MarketLine Case Study

Social lending.

A prospectus investment

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OVERVIEW

Catalyst

The social lending operation is based on one simple yet revolutionary principle - people lend money to each other. Social loans have enjoyed considerable popularity in 2013; demonstrated by sharp increases in the monthly level of social lending operations and continuous activity on websites mediating this type of operation. In fact, social loans have been developing successfully over a number years.

This case study focuses on development of social lending especially in the UK and US and the reasons behind the prompt expansion of this way of financing.

Summary

The unquestionable advantage of social lending loans is their availability and the flexibility of setting the interest rates. The trade-off is of course increased risk as lenders who lend a certain amount of money actually does not have a guarantee that it will be returned.

For the investor, the social lending can be a very profitable investment, where profits may be seen in the short term. However, some believe that such loans can be dangerous due to the lower security of checking the reliability of the borrower.

With social loans almost everyone can benefit, regardless of what financial position the borrower is in. Of course, every investor who wants to give a loan may have an individual requirement that will guarantee them greater security in a particular transaction

Thanks to social lending portals, people have a chance to get far cheaper loans than through traditional banking services. An investor can turn a few percent profits on the deposit into several percent of the income from the amount of money lent. Given the security similar to those offered by banks, it is an attractive way of investment that is currently developing at high pace.

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BILLIONS LENT THROUGH SOCIAL LENDING WEBSITES WORLDWIDE

The global social lending sector has the potential to reach about $19.8bn of funded loans for the whole year of 2013 (this figure is, however, a rough estimation as the sector is not yet regulated).

The options opened by social lending platforms were quickly noticed on the international market. After Zopa.com promptly gained popularity in the UK, then similar portals also appeared in the national market as well as in other countries. Today there are several platforms operating around the world, enabling the direct borrowing of money on the internet. The popularity of social loans is also proved by numbers.

Social lending is on the rise in the UK

The total lending value totaled to over £765m (about $1,231.3m) of total transaction value as of November in the UK alone. From October 2010 to May 2013, almost 49,000 lenders lent their money to 59,800 borrowers only in the UK. The effects of the financial crisis are still felt in the industry four years after it happened and social lending is experiencing its booming period. The social lending system is getting more and more popular especially at a time when banks are reluctant to lend money if there is no solid financial protection.

Portals, which borrow money from other people through the Internet, without the involvement of banks or other institutions are primarily an attractive opportunity for “cheap” sources to raise funds for individuals and companies.

The bigger players in the UK social lending market are Zopa with over £399.2m worth of lending, Funding Circle with £163.4m lent to British businesses and RateSetter with £121m since the beginning of their businesses. The three largest social lending platforms account for 92% of the total national market, however there is a number of new platforms that target specific borrowers. Among others, GraduateRates offers returns of up to 7.5% for investors lending to postgraduate students or Assetz which offers peer-to-peer loans for buy-to-let investors.

The first company in the UK which offered peer-to-peer (P2P) loans was Zopa, the abbreviation for "zone of possible agreement". The company was founded in February 2005, and currently it is the largest UK P2P lender with over 43,000 active savers and 57,000 borrowers. RateSetter launched in October 2010 currently has 315,902 members. Funding Circle opened in August 2010 is currently the second biggest social lending company and the first that is active in peer-to-business lending.

The UK market of social lending developed vigorously in the first few years of presence and still represents quite a big portion of the international social lending market. Compared with the UK market, globally transaction size calculated in 2005 accounted to $118m, in 2006 it jumped to $269m, and to $647m a year after. The average rate of return in 2007 totaled at about 6.44% per annum, in 2008 dropped significantly to only 2.44%, but in 2009 reached the level of 8.10% to eventually get to average 6.2% per annum in 2013.

