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Peer-to-Peer Lending and Community Development Finance

Ian J. Galloway

Federal Reserve Bank of San Francisco

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Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, California 94105
www.frbsf.org/cdinvestments



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Center for Community Development Investments
Federal Reserve Bank of San Francisco
www.frbsf.org/cdinvestments

Center Staff

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Scott Turner, Vice President

John Olson, Senior Advisor

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Peer-to-Peer Lending and Community Development Finance

Ian J. Galloway
*Federal Reserve Bank of San Francisco*¹

Peer-to-peer (P2P) networks directly connect computer users online. Popular P2P platforms include eBay and Craigslist, for example, which have transformed the market for used consumer goods in recent years. Increasingly popular, however, are P2P lending sites that facilitate debt transactions by directly connecting borrowers and lenders on the Internet. In the summer of 2008, the Center for Community Development Investments assembled a working group of community development leaders, investors, and Prosper Marketplace, the largest P2P lending platform in the world, to discuss the potential community development implications of the innovation. This working paper documents this discussion and explores P2P lending in greater detail. Part I offers background on P2P and the state of the P2P lending industry; Part II outlines the potential community development finance implications of P2P; and Part III discusses the working group and next steps necessary to successfully marry P2P technology and community development finance.

PART I: Understanding Peer-to-Peer Lending

P2P Lending vs. Intermediated Lending

In many respects, (offline) P2P lending is the original lending model, involving a debtor and a lender negotiating credit terms favorable to both parties.² In contrast, modern-day banks, credit unions, payday lenders, credit card companies, mortgage companies, and other intermediating institutions use standardized underwriting procedures and risk profiling algorithms to guide their credit decisions. There is a good case to be made for this intermediation. For one, interpersonal relationships can be time consuming and onerous to develop. For another, people that have capital to lend may not know the people that need to borrow it. And finally, institutions tend to have the capacity to streamline the credit allocation process and take advantage of economies of scale.

For these and other reasons, institutions can generally find and underwrite borrowers more cost-effectively than individual lenders. In exchange for lower transaction costs, however, sophisticated risk modeling is used as a primary basis for credit allocation. Institutional lenders rarely “get to know” borrowers, especially when it comes to consumer debt products like credit cards and student loans. Instead, most lenders assume statistically probable default rates and devise ways to limit their exposure. This has dramatically increased the availability of credit but, unfortunately, not for everyone.³ Borrowers with standard risk profiles have better access to credit than those that fall outside established risk profile parameters. This is largely because the modern institutional lending model is not designed to provide customized underwriting. In fact, customized underwriting is anathema to risk modeling—more heterogeneity means more variability and lower predictive power. As a result, many institutional lenders seek to limit their costs by rationing credit to statistically predictable borrowers.

1 My sincere thanks to Frank Altman, Matt Camp, Anthony Chang, Paige Chapel, Klaudette Christensen, Cathy Dolan, Leonard English, David Erickson, Art Fatum, Ed Giedgowd, Mary Kaiser, Chris Larsen, John Olson, Adrienne Penake, Ed Powers, Manjari Raman, Arjan Schütte, Ellen Seidman, Beth Sirull, Mary Tingerthal, and Scott Turner for helping me develop the ideas in this paper. All mistakes and views herein are my own and do not necessarily represent those of the Federal Reserve Bank of San Francisco or the Federal Reserve System.

2 Thomas Meyer. “Financial services 2.0: How social computing and P2P activity are changing financial research and lending.” Deutsche Bank Research. Available at http://www.dbresearch.com/PROD/DBR_INTERNET_EN-PROD/PROD000000000201284.pdf.

3 This refers to the general (admittedly, not recent) availability of credit cards, mortgages, home equity loans, student loans, auto loans, and other lines of credit compared to times past.

Internet-based P2P Lending

With the advent of the Internet, online P2P lending has emerged as a credit alternative to the intermediated financial services industry. Beginning in 2005, P2P lending sites have cropped up all over the world—Kiva, MicroPlace, Lending Club, Prosper, VirginMoney, Loanio, UniThrive, Pertuity Direct, Zopa, MyC4, and others. Currently a \$647 million industry, online P2P lending is expected to grow to \$5.8 billion by 2010.⁴

P2P lending platforms differ dramatically in type and approach. Some connect borrowers and lenders directly; others connect them via a third-party intermediary. Some P2P sites allow lenders to set interest rates; others preset rates based on historical performance and credit score. Many have charitable missions; others are strictly for-profit. Socially-motivated sites tend to promote microenterprise development in developing countries. For-profit sites tend to focus on domestic borrowers, offering unsecured consumer loans to students, car buyers, debt consolidators, and others who either do not want to use mainstream debt products or do not have access to them.





For the most part, Internet-based P2P lending functions on the basis of trust, albeit trust between people that have only met in cyberspace. P2P lending sites match individual borrowers with individual lenders. Borrowers share information about themselves—both personal and financial—and lenders decide whether or not to contribute to their loan request. Every loan is underwritten by multiple individual lenders, each committing a fraction of the loan until it is funded in full. Once fully funded, the loan is originated and the lenders receive their pro rata share of the principal and interest payments until the loan reaches maturity or the borrower defaults.

It is important to note, however, that P2P “lending” is somewhat of a misnomer. In fact, no platform allows lenders to lend directly to borrowers. Platforms either: (1) broker loan reimbursements through interest-free investments; (2) broker the sale of securities backed by their issuers; or (3) facilitate the origination of loans which are sold as securities to P2P investors who behave like lenders (and who may not even realize the nuance). For clarity’s sake, P2P “finance” will be used in this paper to describe all three platforms.

P2P finance platforms can be direct or intermediated when it comes to funding and pricing loans. For example, Lending Club uses a direct funding model but an intermediated pricing model. Investors can directly contribute to a borrower’s loan request on Lending Club, but the interest rate is set in advance. MicroPlace uses both an intermediated funding and pricing model. MicroPlace investors select from among an array of “representative loans” that are originated by microlending partners in developing countries. MicroPlace investors invest in pre-priced securities backed by their issuers which, in turn, invest in the microlending institution that lends to the representative borrowers in the listing. Kiva also uses an indirect funding model and an intermediated pricing model. Kiva investors invest in loans already issued by microfinance lenders and, because they do not allow investors to earn a financial return, the pricing of the loans is preset at zero. Prosper uses both a direct funding model and a direct pricing model. Investors on Prosper facilitate the funding of loans and set their price through auction.

