2016

Forget The Bank: The Future is Peer-to-Peer Lending

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Recommended Citation
http://digitalcommons.uri.edu/srhonorsprog/467

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The year was 2006, the housing market was booming leading to stiff competition between mortgage lenders for revenue and market share. With the supply of creditworthy borrowers limited, mortgage lenders began questionable practices that relaxed the underwriting standards and originated risker mortgage loans for less creditworthy borrowers. The market power began to shift from securitizers to originators and intense competition from private securitizers started to undermine conservative government sponsored enterprises, pushing down mortgage loan standards and generating riskier loans. In combination with the Federal Reserve lowering the federal funds rate target from 6.5% to 1% to soften the effect of the dot.com bubble and perceived risk of deflation. Lower interest rates encouraged borrowing and as early as 2002 it was apparent that the housing market was funded by credit instead of business investments. The result of this in 2007-2008 was the eventual collapse of the housing market, which led to the worse financial crisis since the 1930’s Great Depression. This crisis threatened the collapse of large financial institutions only prevented by a bailout from the national government. The National Government enacted the American Recovery and Reinvestment Act of 2009, a bailout of $831 Billion between 2009 and 2019 leading to capital regulatory of big banks. By establishing these regulations, financial institutions are forced to hold enough capital to ensure continuation of a safe and efficient market and withstand any foreseeable problems. However, these capital
requirements made it harder for the average American to receive a loan from the banks, and near impossible for low FICO score individuals to receive a loan.

As a result borrowers began to look elsewhere to receive a loan. A relatively new form of borrowing known as peer-to-peer investing began to take off. Peer-to-peer lending is the practice of lending money to individuals or businesses through online services that match investors directly with borrowers. Soaring in popularity for its ease of use and ability to receive loans, Lending Club has claimed 15.98B in loans through December 31st 2015. In August of 2014 they launched their IPO on the NYSE and saw the stock rise 56% by the next day. This valued the company at 8.5B. Although a relatively young industry, peer-to-peer lending has been picking up steam and generating extreme interest across the country. Lending Club offers two forms of business the investing and borrowing side. My project, “Forget the bank: The future is peer-to-peer lending”, focuses on the lending aspects of the online platform. With a personal investment of $500, my goal was to garner a 12% return throughout the 4-month honors study.