The social lending platforms turn out to be a looked for alternatives for banks. Despite not having the protection comparable to banking sector, the amount of monthly loans increased year on year. Taking into consideration the UK’s top three social lending companies the annual growth rate of the monthly loans value accounted for 48.4% and 249% in 2012 and 2013 (up to October 2013) respectively with Zopa being in first place in terms of market share.

Table 1: The development of average new monthly loans value over last three years in million US$/month

million US$	2011	2012	2013
Zopa	8	11	29
Fundind Circle	3.5	4.66	21
RateSetter	0.8	2.59	13.7

SOURCE: Lenders Webpages MARKETLINE

Other social lenders active in the UK market are MarketInvoice (the first peer-to-business lender lending specifically against invoices), Assetz Capital, which was launched in 2013. The former's total loans until November 2013 accounted for £92m (approximately $148m) which, considering that the company was founded in February 2011, makes it very profitable Peer-to-Business model. For comparison, the best established Peer-to-Business company Funding Circle lent about £150m (approximately $241.6m) in the first three years, so lent 63% more but in three times longer period, making the MarketInvoice more vibrant and profitable. Assetz Capital is so far the smallest P2P UK company with funded loans of £9.3m (about $14.9m). Even though the two companies are not in the mainstream of P2P industry, their rapid development indicated that this form of investment without the "middle man" is the way forward in the money lending market.

The US social lending market is the biggest in the world totaling to over $2.3bn

Social lending has been adopted particularly well in the US, where users can choose from a dozen of such portals. The US lending sector is growing at an exponential pace, with the world biggest lender - Lending Club lending over $2bn as of September 2013, and is said to be averaging $2.7m of new loans a day. The second most popular lending platform is Prosper.com, whose services are used by over one million people.

Table 2: The amount of loans and growth rates through LendingClub

	2008	2009	2010	2011	2012	2013
LendingClub	2,996	8,277	20,814	42,535	95,902	243,515
		176.3%	151.5%	104.4%	125.5%	153.9%

SOURCE: www.lendingclub.com/info/statistics.action MARKETLINE

Table 3: Total value of loans of the two biggest P2P platform in the US in million USD

	2007	2008	2009	2010	2011	2012	2013
LendingClub	8.2	20.0	51.8	126.4	257.4	717.9	1,959.1
Prosper	81.1	83.6	0.5	26.9	75.1	150.9	431.9
Total	89.3	103.6	52.3	153.3	332.5	868.8	2,391.0

SOURCE: www.lendingclub.com, www.prosper.com

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SOCIAL LENDING PAYS BETTER INTERESTS RATES THAN BANKS BUT CARRIES MORE RISK

The social lending returns pay 59% higher income rates after fees and bad debt but before tax than banks. Nevertheless, bank deposits are the most popular forms of investing money, and although usually it only conserves the capital value it guarantees almost one hundred percent safety. It is worth comparing social lending with well-known deposits offered to most investors that minimize the risk, before anyone is reflecting on investing savings in social loans.

Social lending portals offer much greater percentage rates compared to standard banks accounts.

The average return rate of the investment in social lending totaled to about 4.2% annually after fees and bad debt, before tax. For comparison bank deposits generally allow to earn as much as the inflation rate, give or take a few percent. Currently, the best three year interest paid deposits yield below 2.5% interest per annum. This is equivalent of 0.3% in real terms assuming the inflation to be at 2.2% (as of October 2013).

Social lending loans annual interest rates can reaches high as 5.8%. The most common (average) interest rate oscillates between 4% and 4.4% depending on the various factors such as risk group, maturity etc. Moreover, using the mechanism of compound interest rates a social lending account can achieve up to 6%-7% of cumulative income per annum.