⁴ Interview with Prosper CEO Chris Larsen on July 23, 2009. Source: Celent, a research and consulting firm focused on the application of information technology in the global financial services industry.

Figure 1. P2P Pricing and Funding Models: Intermediated vs. Direct

		Pricing	
		Intermediated	Direct
Funding	Intermediated		
	Direct		

Several states require P2P finance platforms to enforce a suitability test, based on income and net worth, on individual investors before they can purchase asset-backed securities online.⁵ Lending Club, for example, requires its investors to either: (a) have an annual gross income of at least \$70,000 and a net worth (exclusive of home, home furnishings, and automobile) of at least \$70,000; or (b) have a net worth (determined with the same exclusions) of at least \$250,000. In addition, no lender member may purchase notes in an amount in excess of 10 percent of the lender member’s net worth, determined exclusive of home, home furnishings, and automobile.⁶ Prosper has similar restrictions, with an additional proviso that allows California investors to invest up to \$2,500 without triggering the higher-income suitability requirements.⁷ Despite this notable (and partial) exception, however, the test limits the pool of investors to only a small, relatively wealthy, slice of the population.

To date, only one platform, MicroPlace, has been granted approval from the Securities and Exchange Commission (SEC) to sell third-party-issued securities to multiple individual investors on its site without triggering a suitability requirement. While this is a key regulatory achievement, it is important to note that securities sold on MicroPlace are backed by their issuer—not the lender or the end borrower. The SEC has yet to allow any P2P finance platforms to sell *third-party issued* securities backed by assets (loans) online. Such a platform, referred to in this paper as a P2P market for third-party issued loans, could “become an important link between financial companies looking for liquidity and consumer investors’ potentially vast pool of cash,” according to *American Banker* magazine.⁸ Unfortunately, until state regulators re-evaluate their position on P2P investor suitability and the SEC re-examines its position on third-party issued security sales, P2P finance will likely remain a cottage industry with only moderate potential for growth.

State of the P2P Finance Industry

Four platforms have captured most of the American P2P finance market: Kiva, MicroPlace, Lending Club, and Prosper. Kiva and MicroPlace primarily deliver capital to low-income entrepreneurs. Lending Club and Prosper compete directly with traditional lenders in the consumer debt market. All four platforms emphasize the social component of the P2P lending process.

5 Suitability requirements only apply to investors purchasing asset-backed securities. Securities backed by their issuers or traded by authorized brokers (e.g., FOLIO*fn* Investments) do not receive the same regulatory treatment.

6 Lending Club’s prospectus is available at <http://www.sec.gov/Archives/edgar/data/1409970/000095013408021116/f50667b3e424b3.htm>.

7 Prosper’s prospectus is available at http://www.prosper.com/downloads/Legal/Prosper_Prospectus_2009-07-13.pdf.

8 Daniel Wolfe, “Prosper Offers Secondary Market, But Not for Banks,” *American Banker*, July 14, 2009, available at <http://www.americanbanker.com/article.html?id=20090713EF2P5UDP>.

Kiva Microfunds⁹

Founded:	2005
Total Debt Issued:	\$82,599,410
Average Loan Size:	\$157
Min/Max Lender Yield:	0%
Minimum Credit Score:	N/A



Kiva Microfunds (Kiva) facilitates the flow of capital to low-income borrowers in developing countries. Kiva works with 107 microlenders (field partners) around the globe to channel capital from the developed world to capital-starved entrepreneurs in poor geographies.¹⁰ In 2005, Kiva became the first to use the P2P lending model as a microenterprise tool.¹¹ Kiva investors commit to fund loans already issued by field partners in developing countries. Once a loan is fully funded the credit risk (and, in some cases, the exchange rate risk) is transferred to the Kiva investors that funded the listing. Contingent on repayment, the field partner returns the principal upon maturity.

Kiva is not registered in the United States as a securities broker-dealer and therefore cannot offer investors a financial return. However, field partners such as the Alternative Association for the Integral Development of Women (ADIM) in Nicaragua can charge borrowers interest and the spreads they earn (in this case, on a zero percent cost of capital) are used to cover operating expenses and capital reserves.¹² Some consumer advocates have criticized Kiva's microlending partners for charging borrowers "predatory" rates of interest. Microlenders defend these high rates, 55 percent in the case of ADIM, as necessary to cover their relatively high transaction costs and projected loss rates.¹³ Kiva entered the U.S. microfinance market in June, 2009 when it partnered with Opportunity Fund, a microlender in San Jose. This move has generated some controversy among Kiva investors concerned that a domestic lending option will siphon investment away from borrowers in developing countries. Kiva's CEO, Matt Flannery, and president, Premal Shah, explained that the move was intended to expand credit access for "low-income entrepreneurs [in the U.S.] who are often marginalized from the formal credit markets."¹⁴

MicroPlace¹⁵

Founded:	2006
Total Debt Issued: ¹⁶	Unavailable
Average Loan Size:	\$300 — \$400
Min/Max Lender Yield: ¹⁷	1% — 6%
Minimum Credit Score:	N/A



MicroPlace has brokered the sale of more than 30,000 microenterprise securities since 2006 and worked with microlenders in over 40 countries.¹⁸ Like Kiva, MicroPlace allows socially-motivated investors to fund microfinance activity all over the world. Despite nearly identical mission statements, however, MicroPlace differs from Kiva in subtle yet substantial ways.

9 Kiva statistics are available at <http://www.kiva.org/about/facts/>. Statistics are current as of July 20, 2009.

10 Ibid.

11 Kiva Facts, available at <http://www.kiva.org/about>.

12 More information about the Field Partner ADIM is available at <http://www.kiva.org/about/aboutPartner?id=120>.

13 Jennifer Coogan, "Microlending Takes Off on the Internet," *The New York Times*, January 7, 2008. Available at <http://www.nytimes.com/2008/01/07/business/worldbusiness/07iht-lend.4.9059149.html>.

