream and losing their 'alternative' status. Since shadow banking money became involved, the 'power to the people' marketing message that arose when P2P lending was mainly individuals lending to other individuals via an online community has faded away.

The growth isn't just confined to one country. David De Koning, head of communication at the UK's Funding Circle, adds that in the past three years the UK P2P lending market has trebled in size and will be soon bypass the £2 billion mark. The Australian and Chinese markets are growing fast too as the sector professionalises and standardises.

In March, Westpac, one of Australia's 'big four' banks, claimed a world first as a bank investing in a P2P lending firm. Via its venture capital management subsidiary Reinventure Group, Westpac invested A$5 million in SocietyOne, one of the first P2P lending firms to be established in Australia. *Australian Financial Review* reported that the investment was believed to be the first equity stake a bank had taken in P2P anywhere in the world. Along with investments from Rocket Internet, a Berlin-based internet incubator and several local investors including the Australian head of global private equity giant KKR, SocietyOne has raised A$8.5 million in total, which it will use to develop new credit products. Among its existing products are livestock loans and loans tailored for young doctors. To date, the firm has made 200 loans totalling A$4 million.

"Banks face a number of key challenges [in fighting the new lenders]," says De Koning. He cites the need to maintain expensive branches, inefficient legacy IT infrastructures and a challenging regulatory environment that often demands banks have collateral on their books to sanction a loan. These restrictions are allowing P2P lenders to gain market share, although interestingly many banks are now buying loans off practitioners as a commercial investment, as Deutsche Bank and Bank of Montreal have done.

Zopa has a 1 per cent share of the UK unsecured consumer loan market, but is targeting a 15 per cent share in the next decade, says marketing manager, Mat Gazeley. He adds that "margins for retail banks are not that great [versus their costs] so there is a clear opportunity for us".

While Robin Greenlees, Lloyds Bank's head of regulatory response, commercial banking, does admit there are cost advantages in being a new P2P entrant, he doesn't think their advent is a straightforward disintermediation play. A much more nuanced relationship is coming with competition in some areas and acquisition in others. Some takeovers have happened, including Barclays Africa's purchase of a stake in South Africa's RainFin this year.

Cooperation deals are also on the rise as shown by Santander's partnership with Funding Circle, whereby the UK operations of the bank will refer small and medium sized enterprises (SMEs) it turns down for a loan to the P2P

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platform. Funding Circle will in return promote the bank's current accounts and other services, which it cannot offer as a non-deposit taker.

"In addition, strong encouragement of alternative lending sources from governments is likely to spur growth," says Greenlees. The UK regulator, for example, requires banks to refer companies whose applications they've declined to alternative financiers in an attempt to aid economic recovery. If banks and P2P lenders are getting more closely intertwined and investing in each other's operations, is alternative people-based lending still really a different option?

The co-opting of the P2P sector or its professionalisation – depending upon your point of view – is further proven by the cooperation deal between San Francisco-based Union Bank and Lending Club. The two organisations have agreed to work together to create new loan products for customers of both companies and the P2P firm will sell the bank some of its loans. Effectively, the bank is using Lending Club's online platform to make loans without having to underwrite or service them, or use its own more expensive network. This is further evidence of banks increasingly fraternising with what formerly might have been regarded as potential displacers. Some retail or commercial banks might still view P2P lenders in that way, but others are beginning to see them as partners for low-margin business that isn't immediately on their radar.

It must be remembered that the consumer market is different from the SME market and each country has different regulations, rules and norms. The consumer loan segment is traditionally more tightly regulated and success is more hard won, compared to the business sector. The people-funded model of many of the earlier P2P lenders has been replaced by private equity (PE) and hedge fund money in the US.

"The P2P concept has become B2P in the US with the business part of the equation equalling a finance company funded by investors," says Christine Pratt, senior analyst at Aite Group consultancy. "For consumers in the US it's almost bait and switch now. They sign up expecting a friendly, happy trustful family lending model and instead get finance company loans with high interest rates." She adds that Zopa has exited the tough US consumer segment.

