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Peer-to-Peer Lending and Community Development Finance

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Introduction

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. Increasingly popular, however, are P2P lending sites that facilitate debt transactions by directly connecting borrowers and lenders on the Internet. In fact, since 2005, P2P lending sites have cropped up all over the world—Kiva, MicroPlace, Lending Club, and Prosper are a few examples. Currently a $647 million industry, online P2P lending is expected to grow to $5.8 billion by 2010.[2] P2P lending has the potential to channel significant capital to the community development industry by efficiently connecting investors to revitalization efforts in low- and moderate-income (LMI) communities. This article explores the potential challenges and benefits of P2P lending in community development finance and addresses some of the changes that need to take place in order to facilitate the growth of this emerging industry.

The P2P Platform

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 individuals 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,

P2P finance platforms are naturally well-equipped to support these projects because they function at the intersection of finance and social networking.

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.

Capital Markets Challenge: Community Development Assets

The issue of how best to connect community lenders with the capital markets has been a difficult one. Much of the 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. 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 and community development loans tend to be neither.[3] The result is unfortunate on two levels: investors undervalue and 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.

Limited access to the capital markets leads many community lenders, those institutions that finance community development projects, 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—a scenario that is all too familiar in the current economic environment. This poses a particular challenge to community lenders trying to service struggling LMI borrowers because when workouts, principal reductions, and patience are most needed, these lenders are financially hamstrung to provide them.[4]

A Potential Solution: P2P Finance Platforms

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,[5] 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.

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, individual investors could provide much needed seed financing for a 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. For example, 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.

Issues to Consider

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— loans originated by the Low Income Investment Fund, a large national CDFI, average $935,023, for example.[6] The prospect of cobbling together enough individual investors to

fund loans of this magnitude is worrying. As a result, some community development loans seem better suited for P2P finance platforms than others. Predevelopment loans, microloans, small business loans, and working capital loans seem to hold more promise than large affordable housing loans (which constitute the bulk of community lending). Another option is 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 are 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. 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. Individual investors may be ill-equipped to evaluate these risks and understand the complexities of community development lending.

Servicing is also a significant concern. It is important to preserve 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.

Sufficient Lender/Investor Demand

Small institutions with limited capacity likely have the most to gain from an online community development loan market. Small CRA-motivated banks, foundations, pension funds, and individuals could all benefit from the low search and information costs that P2P platforms provide.

A searchable P2P finance platform 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 development, community facility, etc. This would be particularly powerful if coupled with a tool to search for investments in 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: find a cure for 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 are usually below-market rate investments made by foundations that, unlike grants, involve the potential return of capital within a specific time frame. PRIs count against foundations' annual disbursement requirements (five percent of total endowment) and can be below-market investments.

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 (the two California public sector pension funds covering state employees and teachers, respectively) have capitalized on this 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.

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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.

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."[7]

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. As discussed earlier, 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). Such a 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.

Community development is as much about place as it is about people; P2P finance platforms should provide the tools necessary to invest in both.

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 evaluates the "impact performance and financial strength and performance" of CDFIs.[8] 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 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 Rust Belt or California's Central Valley. 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 bor-

rowers. 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 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. 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. CI

Endnotes

Strength in Adversity: Community Capital Faces Up to the Economic Crisis

1. This article is a condensed excerpt of a Community Development Investment Center Working Paper, entitled "The Economic Crisis and Community Development Finance: An Industry Assessment." For the full article by Nancy Andrews, see http://www.frbsf.org/publications/community/wpapers/2009/wp2009-05.pdf
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