14 Andrew Ross, "Furor over Kiva's new loan policy," *San Francisco Chronicle*, July 9, 2009. Available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2009/07/09/BUK518KLG6.DTL>.

15 Interview with MicroPlace's Annie Lescroart on July 21, 2009.

16 MicroPlace does not share this information publicly.

17 "Lenders" on MicroPlace are actually investors in securities issued by third parties.

18 Lescroart interview.

For one, as a registered broker-dealer, MicroPlace can offer investors a financial return. Investors can earn anywhere between one percent to six percent interest on their investments depending upon the microlending partner. Also significant is the degree to which the loans are intermediated. Contrasted with Kiva, which connects investors with specific loans, MicroPlace investors purchase securities from issuers that invest in microfinance lenders which, in turn, lend to low-income borrowers. The investor's relationship with the end borrower is indirect and investors experience losses only if the security issuer defaults. To help protect investors, issuers keep reserves to back potential losses. As an example, securities offered by the Calvert Foundation (one of four issuers currently offering notes on MicroPlace) are senior to \$13.9 million in program-related investments (PRIs) in Calvert from a variety of foundations, banks, and insurance companies.¹⁹ This high level of credit risk protection has resulted, thus far, in a perfect repayment rate to MicroPlace investors.

Lending Club²⁰

Founded:	2007
Total Debt Issued:	\$45,078,700
Average Loan Size:	\$8,626
Min/Max Lender Yield: ²¹	7.05% — 21.21%
Minimum Credit Score:	660



Lending Club has issued more than 5,200 loans since 2007. Lending Club was the first P2P investment platform to receive SEC approval to sell securities backed by loans. Despite this success, however, many state securities regulators still requires investors to meet high-income and net-worth minimums before they can purchase notes on the site. As discussed earlier, this “suitability test” is a major impediment to the continued growth of the P2P finance industry.

According to Lending Club's prospectus, its “obligation to make payments on a Note [is] limited to an amount equal to the lender member's pro rata share of amounts we receive with respect to the corresponding member loan for that Note.” In other words, investors commit to purchase notes that represent a fraction of a loan that has yet to be originated. Once investors commit sufficient capital to fund a loan request, Lending Club issues notes for each participating investor that represent their pro rata share.

Importantly, and unlike MicroPlace, for example, Lending Club investors shoulder the full credit risk associated with the underlying loan. To assist investors with their due diligence, Lending Club has designed a proprietary social networking algorithm known as LendingMatch to automatically match borrowers with investors that share common characteristics. Presumably, the more similarities borrowers and investors share, the fewer the information asymmetries and the more accurate the credit risk assessment. In addition to LendingMatch, Lending Club uses a strict screening process to protect investors from risky borrowers. In fact, to date, Lending Club has declined more than 52,000 borrower applications.²² Requests that are approved are assigned a credit grade and a corresponding interest rate by Lending Club. Investors bid to fund the loan (purchase the note) at the preset rate.

Borrowers can apply for loans ranging in size from \$1,000 to \$25,000 and investors can resell notes purchased through Lending Club on its Note Trading Platform, operated by FOLIO*fn* Investments, a FINRA/SIPC registered clearing broker-dealer. Lending Club was the first P2P finance platform to receive regulatory approval to operate a secondary market for notes issued on its site.

¹⁹ Calvert Social Investment Foundation, Calvert Community Investment Note Prospectus, April 30, 2009, available at https://www.microplace.com/shared/prospectus/cci_prospectus_2009_final.pdf.

²⁰ Lending Club statistics are available at <https://www.lendingclub.com/info/statistics.action>. Statistics are current as of July 20, 2009.

²¹ “Lenders” are actually investors in securities issued by Lending Club.

²² Lending Club statistics, as of July 20, 2009.

Prosper Marketplace²³

Founded:	2006
Total Debt Issued:	\$178,610,222
Average Loan Size:	\$6,172
Min/Max Lender Yield: ²⁴	3.39% — 36%
Minimum Credit Score:	640



Prosper Marketplace (Prosper) is currently the largest P2P finance platform in the world. Since February 2006 it has attracted more than 830,000 members (borrowers and lenders) and facilitated the origination of \$178 million in unsecured consumer loans. Prosper's platform operates as a Dutch auction. In a Dutch auction, the seller starts the auction with a maximum price and multiple purchasers bid that price down until the good is sold or the auction times out. When posting a listing, Prosper borrowers set the maximum interest rate they are willing to accept and Prosper investors have fourteen days to bid that rate down. When the listing expires, the loan is originated and the pro rata notes are sold at the agreed-upon terms. If the loan is not fully funded after the fourteen-day listing period it is not originated and all bids on the loan are voided.

Prosper's auction process is unique among P2P finance platforms. Other platforms assign borrower listings a fixed interest rate and the bidding process is simply a matter of funding—or not funding—a particular loan. Prosper's auction process allows lenders to make their own judgment about what rate is appropriate for a particular loan. Transparency is therefore crucial for the Prosper market to function properly. The more information the investor has available, the better able they are to set an appropriate interest rate for the loan. In an effort to provide some underwriting guidance in the absence of a preset interest rate, Prosper incorporated an estimated-loss tool into the bidding process. This tool evaluates the default likelihood of a particular loan based on a range of financial and social criteria. Investors are free to heed this tool or rely on their own underwriting skills as they bid.

Like other P2P finance platforms, Prosper provides investors with both financial and nonfinancial information. Prosper contends that the added social element enhances the effectiveness of the underwriting process. Prosper investors can substitute social criteria for missing or incomplete credit data and borrowers can make a more compelling case for their creditworthiness. For example, a graduating college senior with a short credit history could argue, as part of their loan listing, that a college degree should factor positively into their overall credit profile.