To achieve this goal, my studies began by focusing on learning the platform and reading about as much information as possible. To begin the lending process an investor invests in $25 “notes”, or partial shares of a larger loan. These “notes” can be denominated all the way up to $100 per “note”. When looking at the loan-browsing page, an investor is given a profile of the borrower requesting a loan. This profile lists important information such as monthly payment, home ownership, length of employment, monthly income, job title, location, debt to income ratio, credit score, earliest credit line, number of credit lines, revolving credit balance,
revolving line utilization, inquires in last 6 months, accounts delinquent, delinquent amount, number of delinquencies, months since last delinquency, public records on file, months since last record, months since last derogatory, and collections excluding medical. The information listed on a borrowers profile is commonly referred to as filters. These filters generate important profile analyzing information and when used correctly, can have an impact on decreasing the risk of an investor's portfolio while maximizing the returns. Through the use of nsrplatform.com the investor can back-test previously issued loans using the borrowers filter statistics and an investor can research the past returns based on these selected filters. Originally my thought was to build a portfolio centered on C and D grade loans and sprinkle in a few B and E grade loans to balance out risk and return. The original filter I created, referred to as “BCDE” filter included the following: Open credit lines: 5-30, delinquencies in last 2 years: 0, home ownership: mortgage, inquires in last 6 months: 0, interest rate: BCDE, loan purpose: reconsolidating debt and credit card refinancing, public record: excluding loans with public record, loan term: 36-month, max loan amount: $30,000, monthly income: $5000+, and credit score: 675+. The results of this filter, although extremely high results in the past, would generate only a few potential loans to invest in that would be quickly funded. I also found that this filter would generally only result in B and C grade loans with the occasional D grade loan. This meant that I would need to create another filter in order to find loans in the D-E grade range. This filter proved to be far more challenging as my existing filter had key attributes that would cut out many of the D-E grade loans. In order to find loans in the D-E grade range, I needed to be far more lenient with my filters and
screen the loans again after the filter results. The “D-E grade” filter I used had the following filters, inquiries in last 6 months: 0-10, max loan amount: $35,000, open credit lines: 0-30, home ownership: mortgage, loan purpose: debt reconsolidation and credit card refinancing, delinquencies in last 2 years: any, interest rate: D and E, monthly income: 0-20000, loan term: 36-months, max debt to income: 35%, and credit score: 660+. The results of this filter provide ample options for loan selections, however as stated above, following the filter results I would then analyze the loans further. Typically I would then key in on a few statistics before investing in a D or E grade loan. First, I would look at their monthly income compared to the monthly payment, ideally their monthly payment would be 10% of their monthly income, but based on other filters may expand it to the 15% range. Following this I would look at the debt-to-income ratio ideally this would be under 25%. From their I would move into the credit history statistics, knowing they would provide the most accurate information considering they are from the credit bureau. I’d prefer a credit score above 675+ with their earliest credit line being around 1996 – this meant that if they opened a credit line at 18 years old they would now be 30 years old. Also, I would look for their open credit lines and total credit lines to be in a reasonable range, too many open credit lines means they would be borrowing from many other locations and have many interest payments. A revolving credit balance that made sense with their loan amount – for example if they had a credit balance of $15,000 but we’re looking for a loan amount of $20,000 it would raise a red flag and I’d often look for a different loan. The most important of these filters to me in their credit profile were inquiries in last 6 months, delinquencies, and public records on file.
Ideally, all of these filters would be 0, however as the case with the risker loan grades of D and E this was often not the case. The delinquencies and public records on file I would always require 0, however the inquires in the last 6 months I would sometime waive. The reason for this being that if the inquiries is at 1, many times this could have been the result of a borrower failing to verify their income or providing important information to the lending club team in a timely fashion. As you can see these filters are many times not the end, many loans require additional analyzing and profile research, but the filters allow the investor to dial in on encouraging loans in their return criteria.

The results of these filters produced a portfolio with a weighted average return of 16.55% barring any delinquencies from the borrowers. Figure 1 below shows the diversity of my portfolio by loan grade:

![Figure 1](image)

The figure above shows my portfolio to date as of May 11th, 2016 and now includes 21 total “notes”. The reason I was able to add a new note to my portfolio
was because each month as the payments roll in, the investor receives both a principal and interest payment. Generally the total payment of both principal and interest ranges from $0.80 – $0.95. This meant that after 3 months of payments I had received enough to purchase a new “note”. The break down of the portfolio by notes is: 2 “B grade”, 6 “C grade”, 7 “D grade”, and 6 “E grade”. To date I have not had any of my “notes” miss a payment, which has allowed me to garner a 16.58% return throughout the first 4 months. As the loan periods lengthen it can be expected that at least 1 of my borrowers will fail to pay their loan.

The key method of dealing with the risk of default would be to diversify your portfolio with as many “notes” as possible. Lending Club suggests that the investor diversify across at the minimum 100 “notes”. The statistics show that when you diversify across 100 “notes”, 99.9% of investors saw a positive return. With only a $500 investment diversification was extremely difficult, so my main concern was selecting the “notes” with the least amount of risk using filters.

As noted above, my original filter was to maintain 25% of my portfolio in “B grade” loans. However, following the first months 2 of my “B grade” loans were paid off in full, meaning I wouldn’t earn the interest on them. After this I decided to increase the risk of my portfolio because the lower grade loans were preforming at a normal level. When those “B grade” loans were paid in full, I took their principal and the little interest earned and funded in 2 “D grade” loans attempting to increase my future return.

As of May 11th, 2016 my account has earned a 16.58% return, with my account now valued at $515.97 with $16.42 earned in interest. As my honors project
comes to a close, I plan to continue with the investments I have established while adding more funds to my account to diversify across more “notes”. This process has taught me vital information such as analyzing a borrower’s credit risk and a new form of fixed-income investing, while allowing me to engage in an investing method that was enjoyable. I still check my account daily, waiting for my cash on hand to reach $25 and allow me to invest in a new “note”. I believe that this process could be an incredible teaching tool in business schools and offers young and new investors the opportunity to invest in an engaging manner.