The Ebay of Loans; Prosper.com links individual lenders to borrowers, stripping out some costs but not the default risk.

By: Christopher Steiner (Forbes)
factiva, 2/27/2007 -- Prosper.com links individual lenders to individual borrowers. It strips out some middleman costs but not default risk.

They want money to buy a K-9 bomb-sniffing dog, to make a house down payment, to set up a videogame studio, to pay tuition. And Gregory Bequette is happy to lend to them personally through a Web site called Prosper.com, the Ebay of small personal loans. Bequette has hitched a good chunk of his portfolio, $878,000, to others' hopes, dreams and debts--and their ability to repay him. An accountant for the University of California system who gets his kicks riding motorcycles, Bequette has lent to 163 cyberborrowers at an average interest rate of 26.4%.

Year-old Prosper functions as an online way station where borrowers and lenders can arrange three-year loans of up to $25,000, at rates three to five percentage points lower than what credit cards charge (see table). Its a-rated borrowers pay an average 8.8% yearly, versus 11.8% for a fixed-rate credit card and 13.8% for a variable-rate card. They could get even better rates, along with tax deductions, if they tapped home equity, but many Prosper borrowers don't own a home.

Why the low rates on Prosper loans? Prosper's believers explain the bargain this way: Their system strips out overhead costs. "If the credit card companies are making so much money, why don't I cut out the middleman and get some of that myself?" Bequette asks.

The San Francisco site provides credit checks of borrowers via Experian and posts their ratings (ranging from AA to HR, for "high risk") with their profiles online. Bids are for interest rates, and the lowest ones win among sometimes dozens of bidders. Borrowers post a requested rate on their Web profiles, mostly in line with their credit rating.

The winning bidders' money, usually in small increments, is packaged into one loan. When lenders browse through the borrower profiles and place bids, it's often for a fraction of the total loan needed, with $50 the minimum. Lenders get the safety of diversity. The profiles allow lenders to see borrowers' debt-to-income ratio, current and past delinquencies. Some borrowers even post monthly phone bills and housing expenses. Borrowers provide photos of themselves, their kids, their pets and--a requirement--what they want to use the money for. Jason42 (full names are seldom used) desires $18,000 to purchase his "dream car," and Bebe19 asks for $10,000 to consolidate credit card debt.

The guy who wishes to buy the bomb-sniffing dog says he has a federal contract to detect explosives in Iraq, where he will be paid $9,000 per month. This 37-year-old father of four, a civilian who did K-9 work before in Afghanistan and Iraq, wants a $20,000 loan, at 25.25% interest, to buy a dog and ship it to the war zone. He notes that he has life insurance worth $300,000, which his widow will use to pay the loan, if need be.

What if things don't work out for borrowers? In its year of existence Prosper has had 0.5% of total loan amounts default and 6.5% fall behind on payments for a month, compared to 4.2% and 4.4% for card companies. Prosper lenders choose among three collection agencies to pursue delinquent borrowers.

Let's not forget, however, that serving as an unsecured lender is a risky business. Most of the loan applicants are clustered in the iffier end of the credit spectrum. While bad loans are minor now, just wait until an economic downturn comes along. Another problem for Prosper lenders is that the loans are not liquid. The company had hoped to set up a secondary market, but that fell through. Lenders are stuck for a loan's whole three-year term. And there's no way to guarantee that the proceeds will be applied to the stated purpose. What if that nice lady wanting to open a beauty shop blows the cash at a Las Vegas craps table?

Prosper makes money by charging borrowers an upfront fee of 1% to 2% and lenders 0.5% to 1% of the annual loan balance. That means Prosper should take in around $1.8 million in revenue this year. The company has $35 million in loans outstanding but is adding new ones at a steady clip and should have at least $120 million by year-end. Prosper won't say what its growth targets are or when it will break even. For now it appears to have enough seed money to keep going: $20 million in venture capital funding.

Company founder Christian Larsen was chief executive of E-Loan until Popular Inc. bought it in 2005. The Ebay model enticed him. So did the wide spread between what banks pay for savings accounts and certificates of deposit, and what they charge card borrowers. That would be a big draw for individual lenders, he figured. Adding to the appeal was that a company called Zopa.com had been doing this successfully in Britain since early 2005.

Prosper hooked up its first lender and borrower in February 2006. It's been a quick bloom: 40,000 loan listings now beckon 12,000 registered lenders. Prosper's loan volume is growing at $6.3 million a month. Larsen, 46, has himself invested $120,000 in 240 loans. He prefers proven borrowers; his portfolio's mean interest rate: 11.4%. "It's fairly addicting," Larsen says of the loan-picking process.

Nobody has yet defaulted on Bequette, 55, who began lending last July. But Bequette does have three accounts with payments overdue (a loan is considered in default if unpaid for more than 120 days). Bequette expects an overall default rate on his portfolio of 8% this year, leaving him a net of 15% after fees. Plus, he professes to feel a ping of altruism when he lends. He's helped a young couple hoping to buy a first house, a woman buried in credit card debt and a small, expanding landscaping business.

To make his loans, Bequette pulled money out of mundane mutual funds. Bequette was so enthused with his early yields that he took out a $270,000 home equity loan at 7.9% to plunge back into Prosper.

Prosper investor Craig McHugh finds himself convinced that the default rates will end up lower than expected: "Because these people are borrowing from individuals who chose to help them out rather than Big Brother, they'll feel more obligated to pay back the loans." A sanguine attitude, to be sure. But McHugh is no naif; he's president of Creative Labs, the $1.1 billion Silicon Valley outfit.

While most Prosper lenders are amateurs, some investment pros are dipping in. Jonathan Hoenig, 31, runs Capitalistpig Hedge Fund in Chicago and has more than $150,000 of its money in 1,300 Prosper loans at an average interest rate of 20%. "This is a way to run a credit card company," he says.

Hoenig won't bid on a loan where the borrower has more than three delinquencies. "I don't want to replace someone's payday loan they weren't going to repay," he says. Nevertheless, he tilts toward the riskier end of the credit ratings because these have juicier yields. Why lend to AA credits at 9% with a projected default rate of 0.2% when you can lend to the Cs at 17% and a default rate of 3.3%?

Personal finance author Jerrold Mundis (50 loans, totaling $10,000) prefers the riskier credits, too. The New Yorker, whose book How to Get Out of Debt, Stay Out of Debt and Live Prosperously is in its fortieth printing, feels that Prosper helps subprime borrowers stay within their means. Mundis has been burned, though, by one delinquent borrower. The deadbeat's credit rating: AA. "That was my one nod to conservatism," he sighs.