PEER REVIEW

Underwriting peer to peer lending still needs to come of age

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The peer-to-peer lending space has proven itself a disruptive element in the financial world — this much cannot be denied.

As with any emerging market space, there comes along with it radical speculation of untapped potential and naysayers who see economic harbingers of a subprime past. The truth of the matter is that disruptive innovation — with all its technology, transparency and more efficient delivery systems — is quickly changing the commercial lending landscape.

This forward-looking disruption finds its roots in a collective of individuals who realize a for-the-people product can yield better results for individual investors and borrowers across the board.

There is a new level of transparency brought about by improved technology, which results in lower interest rates for prospective borrowers, both consumer and commercial alike. The circumvention of traditional lending institutions has created a whole new market for individual and institutional investors.

The challenge is to take the advantages of this new paradigm yet include the best practices of the traditional lending industry.

Every investor wants to see predictable and stable returns on their

investment. Some of these emerging lending platforms are developing and testing new algorithms to underwrite the credit risk of small business loans.

It will take time to prove out how these algorithms perform through the different phases of an economic cycle. In the meantime, investors will be charging a greater premium to cover this underwriting risk.

Combining the best time-tested underwriting practices of the traditional model will accelerate the time it will take to reduce this premium. The sooner the best of these models converge the sooner we can realize a peer-to-peer industry that deploys healthy, risk-based capital across a broad range of credit tiers.

There are a few distinct factors that are deserving of special attention as we discuss the future of the small business lending space:

First and foremost is the fundamental element of scoring. Right now, credit underwriting in this new market is being mostly dictated by proprietary algorithms.

Most of us can only venture to guess the ingredients going into the secret sauce being used by companies in the P2P space in order to evaluate risk. The fact remains that we have years and years of historical performance data that can be evaluated to extrapolate certain risk factors in the small business space.

Combining consumer bureau data on the owners of the business, commercial credit bureau data, industry classification codes and other business specific attributes are being utilized today to rank-order risk in the small business lending space.

There is a certain truth to the adage "you can price for anything." However, statistical models and algorithms and seemingly meaningful data provide rather limited insight into real-world performance.

This brings us to the next piece of the puzzle — servicing and collections. No matter how good you are at underwriting there will always be slow paying customers and defaults.

What's needed is a safety net throughout the life of the loan — and this net consists of a scrupulous servicing platform supported by staff experienced in commercial collections best practices. Due diligence and meticulous servicing of accounts are going to be integral to the success of this burgeoning industry.

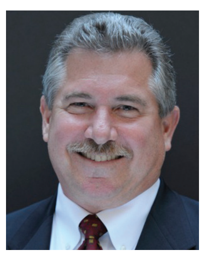
Technology to support the collection cycle, combined with skilled and well-managed staff, will have a significant impact on the overall performance of an asset class — especially as one ventures into higher risk credits.

Collection protocols need to be in place to properly manage this risk, however, care and attention must be focused on the efficient use of human resources to carry out these protocols.

Lenders have the option to build this system internally, or outsource these functions, but either way this will be a vital requirement for long-term success.

This is an exciting time in the small business lending market space. Those of us involved either directly or tangentially understand the inherent risks and rewards that come along with a market in flux.

We seek greater stability at every touch point as the market continues to scale. But more than anything we want to help people and communities grow by deploying capital to small business across America, and this can only be done if we have systems in place that reduce default and mitigate risk.



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