Table 4: Average return rates after fees and bad debt, before tax

	1 year	3 years	5 years
Zopa	n/a	4%	4.60%
RateSetter	3.00%	4.10%	5.30%
Funding Circle	5.8%*	5.8%*	5.8%*
Average Bank	1.80%	2.50%	3%

* average expected return from various maturity

SOURCE: www.thisismoney.co.uk/money MARKETLINE

Social lending is riskier than bank accounts

Social lenders are not guaranteed to recover the money invested and so if the borrower goes under the outstanding debt amount will not be paid back to the lender. Focusing on the three main social lending portals Zopa, RateSetter and Funding Circle it can be noted that all of them do show the average rate of bad debts, 0.27%, 0.35% and 1.4% respectively.

On the other hand bank deposits are guaranteed by bank guarantee funds in every country in the UK all bank and building society accounts are protected under the Financial Services Compensation Scheme up to the amount of £85,000, which means that even if the bank collapses the State will pay money out. For this reason bank deposits are considered one of the safest investments.

Social lenders are not covered by SFCS and so investors can lose all their investment, however, every lending portal does offer risk management protection. RateSetter tries to protect lenders through its Provision Fund, where lenders contribute to via their 'credit rate'. If a payment is missed, then lenders can make a claim through the fund to ensure that that they don't lose out. Zopa offer a more or less similar scheme to protect lenders. The company offers 'Zopa Safeguard' which is a fund held in trust by a not-for-profit organization. This means that Zopa has no rights to the money in it. If a borrower is unable to repay Zopa Safeguard can step in, and give lenders back the money they are owed.

As of April 2014, the Financial Conduct Authority (FCA) in the UK, want to introduce an extra protection for lenders on social lending platforms, who will have to receive detailed information and main terms and conditions of the loan. The risk has to be clearly conveyed to lenders and the information provided has to be easy to understand. There will have to be a standard 14 day cool-off period introduced as well. As of 2017 the lending portals will have to hold reserves of a certain percentage of the loaned funds in order to protect consumers should there be any trouble.

Once the sector is fully regulated by the Financial Conduct Authority, the polls conducted in relation to planned action revealed that over one in four people in the UK said that they will be considering joining the social lending portals, which clearly indicates the massive boom of this kind of investments in the nearest future. In 2012 the Breedon Review estimated small and medium business' demand for new funds in excess of £84bn that will be otherwise difficult to obtain from banks. This is a result of banks becoming more risk adverse and so there is a further gap that can be filled in by social lending.

Social lending offers lower liquidity

Bank deposits can be usually withdrawn at any time should the investor need money, but as a penalty will lose part or all of the interest. Usually up to a few days the money will be withdrawn from the account. Social loans do not allow for immediate withdrawal of the investments unless the lending platform allows for loan trading as Funding Circle does. Usually the investor has to wait for the transferred interests and part of the capital each month. However, some lending platforms offer the selling option where the investor can sell the investments to other interested parties losing a part of income. It is not recommended to invest in social lending should the investor be in instant need of easy accessible money.

Social lending offers mutual benefits

Popularity of social lending platforms is growing at a rapid pace. There are several reasons. Cumbersome bureaucracy in the bank, even in the case of a small loan, it is one of the biggest reasons that make people more often choose to borrow from the social lending on the Internet. In addition to the convenience it comes with more accessible interest rates. It is much more attractive for both investors and borrowers. Furthermore, the borrowers have much better chances to be accepted for the loans even if they straggle with obtaining credit granted by banks. This kind of borrowers will be classified as higher risk borrower, but in majority of cases accepted for the loan from social lenders.

With social lending portals, people can get much cheaper loans than the traditional banking services. An investor can turn a few percent profits in the account for revenues of more than a dozen percentage of the amount borrowed money. Given the security similar to those offered by banks, is an attractive offer for modern investors and individuals who currently need the money for a variety of reasons.

Social lending offer lower then banks loans

James Meekings, co-founder of Funding Circle, states that as the sector is getting bigger; the size of the loans are increasing as well. The starting maximum loan in August 2010 accounted to £50,000 (about $80,450.5) to reach £250,000 (approximately $402,252.6) at the end of 2013. The average loan size borrowed on Funding Circle has gone up from £30,000 to £60,000 (circa $48,270.3 and $96,540.6 respectably).

