bypassing BANKS

PROSPER aims to directly link individual borrowers with lenders using an eBay-type model. But will it work?

BY AARON STEELMAN

You have just started a small business. You have used most of your savings to get the company off the ground. But you need a little more money to really get things going. Where do you go? For decades, people turned either to family or friends or to a commercial bank. But each of those options had downsides. Borrowing from loved ones can be fraught with problems, leading to ended relationships should the business turn sour. And many people perceive, rightly or wrongly, that borrowing from banks can be a real hassle — there's too much paperwork and, at the end of the day, the little guy is unlikely to get the loan anyway. So why bother?

Filling this niche in the marketplace is a new Web site: Prosper.com. Launched in February 2006, Prosper wants to directly link borrowers with lenders — that is, individuals who need money with individuals who have some to lend. Chris Larsen, who co-founded the online loan broker E-Loan, started drawing up plans for Prosper a few years ago. At the time, he thought "the ultimate goal would be to have an eBay for money." Now about five months since Prosper's launch, it's possible to draw some tentative conclusions about how the site has been working and what the future may hold for it.

Nuts and Bolts

Let's say you want to borrow $5,000. How do you go about it on Prosper? The first thing you do is provide some standard information to Prosper, which the company will use to assign you a credit score (in conjunction with Experian, one of the largest credit rating agencies). Credit scores range from AA (the highest) down to HR (high risk), the lowest. There is also a NC (no credit) ranking. After you have been assigned a credit ranking, you will fill out a profile, describing why you want the money and for what purposes you intend to use it. Finally, you will state the maximum interest rate you are willing to pay.

Lenders will then bid on your loan. On rare occasions, one lender may decide to fund your entire loan request. But more frequently, many people will bid on the loan, so that you may receive, say, a hundred $50 bids from different lenders. This allows lenders to diversify their portfolios. Should your loan become fully funded, you will pay Prosper a 1 percent origination fee. In this case, $50. In addition, you will pay the interest on your loan to all of the people who agree to lend you money. All loans are extended on a three-year basis, and they are only made if you receive the full amount of money you requested. For instance, if your loan attracts only $4,500 in bids, your loan request has failed and you have to go back to the drawing board.

How about from the lender's side? Any individual can lend up to $25,000 at one time. The same is true with borrowers: The maximum that any individual can request is $25,000. (Some states do not permit loans this large. Likewise, some states set caps on the amount of interest that can be charged. For instance, in states like Pennsylvania, where the interest rate ceiling is relatively low, you see very few loans being made.) In order to bid on a loan on Prosper, you first must transfer money to the company, which will handle the transactions for you. If you successfully bid on a loan, Prosper will assess a 0.5 percent annual servicing fee. Just as with any other type of loan, there is a chance that borrowers will default. Should this be the case, Prosper will contract with a collection agency to try to recoup your money.

The basic setup on Prosper is in some ways similar to eBay but has some important distinctions. For instance, eBay is a one-to-one auction platform. Someone puts up a good for sale and it goes to the single highest bidder. Larsen says that he didn't think that model would "work with money. You had to have a one-to-many auction system, where multiple lenders provide money to a single borrower." Also, as mentioned, Prosper handles all the administration, effectively

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acting as the middleman. That has some benefits, Larsen says. "First, the borrower and lender never have to worry once they make a match. Second, the borrower and lender can remain completely anonymous if they choose. Third, we have the complete data about what actually happens so we can reliably create an objective ranking system."

The Group System

On eBay, feedback plays a crucial role in determining bids. Sellers with poor feedback ratings often receive lower prices for their items. But the feedback is subjective. It is based on the buyer's perception of how closely the item matched the description and how quickly it was sent. With Prosper, the ratings seem much more clear-cut — you either paid your loan on time or you didn't.

Eventually, Larsen hopes that individuals with particularly good records will pool themselves into groups. For instance, you might get a number of real estate investors with AA or A credit rankings who will form a group, signaling to potential lenders that they are good risks. Once that reputation is established, members will have a strong incentive to monitor the behavior of other members, lest they damage the reputation of the group and drive up the loan rates that others receive. This type of community-based peer pressure, Larsen hopes, will help Prosper, well, prosper.

"The big dilemma is how to get diversification and familiarity working together. That's how the group system came in," says Larsen. "Even though the money is coming from a broad set of lenders, we want the borrowers to always feel a strong sense of obligation to the community to which they belong."

Jim Bruene, the editor of Online Banking Report, who did a study of Prosper about a month following its opening, concurs. "For this thing to work, there has to be some information that goes beyond the credit score that lenders can rely on. I think Prosper is hoping that the group system does that. The problem is the groups don't really have much of a track record now, but over time, groups could become large enough and credibly signal to lenders that their members are good credit risks."