Like Lending Club, Prosper offers a secondary market for loans originated on its site but, unlike Lending Club, the pricing of securities sold on the market is determined by auction. Also operated by FOLIO*fn* Investments, Prosper's secondary market just received regulatory approval and thus has not yet brokered the sale of any Prosper notes. Prosper is also hoping to offer a nationwide P2P market for third-party issued loan sales.²⁵ "The vision behind the development of Prosper's Open Market initiative [a market for third-party issued loans] is to help fill a void left by the collapse in community development financing and the asset-backed securitization markets," said Chris Larsen, CEO and co-founder of Prosper, in an interview.²⁶ While Prosper just received approval from the SEC for the sale and trading of securities issued on its site, it has not yet received permission to allow its platform to be used for the sale of loans issued by third party lenders.

23 Prosper statistics available at <http://www.prosper.com/invest/performance.aspx>. Statistics are current as of July 30, 2009.

24 Prosper's minimum-bid floor is based on the Prosper Rating assigned to the listing and is calculated by adding the national average certificate of deposit rate that matches the term of the borrower loan, as published by BankRate.com, to the minimum estimated loss rate associated with the Prosper Rating assigned to the listing, which is based on the historical performance of similar Prosper borrower loans. In this example, calculated on July 15, 2009, 3.39% is derived by adding the current average three-year CD rate of 2.39% to the one percent minimum expected loss rate of AA Prosper securities.

25 Prosper unveiled a P2P market for third-party issued loan sales in May, 2009 but it was limited to the state of California and was voluntarily shut down shortly after it launched. According to a statement issued by Prosper: "We have been overwhelmed by the outcry from potential investors around the country who want to participate in peer-to-peer lending. Therefore, after much consideration we have decided to voluntarily shut down our operation in order to complete our SEC approval for a nationwide peer-to-peer lending platform." Statement is available at http://www.prosper.com/help/topics/quiet_period.aspx.

26 Interview with Prosper CEO Chris Larsen on July 17, 2009.

PART II: Community Development Implications of P2P

Community Development Finance Challenges

The Center for Community Development Investments (the Center) has actively supported the growth of a transparent and efficient secondary market for community development loans. To that end, the Center has held several convenings and published frequently on the topic since 2005. The issue of how best to connect community lenders with investors has been a difficult one. Much of the Center's focus thus far has been on securitization. Securitization allows lenders to pool assets of a similar type and sell pieces of the pool to investors. This spreads credit risk across multiple loans and reduces each investor's exposure to discrete defaults. Investors can also buy a priority claim to the pool's payment streams. Pools of securities can be layered, or tranced, by payment priority. Senior tranches pay out before junior tranches and they are priced higher. The risk diversification and tranching benefits offered by securitization allow lenders to sell a range of products that satisfy investors with different appetites for risk.

The difficulty with securitization, with respect to community development, is that it relies heavily on the homogeneity of the underlying pooled assets. Unlike commonly traded assets, such as mortgage-backed securities (MBS), community development loans tend to be unconventional and difficult to pool. The capital markets value standardized, predictable assets; community development loans tend to be neither.²⁷

Despite this securitization hurdle, specialized community lenders continue to finance projects that benefit low- and moderate-income (LMI) communities. Lenders such as community development financial institutions (CDFIs), community banks, community credit unions, and others take a "high touch" approach to underwriting and servicing.²⁸ Community lenders tend to be more patient lenders, more willing to work with borrowers and accept late payments. The results have been striking. Community lenders routinely report loss rates of less than one percent. For example, the Low Income Investment Fund (LIIF), a CDFI with \$562 million under management, has reported a capital-loss rate of only 0.12 percent, or one-eighth of one percent over its 25-year history.²⁹ This comes as no surprise to LIIF president and CEO Nancy Andrews, who has argued for years that "weird, funky, nonconforming community loans" can be profitable.³⁰ And she is not alone. Community lenders across the industry report similar performance.

Of course, the costs associated with providing a high-touch borrower relationship are high. Community lenders depend heavily on subsidized capital to support their borrowers. For example, banks provide community lenders hundreds of millions of dollars of below-market capital every year to meet their Community Reinvestment Act (CRA) obligations. Passed in 1977 to combat lending discrimination, the CRA is the driving regulatory force behind much of community development finance. Non-CRA-regulated institutions such as pension funds, insurance companies, and credit unions also play key roles in community development finance, but their participation is dwarfed by that of their bank counterparts. Public sources, such as the CDFI Fund, contribute an important, but limited, amount of capital as well.

27 Laura Choi, "Creating a Marketplace: Information Exchange and the Secondary Market for Community Development Loans." Federal Reserve Bank of San Francisco's Working Paper Series: 2007-01. Available at <http://www.frbsf.org/publications/community/wpapers/2007/wp07-01.pdf>.

28 For purposes of this paper, "community lenders" refers to institutions that finance community development projects.

29 Low Income Investment Fund 2008 Annual Report, available at http://www.liifund.org/MEDIACENTER-NEW/LIIF%20publications/annual_report_2008.pdf.

30 Nancy Andrews, "Taking Capital for Social Purposes to a New Level," Community Development Investment Review: 2, no. 1 (2006). Available at <http://www.frbsf.org/publications/community/review/062006/index.html>.

In practice, community development lenders can grow in three ways: they can borrow money, secure grant funding, or sell their assets into the capital markets for cash. While access to credit has been facilitated by federal regulation (i.e., the CRA) and some grant funding has been available, access to the capital markets, as mentioned earlier, has largely been a non-starter. This is due to a number of interrelated issues: (1) there is little reliable longterm community development loan performance data available; (2) there is a lack of standardization across the industry; (3) loan sizes tend to be too small to attract institutional investors; (4) there is insufficient loan volume relative to other asset classes; and, (5) despite abundant evidence to the contrary, there is a stubborn stereotype that loans to low- and moderate-income borrowers are inherently risky and must be discounted. As a result, community development loans have been difficult to securitize, pool, tranche, and price relative to more “plain vanilla” assets.³¹

The result is unfortunate on two levels: investors undervalue community development assets and conventional lenders shy away from community development loans because investor demand is depressed. This self-perpetuating liquidity logjam has a severely negative effect on community development activity. Adding to this challenge are the myriad public program-related rules attached to many community development loans. Not only do investors have to manage traditional sources of risk—interest rate, prepayment, credit, development, etc.—but community development investors have to manage compliance risk as well. Public program compliance is usually based on rigid income restrictions. Making sure that property managers adhere to income guidelines can be labor-intensive and expensive, creating a financial disincentive to invest in a project.

