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You Are Unlikely To Prosper

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Person-to-person lending is much riskier than you've been told.

100115_TBM_Larsen.jpg [1]

You are a loan officer at a bank. A potential client comes and sits down across from your desk, asking for a loan. She wants to borrow $10,000 to "consolidate her debts," and tells you she is willing to pay a startling 23.70 percent interest. Her credit rating is not bad. But then you lean back in your chair and wonder, "Wait a second! Why in heaven's name would someone pay me this kind of money to take a loan to *repay her other debts?*" You might wonder what the heck the interest rate is on those loans, and how she could possibly be reducing her costs this way. You might even wonder—actually, it would be your job to wonder—if there's something fishy going on here.

That is how things work in the real world. But not so on the Internet, in the world of person-to-person lending, where folks asking to pay those kinds of rates with vague claims about consolidating debt or paying off their credit cards are par for the course. Person-to-person lending--loans made by individual investors who had money to spare to borrowers hoping for better rates than they could get from banks or credit card companies--was supposed to be to loans what eBay was to garage sales. Prosper.com, the pioneer, was one of most hyped internet startups of the last decade.

TIME Magazine chose Prosper.com as its top new website of 2007, and the *Wall Street Journal* featured it in a high profile story [2]. Prosper television commercials picked out nifty stories like that of a New York cop who lent money to a Chicago fashion designer [3], and the press followed with quirky human interest stories (like a loan for breast implants [4]). In short order, Prosper was followed by imitators such as Loanio and Lending Club—the latter a Harvard Business Review featured [5] in the Harvard Business Review's picks for "breakthrough ideas for 2009."

After the press weighed in with the stories about the great new idea in lending, however, hardly anybody except the increasingly unhappy community [6] of Prosper lenders—"Welcome aboard our little trainwreck, [7]" says one poster on Prospers.org, an independent discussion forum for Prosper participants—bothered to keep track of just how well it worked out. The answer is: not well at all. On MSNBC last year [8], Prosper founder and chief executive Chris Larsen pitched person-to-person lending as the solution to the current credit woes. "Every American," Larsen said, "can be their own banker. I can back other entrepreneurs, I can back people in my community, and I can make the money on this. I can do well by doing good. I think that's very empowering, and exactly what we need now to fix this crisis."

To look at the results of Prosper's loan marketplace, though, is to see not a solution to the credit crisis, but a microcosm of it. Loans to unqualified borrowers; reliance on mathematical models that turn out to be a lot less useful than they seemed; failed hopes that high interest rates could make subprime loans profitable; sky high default rates—Prosper has it all. Prosper's Web site [9] advertises returns of 6 percent to 14 percent for lenders. But the reality is that the lenders who loaned $188 million through Prosper have not earned anything like these returns. On the contrary, the majority of them have lost money, as they've watched their loans go bad at shockingly high rates.

Much like the loans made by banks during the mortgage boom, Prosper's loans have gone into default at rates much worse than predicted by historical credit data. In November, 2007, Larsen told the Associated Press [10] that Prosper's default rate "hovered at around 2.7%." That, however, included many new loans that simply hadn't had time to go bad. Larsen refers to this obliquely in the AP story, noting that as more loans matured the rate would rise, but there's no hint of just how steep that rise would be. Prosper's data now shows that now shows that close to 36% of the loans made before Nov. 27, 2007—the date of the AP story—have ended in default, roughly thirteen times what a casual reader would have thought from Larsen's comments. That is close, coincidentally, to the total 39% (or roughly two in five) default for the Prosper loans that have reached the end of their three year term. (You can go here [11] to see the data for yourself, just try plugging in the ending dates).

For those lenders who hoped, as subprime banks did, to counter high default rates with very high interest rates, the numbers have been even more depressing. Prosper, to its credit, provides data to outsiders that lets potential lenders and other Web sites analyze Prosper's loans in detail. The best Prosper analysis site is Eric's Credit Community [12], run by a Michigan programmer named Eric Petroelje. Thanks to Petroelje's site, it's easy to cut up the data, to find, say, how many of the loans with interest rates of 18 percent and up have gone into default before the three-year payment period is up. The answer: 54 percent. So *more than half* of these high-rate borrowers failed to fully repay their debt.