Myron McCrensky is a group leader. In other words, he started and organizes one of Prosper's groups, in this case the "Business Owners Cooperative." McCrensky, who spent most of his career working for the federal government, retired about seven years ago and started a pet-care business in Alexandria, Va. He created an account on Prosper about a month after the site opened. He initially intended to serve as a lender, but he quickly decided that he wanted to start a group for small business owners in Virginia. Eventually, though, he decided that he should expand the geographic range of members and now accepts applications from around the country. For his efforts as group leader, he receives a one-time payment when a member's loan gets funded. In addition, when loan payments are made, he receives a small amount of income that he can share with other members of his group. McCrensky currently divides those proceeds on a 50-50 basis with the 120 or so members of his group.

McCrensky says he is fairly open when considering applications. But he has established a stricter set of guidelines recently. "I think the big fear that people have about Prosper right now is that it's still possible for someone who wants to defraud others to accomplish that. There is still a lot of good faith that has to go into making a loan." So in recent months, he has rejected a few people. "There was one guy last week who had belonged to another group and the loan description he wrote — why he needed the money — began to change from one posting to another and that, naturally, made me a bit suspicious."

His experience with Prosper has made him skeptical about how well the group system will actually work in transmitting information to potential borrowers. The reason: The monitoring costs for group leaders can be prohibitively high, if all you are interested in doing is turning a profit. "I think that I am fairly hands-on, but it takes a lot of work to adequately screen all of your members, and you are not going to be perfect. And for what a group leader gets in terms of financial rewards, the money is pretty nominal. It's really a labor of love more than anything." The one way this can work, McCrensky thinks, is for group leaders to take on a lot of members, increasing the number of loans and, thus, fees received. "But, of course, that also increases your monitoring costs. So it's not clear to me in which direction the group system will move."

Distribution of Loans on Prosper.com

Borrower's Credit Grade	Average Interest Rate	Average Loan Amount	Successful Loan Account	Percentage Successful
AA	9.37	$7,142	174 of 654	27
A	10.88	$6,859	161 of 611	26
B	13.96	$6,653	206 of 804	26
C	16.81	$4,982	328 of 1,508	22
D	20.64	$3,893	287 of 2,106	14
E	23.55	$3,496	310 of 4,307	7
HR	25.13	$2,504	333 of 12,937	3
NC	21.41	$2,322	31 of 448	7

NOTE: Data last updated on July 10, 2006
SOURCE: www.savagenumber.com

Who Wants to Borrow and Who Gets Funded?

Intuitively, it makes sense why a person with a D or E credit rating might head to Prosper instead of his community bank. Indeed, many of these people are not interested in getting small businesses off the ground. Instead, they are looking to make consumer purchases, such as home improvements or travel plans. A large share are trying to borrow to finance other debt they have accumulated, mostly high-interest credit card debt.

But what about people with AA or A ratings? "At the beginning, I think there were some good deals out there. There was some seed money and you could get a 6 or 7 percent loan, which was very competitive. But now you go to Prosper and you see the loans don't appear to be as competitive — they are 10, 11, or 12 percent," says Bruene. "So now the question is: Looking at it rationally, why would you choose to get one of these loans instead of taking a good credit card deal?"

Overall, the number of loans approved is relatively small. This is true even for people with very good credit ratings. As you drop down to people with E and HR ratings, the share approved becomes miniscule — and this is off a pretty big base. For instance, the number of loans requested by people with HR ratings is more than every credit rating combined. (Larsen says that at any one time there are about 1,000 loan listings on Prosper. The listings last for 10 days, so there are always some that are ending and others that are beginning.)

So who is taking a shot on the people looking for money on Prosper? It runs the gamut. There are some people who loan only to those with AA and A credit ratings. They figure that they are going to get a relatively small return on their money, but they like the safety of lending to people with good track records. Meanwhile, some lenders "are willing to put up a lot of $50 loans to relatively high risk people at high interest rates, hoping that, say, 80 percent of the people wind up making good on their payments," McCrensky says.

Finally, there are some people who see their activity as something akin to providing a public good. They may serve as both borrowers and lenders. They borrow money through Prosper and then wind up loaning it out to activities they deem worthwhile. Larsen says that he remembers "one person with an AA credit score who was borrowing on Prosper and using the loan proceeds for microlending in Africa." Of course, there are other people who serve as both borrower and lender with strictly pecuniary interests in mind. They believe they can effectively use Prosper as an arbitrage opportunity: borrow at, say, 10 percent and then loan at 20 percent, pocketing the difference.

When asked if this type of activity violates the community standards of Prosper, Larsen is agnostic. "I have definitely seen that. I don't endorse that. But I also don't want to prohibit it," he says. "We don't want to squeeze too hard by saying this type of borrowing is OK, but this type isn't. We have looked at social networking sites and those that have failed have usually squeezed too hard early on. The ones that have thrived have operated on the assumption that most users will act responsibly and have made systems that filter out the exceptions."

If there is one guiding principle for Larsen and his colleagues it is this: "We have to make sure that the market is safe, secure, and transparent." That, more than anything else, they believe, will determine Prosper's fate.

A Missing Market?