Other social lending platforms like Zopa offer loans from $1,000 to $15,000 and there is a standard borrowing fee added to the loan. Unlike Zopa, Ratesetter does not set an overall borrowing limit but tailors this to the individual, depending on their credit score, however the average loan amount will fall into the bracket of between $1000 to $15000.

Individuals and businesses still tend to turn to traditional forms of banking while applying for bigger loans like mortgages or strategic investments in the amount of over $500,000.

SOCIAL LENDING WILL CONTINUE TO DEVELOP

The UK social lending market alone is estimated to be worth £1bn (approximately $1.6bn) by 2016 according to Bank of England provided it continues to grow at its current speed.

Convenience and an being seen as an effective alternative to banks - are the main reasons that make social networking lending and related services to them so popular. So called "crowdfunding" is gradually regulated by the Financial Conduct Authority finding a niche in the financial market. Despite the skeptical opinions of some experts, borrowing portals can be long lasting, profitable business.

Table 5: Amount of P2P companies in the UK market

2005	2006	2007	2008	2009	2010	2011	2012	2013
1	1	1	2	4	8	11	17	35*

* including four which starting data are still unknown

SOURCE: www.p2pmoney.co.uk/companies.htm MARKETLINE

Social lending becomes more convenient than banks

Taking a direct loan through the Internet is easier and more accessible through lending platforms. Thanks to them, users can borrow money without the intermediation of a bank, proposing a high percentage, and additional commission on borrowed funds. Getting money through a social lending is cheaper and simpler for borrower. It also provides the possibility of more effective, than a standard bank deposit, investment for people who lend money to others. Because in this form of lending the interest rates are set manually, the investor may benefit from significantly higher interest returns

It would have seemed that over last nine years, since Zopa was introduced, the social lending market should have consolidated and stabilized. Meanwhile, the list of platforms operating worldwide is still increasing indicating the need for this type of services.

The stream of funds is increasing through social lending

The financial results of social lending platforms shows that people are increasingly willing to lend through the Internet. The oldest social lending portal in the world - the British Zopa.com – has lent over £426m (about $685.4m) as of November 2013 and has about 116,000 active accounts. The first year of the portal was a great success with 25,000 registered users and three million pounds of revenue from completed loans. However, since then the company has been growing constantly and had the biggest amount of funds lent over last year (2012) with lenders investing over £165m (approximately $265.5m).

The development of global social lending is also confirmed by increasing interest of this form of lending in other countries. The results of the current market leader - the LendingClub in the US market or Auxmoney in Germany. These services have helped to lend and invest funds of over $2.9bn and EUR43m (about $59.7m) respectively. The number of users and value of transactions made on social lending platforms is still growing at a stable level.

Social lending services are differentiating

The popularity of online loans is also indicated by provision of diversified portals, allowing the social lending to move into the Peer-to-Business area. Here, portals, in addition to standard social lending to individuals, offer services to companies. There are also platforms allowing for so-called crowdfunding through which investors can loan to entrepreneurs around the world.

Kiva.org portal is offering the crowdfunding services involved in delivering funds to developing countries corporate financing. On this portal, owners and shareholders of Peru, Cambodia and Ghana offer theirs bids and define the conditions under which they are willing to raise funds. Individual investors from the US, Poland or Japan can give them the money of no less than $25. Since 2004, the service Kiva.org helped in granting loans with a total value of $501.1m, of which nearly half relates to transactions carried out in the past year.

The British government invested £100m to small businesses through alternative lending channels

In May 2012, the UK government promised £100m to be available to small businesses not through banks but other forms of lending networks like social lending platforms. Financial channels like peer-to-peer lending platforms, were taken into consideration in order to bypass the mainstream banks. The peer-to-peer companies were predicted to issue up to £200m of loans in 2012. The government's move shows the opportunity of new profitable investments that can be done outside of the bank services.