Despite these challenges, Community Reinvestment Fund, USA (CRF), a national nonprofit, has successfully pioneered a large-scale secondary market for community development assets.³² CRF purchases economic development and affordable housing loans from community lenders and pools them into asset-backed securities and New Markets Tax Credit (NMTC) investment funds. CRF tranches the pools and sells them to institutional investors through private placement. In 2004, this approach led to the first-ever community development debt offering to receive a public debt rating. In its 21-year history CRF has issued 20 notes, three affordable housing debt securities, and sold participation in seven NMTC funds.³³ This success has come at a price, however. In order to overcome investor anxiety, CRF has had to credit enhance its offerings with below-market capital from foundations and charitable donors. While this subsidy-driven approach works, it is difficult to scale.

Limited access to the capital markets leads many community lenders to depend heavily on borrowed funds. Unfortunately, this increases their exposure to down-cycle economic risk. When the economy weakens, bank lending dries up, foundation giving contracts, and community lenders have nowhere to turn for new capital. This poses a particular challenge to community lenders trying to service struggling LMI borrowers because when workouts, principal reductions, and patience are most needed, community lenders are financially hamstrung to provide them.³⁴

P2P as a Tool for Community Development Finance

P2P finance platforms are well suited to both originate and broker the sale of community development loans for a number of reasons. For one, they depend heavily upon transparency. For another, a P2P market for third-party issued loans, should the SEC permit it, would offer community lenders a much-needed source of additional capital. And finally, whether they broker the sale of securities or originate loans on-site, P2P finance platforms would allow investors to evaluate community development loans on a loan-by-loan basis at relatively low cost. This may make community development assets more attractive to investors with little appetite for opaque pools of hard-to-price community development securities.

31 Choi, “Creating a Marketplace.”

32 Community Reinvestment Fund, USA Quick Facts, available at <http://www.crfusa.com/AboutCRF/Pages/QuickFacts.aspx>.

33 Ibid.

34 Nancy Andrews, “The Economic Crisis and Community Development Finance: An Industry Assessment,” Federal Reserve Bank of San Francisco Working Paper Series, June 2009. Available at <http://www.frbsf.org/publications/community/wpapers/2009/wp2009-05.pdf>.

P2P finance platforms could also provide individuals a means, other than charity, to invest in their own neighborhoods or causes that they care about (e.g., Gulf Coast recovery). Instead of waiting for large institutional investors to lead the neighborhood redevelopment charge, activist investors could provide much needed seed financing for all number of community development projects—new community facilities, affordable housing, school rehabilitation, street beautification, playground construction, etc. P2P finance platforms are naturally well-equipped to support these projects because they function at the intersection of finance and social networking.

Institutional investors may find P2P finance platforms useful as well. As mentioned earlier, CRA-regulated institutions invest heavily in community development assets. Because these assets can be difficult to identify, some banks invest in mutual funds composed of loans located in their LMI geographies. While participating in these funds can be less labor-intensive than ad hoc investing, banks pay a premium to farm their underwriting out to a third party. P2P finance platforms could offer a more cost-effective alternative.

PART III: Marrying Community Development Finance and P2P Technology

P2P Community Development Finance Working Group

The P2P community development lending working group was created in early 2008 by the Center for Community Development Investments. The goal of the working group was to explore how P2P technology could be used to address several community development finance challenges:

- High transaction costs
- Overexposure to default risk/lack of portfolio diversification
- General liquidity constraints
- Relatively small universe of investors
- Difficulty meeting borrower demand, particularly for small dollar loans

The working group met in August, 2008 to discuss P2P finance’s potential community development applications. The group was comprised of representatives from banks, foundations, pension funds, community lenders, and industry trade groups. Prosper Marketplace, which had previously indicated a strong interest in the concept, provided the group with background on P2P finance and how its platform could be adapted for the community development industry. Several key themes emerged from the meeting, as described below.

Loan Size and Terms

The average P2P loan size is small—\$8,626 on Lending Club, \$6,172 on Prosper, and even smaller on the microfinance platforms Kiva and MicroPlace. Community development loans, in contrast, tend to be much larger—LIIF loans average \$935,023, for example.³⁵ The prospect of cobbling together enough individual investors to fund these loans worried many members of the working group. Different products were discussed. Some community development loans seemed better suited for P2P finance platforms than others. Predevelopment loans, microloans, small business loans, and affordable housing working capital loans seemed to hold more promise than large construction loans (which constitute the bulk of community lending). Another option ventured at the meeting was to use P2P finance platforms to raise money for smaller projects that complement larger community developments. A playground on a new charter school site; a computer lab in an

employment resource center; a mural on a park wall—P2P investors could augment large projects with targeted, yet appropriately modest, funding commitments.

Loan terms were also a concern. Most P2P finance platforms offer a single product: a three-year fixed, amortizing loan. Designed to simplify the transaction for the lender and borrower, these terms do not mirror those typically offered by community lenders. Community development loans often have longer maturities, variable rates, and balloon payment terms. The group concluded that P2P finance platforms would have to offer a more diverse set of products to meet the unique needs of community development borrowers.

Underwriting and Servicing Challenges

Underwriting community development loans takes special expertise. As discussed earlier, funding community projects is challenging and complying with public program rules can be complex. Lenders need to understand all projects risks, including compliance risk, and the recourses available to them should the project fail. Many members of the working group were concerned that laypeople may be ill-equipped to evaluate these risks and understand the complexities of community development lending.

Servicing was also a significant concern. The group was committed to preserving the “high touch” relationship that distinguishes community lending from conventional lending. Community development borrowers require active servicing. While charge-offs and defaults are rare, forbearance and late payments are not. Any P2P finance platform used for community development must retain community-minded servicers to ensure that borrowers have sufficient flexibility to manage their debt payments.