In a world with an extremely well-developed banking system why is Prosper necessary? What type of market opportunities currently exist that Prosper can exploit? At the most basic level, Larsen argues, there are still large information asymmetries. "I was involved in the effort to increase the transparency of credit scores. But for a long time the lending side had all of this information on potential borrowers, while on the other side everyone had a score, but you couldn't find out what it was," he says. "One side having fundamentally more knowledge than the other can create real inefficiencies. And I think that's still true to some extent today."

In addition, Larsen thinks that one side of the market — individual lenders — currently has no place to go. "It always seemed to us the element that was missing in consumer finance markets was that people with a little bit of money to lend really didn't have access to directly compete with banks or with payday lenders. We thought Prosper was one way to remedy that. People who saw an opportunity could now compete in the capital markets."

Consumer psychology — at least among some segments of the population — may also make Prosper a viable business opportunity. "For instance, some people just inherently don't want to work with banks, others may have had bad experiences with banks, and others may believe that the paperwork needed to do business with a bank is too burdensome, especially if they don't have standard W-2 forms to show to loan officers," Bruene says. Some of these people might qualify for loans at relatively good terms through banks, he says. "But they just don't like those institutions and instead want to borrow in a way that has more of a community feel to it. So it's like a virtual credit union, in a sense."

Which gets us to the personal aspect of Prosper. All borrowers are given the opportunity to compile a personal history, explaining possible credit problems in their past, why they want the money now, and what good they will do with it. Many borrowers feel this is information that many banks simply ignore — but that may be vital in assessing their creditworthiness. Apparently, many lenders agree.

"The lenders are no fools," says McCrensky. "They are trying to acquire every piece of information available to them. Borrowers have to convince lenders that they are a good risk and have a good business plan. They have to be able to write seriously and provide a compelling case. Otherwise, they probably won't get funded."

The amount of personal information provided by lenders has surprised Larsen. He expected more people to go on the site anonymously, simply listing their credit grade and the amount of money they would like to borrow. Instead, most people provide detailed stories and even photos. "And I think those people are probably getting better bids," says Larsen.

How long this will last, though, is unclear, says Bruene. Already, there have been a large number of blogs that have grown up around Prosper. Many of these blogs have analyzed which loan solicitations have been most successful and offer advice on how to copy those approaches. "So when that information becomes widespread, lenders may realize they are getting less meaningful data from the profiles and discount that in the future," says Bruene. "In a few more months, are those descriptions going to have any value anymore?"

Getting back to the larger picture, Bruene has his doubts about how successful Prosper will be. "In total, this is not a market that is underserved. There may be some pockets that are underserved — in fact, I'm sure there are — but whether Prosper can find them and provide adequate service is hard to say." **RF**

Readings

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Meet the New Grundy

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number of applications. In 2006, there were 1,500 applications for 145 spaces.

Students who live and shop nearby add to the liveliness of the community and spend money, for example, at the Internet café across the street. A few students on a Sunday afternoon play a quick football game out front. Some students stay in the area after graduation, and many settle in the Appalachian region.

"I think the idea of the schools is that the students will have a higher propensity to remain in the region; it's increasing the human capital," says Brad Mills of Virginia Tech. "The idea is that you create human capital, and you'll get an adequate skilled labor market. Jobs do tend to cluster around people … there definitely is evidence of that."

The school aims to train lawyers for a solo or midsize practice, and specializes in community service. (For example, the students work in elementary schools teaching conflict resolution.) Each law class starts with about 140 students; about 100 stick around to finish. Seventy percent of the students come from the local five-state Appalachian area, with 28 states represented at the school.

Beth Maurer, a third-year student from Asheville, N.C., chose the school because it's small and personal, like her undergraduate college in West Virginia. Plus she enjoys outdoor recreation, and there's plenty of that, especially at the Breaks Interstate Park on the Kentucky border. (There are also few distractions to studying, she adds.)

Associate Dean Stewart Harris, like many faculty members, sought the school because of the region and the mission; he and his family moved from the University of Florida, where he taught law. "This is really an unusual school, focused as it is on community service, community leadership," he notes. "We've been lucky in recruiting top people." There's also an emphasis on arbitration and mediation, a growing need in legal circles.

The University of Appalachia's School of Pharmacy also thinks regionally, although its applicant pool is rising. "We've got applicants from 30 states in this second go-round," says Kilgore. The school's mission is to improve health care in Appalachia so those applicants get priority. "You could fill your class with California applicants if you wanted to, but that wouldn't help your region."

Roger Powers, the mayor, says the town's population is slowly growing, and that can only accelerate with the town reconstruction project. The schools, the flood control project, and the new town are all finally coming together. The law school alone probably brought in 39 or 40 jobs, plus students. "A lot of people I know say, 'A school in Grundy?' Look at Blacksburg [home to Virginia Tech]," he says. In the 1950s, it was just another small Appalachian community.

Grundy's sprucing up. "It's like the whole town is getting a facelift," Flora Rush says.

After all, they hope they've got company coming. **RF**