If you have ever taken a personal finance class, you likely remember that the teacher emphasized the importance of maintaining a good credit score. The teacher might have said that a good credit score gives you access to loans and credit cards with comparatively lower interest rates. In addition, you were likely warned of the consequences of a bad credit score and the potential dangers of easy-access payday loans that offer cash at an annual percentage rate (APR) as high as 400 percent.1

As the terms “FICO® score,” “interest rate,” and “loans” were thrown around in class, perhaps it wasn’t long until you found yourself wondering about your own credit score and its implications. So, what does a Fair Isaac Corporation (FICO) score tell lenders? What’s a good credit score, and how does it affect the interest rate you’ll pay? How is traditional lending different from other types of lending? And if payday loans are risky, are there other alternatives to traditional lending?

Traditional Lending and Credit Scores

When creditors consider making a loan, they look at the borrower’s credit score to assess that person’s ability and willingness to make payments on time. While an individual’s credit score is not the sole factor affecting a credit application, the credit score influences not only the amount a lender will provide but also the terms of the loan such as the interest rate. One of the most common scoring techniques used by 90 percent of top lenders is the FICO score. A base FICO score ranging from 300 to 850 is generated by considering a combination of an individual’s information (see the boxed insert). As with most scoring methods, a higher score is better; the premise is that the higher the score, the less risk posed to lenders.2

In addition to reviewing the FICO score, the lender also carefully reviews the borrower’s credit report, a summary of the individual’s payment history. The three major credit reporting bureaus—Experian, TransUnion,
and Equifax—collect information from banks, credit card companies, finance companies, and other lenders to generate credit reports. In fact, the FICO score and the credit report go hand in hand in determining the creditworthiness of a loan applicant.

Peer-to-Peer Lending: An Alternative

Peer-to-peer lending is a relatively new method for obtaining credit. Similar to microloans and crowdfunding resources, peer-to-peer lending started as an avenue for impoverished borrowers to access loans without collateral. Sites such as Kiva connected donors of the developed world to entrepreneurs in the developing world. However, the concept has since evolved to serve as a credit opportunity for individuals in the developed world as well. Sites such as Lending Club and Prosper connect individual investors to borrowers who may not be able to obtain loans through traditional avenues. These sites provide mainly debt consolidation loans, credit card payoff loans, and small business loans. However, borrowers are not limited to these uses and may apply for loans to cover a wide range of needs such as car loans.

Aside from providing high-risk borrowers with potential credit, a couple of key characteristics differentiate peer-to-peer lending from traditional lending. Perhaps the greatest difference is that peer-to-peer lending sites offer loans that are directly backed by investors as opposed to financial institutions. The majority of peer-to-peer loans are funded by many investors—not just one investor. Depending on the borrower’s payment history, loans can be received in as little as one business day and usually have a payoff expectation of about 36 months. In addition to providing a FICO score, borrowers have the option to share private information in their profiles and are able to receive “endorsements” from other users to increase their credibility as a borrower. As with traditional lending methods, an individual’s FICO score and debt rating factor into determining the interest rate of a peer-to-peer loan request. Borrowers are not required to submit collateral and thus the loans are unsecured. In addition, the sites charge borrowers in the form of origination or closing fees that range from 0.5 to 5 percent of the value of the loan.

The average peer-to-peer borrower has a FICO score of about 700 and is granted a loan with an interest rate ranging from 8.67 to 13.5 percent. However, some investors are willing to accept riskier borrowers with credit scores close to the minimum of 630 and offer to fund loans at APRs of more than 30 percent. Thus, peer-to-peer sites can serve as credit opportunities for those who are turned down by traditional lending institutions. Likewise, peer-to-peer loans are an alternative to payday loans that on average leave a borrower indebted for about 6 months with annual interest rates over 400 percent. Furthermore, while borrowers can receive loans ranging from $1,000 to $35,000, it is important that they do not borrow more than necessary because they will be faced with not only higher interest rates but also higher origination or closing fees. Finally, it is wise for borrowers to apply to more than one peer-to-peer lender to compare the different rates offered. Unlike traditional loan applications, a peer-to-peer application does not negatively impact the borrower’s credit score because it is classified as a soft inquiry.

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1 Category ranges vary by creditor. If you apply for a loan, a loan officer from one institution may consider a FICO score of 680 to be in the “good” range, while a loan officer from another institution may consider it only “average.” The ranges shown above are from Credit.org. See Lamb, Lori. “What Is a Good Credit Score?” Personal Finance News and Advice (blog), January 22, 2014; http://credit.org/blog/what-is-a-good-credit-score-infographic/.
Peer-to-peer lending is a high-risk, high-return option for investors. While the yields tend to be higher than similar investment options, such as certificates of deposit, the loans are unsecured with no guarantee of repayment from either the borrower or a third-party governmental agency. However, there are still strategic ways for investors to choose lending options, such as diversifying their loan choices and watching trends. As with stocks, the best way for an investor to hedge risk is to invest in a range of borrowers. Instead of fulfilling one borrower’s entire loan, it is wiser to partially fund a variety of loans from multiple borrowers of different risk levels. Similarly, it is often beneficial to gauge the credibility of a borrower by watching the investments of other investors. For example, if two borrowers of very different risk levels receive the same amount of money, it is likely that an investor studied the higher-risk borrower and determined that (despite the high risk) the borrower is in fact creditworthy. As a result, other lenders might consider this an indication of a good investment choice and add to the funding of the loan request. This phenomenon is known as herding and refers to how investors often look to their peers to gain more information on the borrower than a simple FICO score or other rating may reveal.

Conclusion

Encouraged by the demands of consumer culture, peer-to-peer lending has evolved tremendously over the past decade. Borrower requirements are more accommodating than they are for traditional lending, and interest rates are lower than they are for payday lending. Sites such as Lending Club and Prosper offer loan alternatives for borrowers and investment opportunities for lenders. What started out as a modest effort to allow more low-income and credit-risky borrowers to obtain loans has become a revolutionary tool connecting borrowers to investors.

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