Choosing the Best Model: Direct vs. Intermediated, Lending vs. Investing

Many members of the working group expressed reservations about directly funding and directly pricing community development loans via P2P finance platforms. Are P2P lenders astute enough to underwrite unconventional community borrowers? Community development loans also tend to have low yields; are lenders and investors capable of pricing loans appropriately, as would be required with the direct pricing model? The answers to these questions, the group concluded, should dictate the degree of intermediation.

Generally speaking, the group preferred the P2P investing model to the direct P2P lending model, largely because it would potentially allow for third-party issued loans sales. If community lenders could use P2P finance platforms to sell their loans to investors, the liquidity benefits would be enormous. Furthermore, from the standpoint of the individual investor, no sophisticated underwriting skills would be required. Individual P2P investors that are uncomfortable underwriting community development borrowers could, instead, underwrite the lending institution and decide, based on historical loss rates and other considerations, whether to fund the listing. This would keep existing intermediaries—community lenders—in a position to capitalize on their skills as underwriters and preserve their close relationship with borrowers.

Sufficient Lender/Investor Demand

In general, the group concluded that small institutions with limited capacity have the most to gain from an on-line community development loan market. CRA-motivated banks, foundations, pension funds, and individuals were all identified as primary potential users.

To meet their CRA obligations, large and intermediate-small banks are required to invest in qualified CRA investments within their regulatory assessment areas. A searchable P2P finance platform, guided by carefully assigned social tags, would allow CRA-motivated banks to identify investments that meet their CRA requirements. For example, banks could limit their searches to loans originated by certified community development lenders, such as CDFIs. Banks could easily identify particular types of loans as well: small business, rural

35 Low Income Investment Fund Frequently Asked Questions, available at <http://www.liifund.org/ABOUTLIIF/FAQ.htm#averageLoanSize>.

development, community facility, etc. This would be particularly powerful if coupled with a tool to search for investments in low- and moderate-income (LMI) neighborhoods. A well designed search engine would allow CRA-motivated banks to quickly sort investments by qualified LMI census tract within their regulatory assessment areas. While not all social investments would be CRA-eligible, such a system would allow banks to target investments that meet basic community development and geographic criteria.

Foundations and, in particular, small foundations, could benefit from a community development P2P finance platform as well. Small foundations are often held to strict operating expense limits intended to maximize corpus impact. Potentially, a P2P finance platform could enable small foundations with limited capacity to identify investment opportunities that otherwise may be too costly to search out. Many foundations also have specific social goals: cure cancer, support early childhood education, help the environment, etc. Foundations could use such a platform to find investments that align with their mission. At a minimum, foundations could look to P2P finance platforms for program-related investments (PRIs). PRIs count against foundations' annual disbursement requirements (five percent of total endowment) and can be below-market investments. To date, negative screening has been the most reliable way for foundations to ensure that their corpus investments do not undermine social mission. Screening is a blunt instrument, however. Foundations may appreciate greater transparency and control as they commit larger and larger portions of their endowment in support of their missions.

Pension funds could use P2P finance platforms to find economically targeted investments (ETIs). Pension funds tend to be patient investors. Large pension funds like CalPRS and CalSTRS have capitalized on this competitive advantage by investing in underdeveloped neighborhoods decades before they are rehabilitated. In some cases, this approach has yielded strong financial returns and positive social outcomes. While it is likely that CalPRS and CalSTRS do not need an online marketplace to identify ETIs, small municipal pension funds may benefit. P2P finance platforms could offer a cost-effective way for smaller funds to identify and fund ETIs that would otherwise be difficult and costly to find.

There may also be significant individual demand for community development investments. International microfinance platforms like Kiva and MicroPlace have demonstrated success in connecting socially motivated individuals with wealth-building projects around the globe. If their success is any indication, asset-backed community development securities may be very popular among individual investors. As discussed earlier, this would provide community lenders an additional funding source beyond CRA-motivated bank borrowing, grants, and subsidized private placement debt offerings.

Potential for Fraud

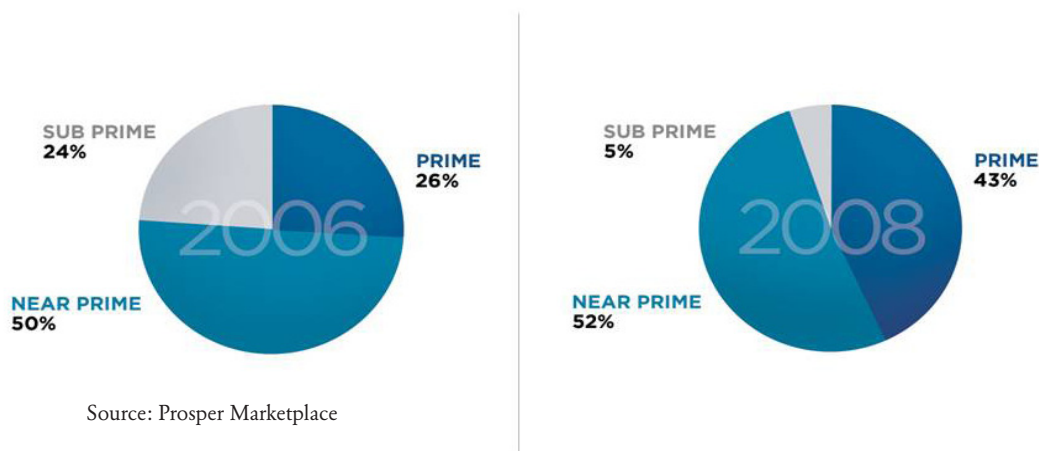
P2P finance platforms rely heavily on borrower- and security issuer-created content. Unfortunately, these disclosures, while revealing useful information, also create an opportunity for fraud. For the most part, P2P finance platforms have no ability to confirm nonfinancial information provided on their sites. This is arguably the biggest weakness of P2P finance—it often places a heavy burden on investors with little formal investment experience to root out fraudulent borrowers and evaluate social and financial criteria accurately.