However, lending procedures lasted far longer than planned, and only after the procedures and formalities were out of the way, in March, 2013 the UK government authorized the first loan. The aim was to omit traditional banks and to lend money directly to small businesses at an interest rate of up 7 - 8%. As a result of these actions 55 million pounds went to four companies offering social lending.

British Secretary of State for Business, Vince Cable, speaking about new funds, said: " Small and medium-sized businesses need access to a variety of financing options, including non-bank loans. New forms of financing are now a small percentage , but they should eventually create more choice and more competition in the credit market.

Not only the UK Government is supporting companies in the form of non-bank loans. In November 2012 Lancashire County Council announced that £100,000 (about $160,901) was donated through Funding Circle in order to help businesses in the county. The council established a new loan as "a groundbreaking new way of funding business growth."

The longer the financial crisis affects the banking landings, elevating the rates and requirements for borrowers, the more likely individuals and companies are to use social loans. The three major social lending companies in the UK borrowed more than £683.6m (about $1,085.1m) since 2005. In the United States the two biggest players Lending Club and Prosper Marketplace in the years 2009 - 2013 gave away loans with the value totaling $3.2bn. This coupled with the growth in number of social lending platforms which came to life after 2009 indicates the significance of this type of service.

The growing popularity of non-bank loans in the UK and the US is helping to lead to the development of the national economy. Banking institutions, greatly accused by some of having caused the economic problems, have lost the confidence of not only their customers but also governments that realized that traditional banking system does not meet the needs of the businesses and individual in current circumstances. Time will tell whether the British Government decisions entail other countries to transfer funds to non-bank institutions.

CONCLUSIONS

Social lending is set to continue to grow fast

Social loans are developing very quickly worldwide. The popularity of this form of borrowing indicates continued rapid growth of Internet users interested in social networking loans. The popularity is boosted by faster and less complicated procedures for borrowers and for lenders there is greater interest paid which mitigate the greater risk. The choice of social lending provides the most opportunity to receive quick loan, often for a short period, without unnecessary formalities. Every day several hundred accounts are opened on social lending portals and loan applications are processed. On average, every second auction and application results in the loan being granted.

Social Loans are ideal for investors who want to diversify their investment portfolio. There is the opportunity of gaining much more return on capital invested than on traditional deposits. In certain countries the investors can earn up to 20% per annum, and if capital is reinvested even more. Although, as with all investments, social lending involves risk it is, however, compensated by large potential profits. Experienced investors are able to achieve a rate of return equal to or close to 15% on average. Due to the potential of high return on investment and flexibility of the investment where anybody can start investing even small amounts of money coupled with the elimination of the rigid banking rules and fees it's clear why the demand for the social lending is fast increasing.

Social lending has been present in the global market since 2005. Since that time hundreds of social lending sites have been established in many countries and this number is constantly growing. Social loans are a response to the need for easy, fast, secure and relatively cheap money and way of investment. Social lending was recently described as a phenomenon, and is now recognized as a complement to traditional banking services. Certainly, it is fashionable to invest and borrow from Internet users and slowly this trend is changing into standard behavior of Internet users around the world.

Social lending, despite high growth rates, is treated by the social lending account holders as a complement to traditional banking services. This form of lending allows for making use of innovative solutions. Borrowers still turn to banks for bigger loans; however, the smaller amounts are willingly borrowed through the Internet.

For investors social lending is an addition to the investment portfolio and for borrowers variation to traditional banking services.

APPENDIX

Definitions

Financial Conduct Authority (FCA) - is a regulatory body in the United Kingdom; formed to regulate financial firms providing services to consumers and maintain the integrity of the UK's financial markets.

Crowdfunding - the collective effort of individuals who network and pool their money, usually via the Internet, to support efforts initiated by other people or organizations.

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Ask the analyst

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