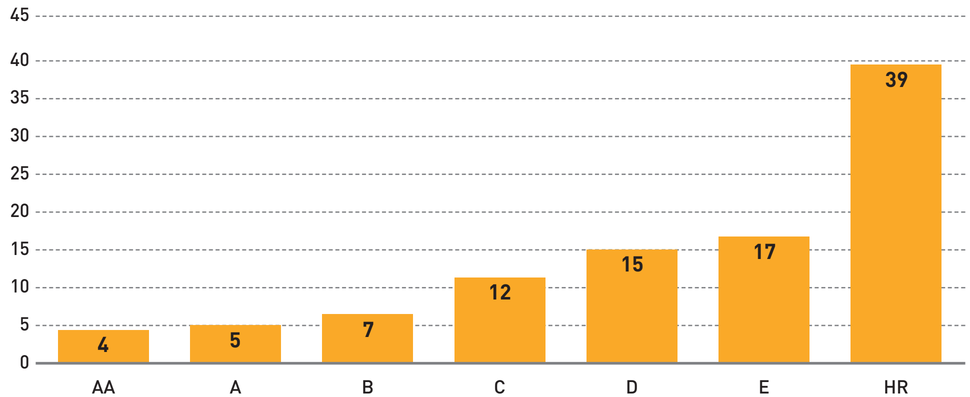
Insideview

Is Peer-to-Peer Lending a Threat to Banks?

Interview with Dr. Thomas Meyer Economist; Deutsche Bank Research

A new report of Deutsche Bank Research investigates online lending platforms sprawling in the US (e. g. www.prosper.com) as well as in Great Britain (www.zopa.co.uk) and in continental Europe (in Germany e. g. www.smava.de). Online lending platforms match people needing small loans with those who have extra-cash – without an institutionalized bank as a mediator so that, step by step, some funds may be deviated from the banks. P2P lenders typically bear the credit risk. Therefore, a core question is how to pick the right loan. Prosper for example allows borrowers to explain publicly who they are and why they need money – and customers bid on the loan requests they like. www.circlelending.com for which radio ads are run in the US builds on the credit discipline among families and friends.

High-risk borrowers request the most loans
Share of requested loan volum (%), by credit score at Prosper



Credit quallity decreases from AA to E; HR=High Risk

Figure 1: Sources: DB Research, Wiseclerk.com as of 14 Sep 2007

Dr. Thomas Meyer,
Economist, Deutsche Bank Research,
author of: "The power of people: Online P2P lending nibbles at banks' loan business" (E-Banking Snapshot, July 2007)

How does group pressure work reliably in P2P online lending platforms like Prosper?

Some platforms allow borrowers to organize in groups. The group's reputation is an important signal to lenders. It depends on the punctual payment by all members. Hence, groups only admit those whom they trust not to dilute the achieved credit standing. Acceptance by a group of borrowers is thus a sign of confidence. After joining the group, there is social pressure to behave well – i.e., to service outstanding debt on time – in order to protect the group's reputation. Often, the group members know each other personally which makes late payments even more shameful. Our research shows that both mechanisms (selection and monitoring) seem to work: group members are more likely to receive funding and their default rates are typically lower – other things being equal.

You conjecture that high-risk borrowers and non-standard loans are the untapped potential for P2P lending. Why?

There are two reasons. Firstly, P2P sites may leverage their social networks of groups, endorsements from friends, and interaction within the community to make better judgments on the credit worthiness of riskier or out-of-the-ordinary borrowers than traditional banks could. Secondly, there is cut-throat competition in the market for standardized, low risk loans. This limits the growth potential of P2P sites in this segment because potential borrowers can choose among many attractive alternatives from traditional banks. This shows, for instance, in the composition of loan applicants at Prosper (see Figure 1): less then 10% of loans (by volume) are requested by borrowers with a credit score of AA or A (the best) whereas more than 70% of requests come from borrowers with a credit score of D or worse. However, this potential is yet untapped because most P2P- lenders have so far ignored riskier borrowers.

To which extent is P2P lending a threat to banks?

The key challenge for P2P lending sites is to convince many more lenders to fund loan requests. This may be difficult given the inherent risks and the multitude of attractive investment alternatives. Thus, it seems unlikely that P2P lending will be more than a niche product to those who enjoy the social aspect and want to immerse themselves in screening the credit requests.

Thank you for this interesting conversation.