Adequately Serving Community Development Borrowers

Risk profiling by conventional lending institutions renders some borrowers outside the financial mainstream. P2P finance would seem to be a solution to credit rationing, particularly given that many platforms emphasize the social aspect of their lending models. Furthermore, having access to a more complete picture of a borrower (i.e., veteran, family provider, etc.) allows lenders to more accurately evaluate their credit risk. Unlike credit card companies, banks, payday lenders, and other conventional lenders which depend heavily upon sophisticated risk models to estimate default probabilities, P2P investors evaluate risk on an ad hoc basis. This, theoretically, creates an opportunity to allocate credit to people outside the financial mainstream, such as low- and moderate-income (LMI) borrowers.

In practice and over time, however, P2P finance platforms have begun to screen out subprime borrowers. In a November, 2008 study of Prosper, for example, Freedman and Jin observed that “while it is tempting to expect P2P lending to alleviate credit rationing for near or subprime risks, we find Prosper evolving from a comprehensive market toward a market that primarily serves borrowers who have access to traditional credit.”³⁶ Driven partly by poor subprime loan performance and partly by Prosper’s new, higher, credit score minimum requirement, Prosper investors have begun to emulate conventional lenders: funding borrowers with more mainstream, predictable risk profiles.

Figure 2. Prosper Credit Mix of Loans over Time (2006–2008)



Other P2P finance platforms have moved in a similar direction. Lending Club rigorously screens loan requests which results in a high loan request rejection rate. Lending Club CEO and founder Renaud Laplanche explained this approach in a 2007 interview; “As a way to help build confidence on the lenders’ side, we have decided to limit access to borrowers with at least a 640 FICO score and less than 20% debt-to-income ratio. This combination will result in low defaults and excellent net returns for the lenders. The flip side is that we have to turn down a fair number of borrowers.”³⁷ Yet, by turning away so many borrowers (91 percent of applicants), Lending Club becomes harder to distinguish from conventional lenders which, like Lending Club, use a credit algorithm to whittle down loan applications and set pricing levels.³⁸ Even Kiva, the only nonprofit P2P finance platform discussed in this paper, is being criticized for watering down its stated antipoverty mission by expanding its platform to the United States which, as critics point out, is the richest country in the world.³⁹ For P2P finance to emerge as a viable community development tool, more must be done to reconcile the potential for social good with the realities of responsible investing.

36 Seth Freedman and Ginger Zhe Jin, “Dynamic Learning and Selection: the Early Years of Prosper.com,” University of Maryland Department of Economics, June 20, 2008. Available at <http://www.prosper.com/downloads/research/Dynamic-Learning-Selection-062008.pdf>.

37 Allen Stern interview of Renaud Leplanche on August 6, 2007. Available at <http://www.centernetworks.com/lendingclub-founder-and-ceo-renaud-laplanche>.

38 To its credit, Lending Club “open sourced” its pricing algorithm to preserve a high level of transparency. Daniel Roth, “Road Map for Financial Recovery: Radical Transparency Now!”, *Wired*, March, 2009, available at http://www.wired.com/techbiz/it/magazine/17-03/wp_reboot?currentPage=1.

39 Andrew Ross. “Furor over Kiva’s new loan policy.” *San Francisco Chronicle*. July 9, 2009. Available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2009/07/09/BUK518KLG6.DTL>.

Changes P2P Finance Platforms Should Make Going Forward

Develop a Fractional P2P Market for Third-party Issued Loans

With respect to community development finance, a P2P market for loans issued by third-party lenders would be a significant improvement over existing platforms (which only broker the sale of loans originated on site or securities backed by their issuers). For one, “high touch” intermediation is critical to successful community lending, necessitating the presence of a skilled community lender. For another, contingent upon SEC approval, such a market could offer community lenders a direct route to the capital markets which, heretofore, has proven elusive. Prosper’s Chris Larsen, for example, “looks forward to extending the Prosper marketplace to community development organizations and other financial institutions as soon as we complete the securities regulatory process.”⁴⁰

Preferably, a P2P market for third-party issued loans would allow for fractional investing as well. In fact, fractional investing—the ability to purchase a piece of a security and not a whole loan—is essential to the P2P finance innovation. Preserving this feature is particularly important for community development loans. Community development loans are often quite large and the P2P finance market for large community development securities would be small relative to that for fractional investments. Fractional investing is also the key to successful diversification. P2P finance platforms are an alternative to the conventional diversification strategy—securitization, pooling, and tranching—but only insofar as they allow investors to purchase small pieces of multiple loans. A P2P market for third-party issued loans that does not allow fractional investing will substantially reduce diversification opportunities.

Advocate for Regulatory Reform

The primary obstacle slowing the development of a fractional P2P market for third-party issued loans appears to be regulatory, not technological. This is largely because P2P finance platforms are prohibited from direct lending activities and, instead, are forced to broker the sale of securities representing shares of consumer loans (triggering state and SEC regulation). P2P finance platforms interested in community development lending would benefit from a regulatory regime better suited to their core function: the facilitation of credit, not securities brokerage.

Create a Standalone Community Development Asset Class

While community development assets are used by some investors to protect against down-cycle economic risk, most community development investing is done for socially motivated reasons. Distinguishing community development assets from other investment types—debt consolidation, auto financing, etc.—is therefore very important. The easiest way for P2P finance platforms to effectively broker the sale of community development securities is to create a standalone community development asset class. This would give investors a clear way to target investments that meet their social criteria. P2P markets for third-party issued loans, if developed, should also carefully vet community lenders to protect against fraud. The most efficient way to vet community lenders is to use a proxy test, such as CDFI certification (granted by the U.S. Treasury) or nonprofit tax status (granted by the Internal Revenue Service). Either measure would offer a reasonable guarantee to investors that the security being sold by the lender constitutes a legitimate community development product.

Offer a Wider Range of Products

Today, most P2P finance platforms offer a single product: a three-year, fixed, unsecured, amortizing loan capped at \$25,000. To be attractive to the community development finance industry, however, they will have to allow for larger, collateralized loans with longer maturities and balloon payment options. Standard P2P finance terms may be sufficient for small working capital loans and other, more modest credit products, but they are not consistent with the bulk of community development finance activity.

