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Common Core State Standards (see page 7)

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Peer-to-Peer Lending

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> "Some debts are fun when you are acquiring them,
> but none are fun when you set about retiring them."
> —Ogden Nash, American poet

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,

GLOSSARY

Annual percentage rate (APR): The percentage cost of credit on an annual basis and the total cost of credit to the consumer. APR combines the interest paid over the life of the loan and all fees that are paid up front.

Credit report: A loan and bill payment history kept by a credit bureau and used by financial institutions and other potential creditors to determine the likelihood that a future debt will be repaid.

Credit reporting bureau: An organization that compiles credit information on individuals and businesses and makes it available to businesses for a fee.

Credit score: A number based on information in a credit report, which indicates a person's credit risk.

Interest rate: The percentage of the amount of a loan that is charged for a loan. Also, the percentage paid on a savings account.

Liability: money owed; debt.

Microloan: A small, short-term loan at low interest, often used by self-employed individuals or entrepreneurs for start-up expenses, inventory, or equipment.

Soft inquiry: Any check of a person's credit report that occurs when the person's credit is not being reviewed by a prospective lender. Examples include inquiries as part of a background check, a person checking his or her own score, and checks by a financial institution with which a person already does business.

Determining a Credit Score

What type of information is used to determine your credit score? FICO uses the following information to generate credit scores:

- Payment history
- Length of payment history
- Types of credit in use
- New credit accounts
- Current **liabilities**

Scores range from 300 to 850. In general, FICO credit levels fall into the following categories:[1]

- 300-550: Poor credit
- 550-620: Subprime
- 620-680: Acceptable credit
- 680-740: Good credit
- 740-850: Excellent credit

[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/.

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.[3] 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.[4]

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**.[5]

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 investment—in this case, 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. ■

Notes

[1] See Center for Responsible Lending. "Payday Loans." http://www.responsiblelending.org/payday-lending/.

[2] See Fair Isaac Corporation. "What Is a FICO Score? http://www.myfico.com/crediteducation/articles/; and Kapoor, Jack R. "Consumer Credit," in Jack R. Kapoor, Les R. Dlabay, and Robert J. Hughes. *Glencoe Business and Personal Finance*. Columbus, OH: McGraw-Hill Education, 2012, pp. 451-514.

[3] Zhang, JuanJuan. "The Wisdom of Crowdfunding." Federal Reserve Bank of Boston *Communities & Banking*, Winter 2013, *24*(1), pp. 30-31; https://www.bostonfed.org/commdev/c&b/2013/Winter/the-wisdom-of-crowdfunding.pdf; and Hayes, Adam. "What Is Microlending and How Does It Work?" *Investopedia*, April 7, 2015; http://www.investopedia.com/articles/personal-finance/040715/what-microlending-and-how-does-it-work.asp.

[4] See Horymski, Chris. "What You Need to Know About Lending Club and Prosper." *Consumer Reports*, January 5, 2015; http://www.consumerreports.org/cro/news/2015/01/what-to-know-about-lending-club-and-prosper-peer-to-peer/index.htm.

[5] Jones, Sally. "Peer to Peer Lending Site: Lending Club vs Prosper vs Upstart." ASecureLife.com, March 20, 2015; http://www.asecurelife.com/lending-club-vs-prosper-vs-upstart/.

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Name____ **Period**________

Federal Reserve Bank of St. Louis *Page One Economics*®:

"Peer-to-Peer Lending"

After reading the article, answer the following questions:

1. Your credit score may not be the sole factor in determining whether you get a loan, but it can influence which two important provisions of the loan?

2. What type of information is included in the calculation of an individual's FICO® score?

3. What are the three major credit reporting bureaus?

4. Circle the documents used to determine your creditworthiness.

   birth certificate   high school diploma   credit reports   report card

   FICO score   tax return   marriage certificate   LinkedIn profile

5. In what ways do peer-to-peer lending and traditional lending differ?

6. What are some of the advantages of peer-to-peer loans compared with payday loans?

7. How would you advise a potential investor who is considering peer-to-peer lending?

Teacher's Guide

Federal Reserve Bank of St. Louis *Page One Economics*®:
"Peer-to-Peer Lending"

After reading the article, answer the following questions:

1. Your credit score may not be the sole factor in determining whether you get a loan, but it can influence which two important provisions of the loan?