Which brings us to bottom line: After you take the defaults into account, investors have lost money on most of their Prosper lending. Prosper does provide all this data to potential lenders, but you'll have to look hard to find it on the Prosper.com Web site. Prosper grades loans based on borrower's credit scores and other factors with a rating system that rates the risk from AA (at the top) through E and a final category of "HR" (for "high risk"). A visitor who gives the "marketplace performance" charts on Prosper.com a quick once over sees the encouraging information that the loans in the AA to E categories, at least, have been profitable.

But there's a sleight of hand that only those who are familiar with the history of Prosper's borrower ratings and sift through the data carefully are likely to notice. Prosper reopened its marketplace to new loans last July after a long hiatus to comply with new regulatory requirements, and in the meantime changed the rating criteria, making the requirements for each category much more stringent. Most older Prosper loans—including some that had top ratings under Prosper's *old* AA to HR criteria—have now been reclassified as "HR" loans or are listed in an "N/A" column that includes loans that would no longer meet Prosper's criteria or (for some of the older loans) are missing some of the information that's used in Prosper's new rating algorithm.

Those two columns make up $136 million of the $188 million in loans that Prosper lenders have funded since the loan marketplace started. Close to $38 million of that $136 million in loans has already been charged off as bad debt. Overall, Prosper admits that investors in these categories, which Prosper's chief financial officer characterizes in bank-speak as "under-priced," will wind up losing money.

In other words, only by cutting out *more than two-thirds* of its loans, does Prosper manage to eke out the positive results for AA to E rated loans that prospective lenders see on Prosper.com. Or you can look at it another way and ask how many investors have actually gotten returns in the 6 percent or 14 percent range that would-be lender see blazed across the Prosper.com front page? Thanks again to Eric's Credit Community, we have a pretty good idea: Of investors with a portfolio of loans that are an average of at least two years old, folks who have lost money outnumber those who've earned 6 percent annual return by more than six to one.

Prosper's Web site now prominently displays what look like very attractive returns for loans made since the marketplace reopened in July, with estimated returns of 7.86% to 12.87% on loans to the more creditworthy borrowers. But these are based on estimated default rates and repayment rates, about which Prosper has time and again been wrong. This time, Larsen says, Prosper has it right. In the past, according to Larsen, Prosper had to rely on credit-score data that turned out, for banks as well as for Prosper, to vastly understate the losses in what turned out to be the worst credit crisis in 70 years. Prosper's new algorithms, promises Larsen, will actually reflect how loans perform. "It's only three years in that we could do the rating system based on actual data from the marketplace."

Recall, however, that in November 2007—already close to two years into Prosper's life—Larsen was talking about Prosper's 2.7 percent default rates. Maybe a new crop of lenders will believe that this time things will be better. Prosper's more seasoned lenders, though, don't seem to be biting. "Prosper will change the lipstick on the pig, but that's just about it," writes one disenchanted lender [13] on the Prospers.org message board. Prosper's loan volume is a fraction of what it was at its height in 2007 and 2008. Eric Petroelje says that the traffic on his site is down from 500 or 600 visitors a day to just 100 or 150.

Meanwhile, since the Prosper marketplace, Prosper has again been trying to drum up business, and again the press has is along for the ride: the MSNBC appearance in which Larsen chatted up how "empowering" peer-to-peer lending can be, a Washington Post piece [14] about Prosper.com being a source of credit for folks faced with tightening credit card standards, promising (incorrectly) rates as low as four percent. The difference is that now, unlike at Prosper's launch, there is plentiful data about just how bad the performance of Prosper.com loans has been. Much of this information has been carefully cataloged [15] by bloggers who follow Prosper, yet little of it finds its way into major media stories.

In this way, too, the story of Prosper.com is reminiscent of the larger story of the credit crisis. Calculating the returns on loans and digging through statistics about default rates and pre-payments can be tedious work. It is the kind of work that reporters rarely want to do, and all the information that was hidden in the data only comes into public view after the money is long gone. In an interview last week, Chris Larsen argued that given all the changes in Prosper's lending criteria, a story that looks at how Prosper's loans and lenders have fared in the past, is "oddly late." On this, unfortunately, Larsen is completely right. It's clearly a story that would better have been done long ago. But it's still better to do it now than to wait for yet more loans to go bad, yet more money to be lost, and yet another cohort of lenders to be sucked in by the latest failed idea in finance.

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