40 Interview with Chris Larsen on July 17, 2009.

Adopt a Social-Impact Ratings System

Many P2P finance platforms have already developed their own credit ratings to complement borrowers' credit scores. These ratings systems are designed to internalize important borrower information not normally captured by the credit bureaus. Similarly, a social-impact rating system would be a useful way to capture and convey important mission-oriented information to socially motivated investors. In fact, several social impact ratings systems already exist. For example, the CDFI Assessment and Ratings System (CARS), developed by the Opportunity Finance Network (OFN), evaluates the "Impact Performance and Financial Strength and Performance" of CDFIs.⁴¹ A ratings system, such as CARS, should be presented alongside financial metrics on P2P finance platforms that broker the sale of community development securities issued by community lenders.

Provide a Geographic Search Tool

Geography is an important consideration for many mission-driven investors. Banks, for example, are motivated by the CRA to invest in low- and moderate-income (LMI) neighborhoods. The ability to narrow investment opportunities to those located in LMI census tracts would help attract banks and other CRA-regulated institutions to P2P investing. Other investors, both institutional and individual, could benefit from this tool as well. Investors with a localized focus, such as small family foundations and small municipal pension funds, may want to use P2P finance platforms to target investments in very specific geographies—a task made considerably easier by geocoding the investments. Individual investors may also be motivated to invest in specific geographies, be it their own communities or those communities that have piqued their interest, such as the Gulf Coast or the Rust Belt. Community development is as much about place as it is about people. P2P finance platforms should provide the tools necessary to invest in both.

Changes Community Lenders Should Make Going Forward

Issue Smaller Loans with Shorter Maturities

Community development lenders tend to favor real estate projects over microfinance or small business borrowers. This is largely due to the relatively high transaction costs associated with the latter. Nevertheless, if community lenders want to use P2P finance technology effectively, they need to offer products that meet the needs of P2P investors. This typically means smaller loans with shorter maturities.

Originate-to-Distribute

Most community lenders earn the bulk of their revenue on interest-rate spreads. Very few lenders can generate sufficient loan volume to rely heavily on fee-based income. A P2P market for third-party issued loans would allow community lenders to sell their loans to P2P investors and quickly recoup the borrowed funds. This added liquidity creates an opportunity for community lenders to move away from their typical originate-and-hold model and toward an originate-to-distribute model, which would generate fee-based income. Of course, this need not be an either-or shift. To the contrary, community lenders would be wise to retain a diversified approach, generating a mix of spread-based and fee-based income; P2P finance platforms would simply be a new means of garnering the latter.

Compile Loan-specific Social-impact Information

In general, most investors are reticent to take a below-market financial return without a corresponding "mission return." That investor expectation will only grow in a P2P finance context. There is a good reason that existing P2P finance platforms advertise the social aspect of P2P lending: many investors are nearly as interested in social impact as they are in financial return. It is likely, therefore, that P2P community development investing opportunities will amplify this interest in mission. Should a P2P market for third-party issued loans emerge

⁴¹ Opportunity Finance Network's CARS website available at http://www.opportunityfinance.net/financing/finance_sub4.aspx?id=56.

for community development securities, community lenders will be expected to provide detailed social-impact information on their loans. This high level of loan-specific information will be costly for lenders to compile and communicate effectively. Community lenders interested in selling their loans via P2P should consider this cost before pursuing it as a liquidity option.

Partner with Other Community Development Finance Organizations

Many different types of community development finance organizations work in concert to deliver capital to LMI communities. Several have already been mentioned, including banks, community lenders, credit unions, foundations, pension funds, insurance companies, and wealthy individuals. The use of P2P technology for community development presents new opportunities for collaboration. For example, community lenders may find that P2P investors are unwilling to pay what they perceive to be fair-market value for their community development securities. Instead of selling their loans at a discount—or not at all—community lenders could partner with other community development finance organizations to create a credit enhancement for securities sold via P2P. Specifically, they could form a first loss reserve pool backed by subordinate equity-equivalent investments (EQ2s) or program-related investments (PRIs) as a way to engage investors with differing appetites for risk and impact. This is only one example of potential collaboration; many other partnership opportunities may develop as the technology matures and community lenders grow more comfortable with the technology.

Conclusion

P2P finance is representative of a growing interest in active, social investing. Federal Reserve Chairman Ben Bernanke commented on this trend in a recent speech about CDFIs:

[The] cultivation of nontraditional funding sources might prove fruitful. Increased interest by socially motivated individual investors has expanded the pool of investment capital for community development. One CDFI [Calvert Foundation] has created a product similar to a mutual fund where individuals purchase ‘community development notes’ that are invested in community development organizations. The fund has raised capital from about 4,700 individuals and invested about \$160 million; further, it has performed well, with an average three percent rate of return to investors and very low loss rates. Even during the recession, new investors have been drawn by the appeal of supporting low- and moderate-income communities while earning relatively good rates of return. Other developments, such as emerging peer-to-peer lending platforms, also hold promise.⁴²

While online platforms may never replace conventional lending institutions, such as banks, it is important that the community development finance industry be aware of this emerging technology. Moreover, P2P finance platforms will continue to evolve—allowing for third-party issued loan sales, for example—which may fundamentally alter the way credit is allocated in the future. In either case, the potential community development finance implications are too significant to ignore.

Ian Galloway is an investment associate at the Federal Reserve Bank of San Francisco. Before joining the Bank, Ian worked for O-H Community Partners, a nonprofit consulting firm in Chicago, and the Chicago Community Loan Fund, a CDFI with \$21 million under management. Previously, Ian helped develop a “social enterprise” dog daycare center in Portland, OR that provides homeless youth on-the-job vocational training. Owned and operated by Outside In, “Virginia Woof” has graduated dozens of youth to full-time employment and higher education while earning enough revenue to support its ongoing operation. Ian has a BA in political science and philosophy from Colgate University and a master’s degree in public policy (MPP) from the University of Chicago.

⁴² Federal Reserve Chairman Ben Bernanke. Speech delivered on June 17, 2009 at the Global Financial Literacy Summit in Washington, DC, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090617a.htm>.

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