Other crowd funders such as Kickstarter and SoMoLend have arisen, replacing the more professionalised P2P lenders, many of which tap into PE money. Digital platform providers such as Amazonloan.com and PayPal are also looking to lend to their users and small microfinance lenders in emerging markets are competing with traditional »

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banks for their loan books. The market is fragmenting as it grows and is more complicated than it might first appear.

There are still newcomers setting up, such as RateSetter in the UK, Ezbob and many others using online, social media and mobile technology to disrupt the traditional relationship and branch-based model of the banks. The model of using crowd sourced funding is not going away. Using people power funding to match individuals that want to invest with those wanting to borrow online, without banks, has been replicated around the world.

Dianrong.com is one of a number of P2P lenders recently established in China. The Chinese P2P lender went public in March 2013 after being co-founded by Soul Htite, ex-head of technology at Lending Club. "P2P lending is still in its early stages in China," he says, "but the speed of growth is prominent and regulators are encouraging transparency."

Microfinance initiatives in emerging markets in Latin America and Africa are common, as the P2P segment globalises and expands, heightening the disintermediation threat to banks or at least the disruption threat to their traditional branch-based model. The micropayments sector developed by M-Pesa in Kenya, for example, is likely to be replicated for loans as online micro lender websites and mobile players proliferate in Africa.

The P2P threat is materialising just when new regulations and market conditions make lending more difficult than ever for traditional retail or corporate banks. These institutions are repairing sometimes battered balance sheets and reputations, limiting loans and dealing with impending Basel III capital adequacy requirements and changing collateral needs. No doubt this will prompt large corporate customer lending to be prioritised over consumer or SME lending.

"The P2P sector is growing globally, providing more consumer and business loans," says Dean Henry, director of global payments product innovation at Bank of America Merrill Lynch (BAML). He cites the $2.4 billion lent in 2014 versus $871 million the year before in the US, "but a lot of the loans are only on the edge of where banks currently operate".

Many US P2P customers are looking to repay credit card debt, for instance and the unsecured market isn't of such interest to banks at the moment. With the collateral requirements facing traditional banks post-crash this is hardly surprising as they invariably turn towards larger corporate and multinational firms to help meet their own capital requirements and return on equity targets.

Long-term, Henry doesn't think banks will necessarily ignore lower margin segments and traditional players could eventually return using their bigger capital resources, economies of scale and risk management expertise. They will hope to win back any lost ground in the consumer or micro-business loans arena once the economy improves.

"While it may also be valid in the short-term since the 2008 crash for some to highlight trust issues in banking, it is a fact that banks have been around for a long time and can offer the security of being regulated [and protected] deposit takers," adds Henry. "Digital platforms, with smaller teams, have their own information security issues too and because they're on the edge of innovation may face operational issues themselves."

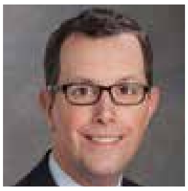
That is not to say there aren't lessons that banks can learn from P2P newcomers. "We can learn how to assess and serve customers more quickly; to be more user friendly, with better marketing aids such as online calculators and service tools," says Henry.

He knows what he is talking about, having previously founded the US' Insurance-1st.com website which applied the 'lending tree' P2P business model to insurance. "The biggest lesson banks can learn from the P2P industry is how to incorporate new data sources into credit scoring."

The credit modelling at banks hasn't changed for decades and typically cannot accommodate unstructured data or other supporting evidence to OK or decline a loan quickly. This means banks often lose out to P2P lenders that act more speedily. "Again though, I believe this is a short-run advantage. The technology edge doesn't last forever for newcomers as the bleeding edge becomes the mainstream," says Henry.

The hedge fund investment that typically drives US P2P lending also tends to operate on a short three to five year profit cycle, so it may not last. Once the present upswing has run its course banks may once again return in strength when PE money exits.

Zopa's Gazeley does think P2P lenders such as his firm present a genuine disintermediation threat in the loan market, insisting that "P2P is here to stay" and "offers the best rates and returns". He does admit though that there always will be a need for traditional banks. "We use RBS for our clients' deposits, for instance."



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The future may involve a coming together of the newcomers and the incumbents as evidenced by the recent deals involving Santander and Funding Circle in the UK and Union Bank and Lending Club in the US.

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