   Your credit score can influence the amount of money the lender is willing to lend to you and at what interest rate.

2. What type of information is included in the calculation of an individual's FICO® score?

   The FICO score includes information about an individual's payment history, length of payment history, types of credit already in use, new credit, and current liabilities.

3. What are the three major credit reporting bureaus?

   Experian, TransUnion, and Equifax

4. Circle the documents used to determine your creditworthiness.

   birth certificate   high school diploma   credit reports (circled)   report card

   FICO score (circled)   tax return   marriage certificate   LinkedIn profile

5. In what ways do peer-to-peer lending and traditional lending differ?

   Peer-to-peer lending sites offer loans that are directly backed by investors rather that financial institutions, such as banks. With peer-to-peer lenders, most loans are funded by a pool of investors, not single investors. Loans obtained through peer-to-peer lending are short in duration and can be granted quickly, depending on the borrower's payment history. Peer-to-peer borrowers are not required to submit collateral.

6. What are some of the advantages of peer-to-peer loans compared with payday loans?

   Peer-to-peer loans generally span a longer period of time and are offered at lower interest rates.

7. How would you advise a potential investor who is considering peer-to-peer lending?

   Answers may vary, with some students considering peer-to-peer lending too risky for some investors. For those who would recommend peer-to-peer lending, they may also recommend that investors choose to spread their lending among several borrowers to diversify their risk. They may also recommend choosing borrowers who fit the level of risk the investor is willing to accept. For example, for investors who are somewhat risk averse, a borrower with a relatively high credit score would be preferred.

For Further Discussion

The Federal Reserve Bank of St. Louis has prepared several resources for teachers to use with their students. These include lesson plans, videos, online modules, interactive whiteboard lessons, and podcasts on economics and personal finance. These free resources are available at https://www.stlouisfed.org/education.

One such resource is "Episode 1: Understanding How a FICO Credit Score Is Determined" in the Continuing Feducation Video Series. This six-minute animated video explains how credit scores are calculated and why a FICO score is important. The video is available at https://www.stlouisfed.org/education/continuing-feducation-video-series.

In addition, "Diversification and Risk," a lesson plan, can be used to teach your students about risk and reward. In the lesson, groups of students develop a portfolio of investments by participating in an egg hunt. They compare various life situations they could encounter and analyze them according to risk and reward. They then assess the relative risk associated with the products in their portfolios. They later determine which savings and investment instruments might be most suitable for clients of different ages and economic status. This lesson plan is available at https://www.stlouisfed.org/education/diversification-and-risk.

Common Core State Standards

Grades 6-12 Literacy in History/Social Studies, Science, and Technical Subjects

- **Key Ideas and Details**

  RH.11-12.2: Determine the central ideas or information of a primary or secondary source; provide an accurate summary that makes clear the relationships among the key details and ideas.

National Standards for Financial Literacy

Standard 4: Using Credit

Credit allows people to purchase goods and services that they can use today and pay for those goods and services in the future with interest. People choose among different credit options that have different costs. Lenders approve or deny applications for loans based on an evaluation of the borrower's past credit history and expected ability to pay in the future. Higher-risk borrowers are charged higher interest rates; lower-risk borrowers are charged lower interest rates.

- **Grade 12, Benchmark 5:** Lenders make credit decisions based in part on consumer payment history. Credit bureaus record borrowers' credit and payment histories and provide that information to lenders in credit reports.
- **Grade 12, Benchmark 5:** Lenders can pay to receive a borrower's credit score from a credit bureau. A credit score is a number based on information in a credit report and assesses a person's credit risk.

National Content Standards in Economics

Content Standard 2: Decision Making

Effective decision making requires comparing the additional costs of alternatives with the additional benefits. Many choices involve doing a little more or a little less of something: few choices are "all of nothing" decisions.

- **Grade 12, Benchmark 6:** Some decisions involve taking risks in that either the benefits or the costs could be uncertain. Risk taking carries a cost. When risk is present, the costs should be treated as higher than when risk is not present.
- **Grade 12, Benchmark 7:** Risk can be reduced by diversification.

Content Standard 12: Interest Rates

Interest rates, adjusted for inflation, rise and fall to balance the amount saved with the amount borrowed, which affects the allocation of scarce resources between present and future uses.

- **Grade 12, Benchmark 4:** Riskier loans command higher interest rates than safer loans because of the greater chance of default on the repayment of a risky loan.