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Lending goes online

In our ongoing series, we look at how peer-to-peer lending is hoping to fill a niche in Canada

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The list of things you can get on the Internet is about to grow longer. As early as this week, a Toronto-based startup will go live with a new business model that could give the banks a run for their money.

Think of CommunityLend.com as a sort of online marketplace where borrowers can hitch up directly with people who have money to lend, without the hassle of dealing with a middleman. Lenders -- they must be accredited investors -- have access to borrowers' credit information, which determines the interest rate on the transaction. If they default, borrowers face the same penalties as failing to repay a bank loan.

The concept of lending among individuals, or peer-to-peer lending, has been around for thousands of years, says Colin Henderson, the company's co-founder and chief technology officer.

According to CommunityLend, the market for unsecured consumer loans in Canada is more than $100-billion, with annual interest payments of more than $15-billion.

"We hope to take a slice of that," says Mr. Henderson, who spent much of his career developing online technology at traditional banks, most recently at Bank of Montreal.

The concept of peer-to-peer lending over the Internet has enjoyed success in the United States and Britain, where market leaders such as Prosper and Zopa have been around for about five years. Peer-to-peer lenders, such as CommunityLend, claim to offer competitive rates and less red tape for borrowers. For lenders, there is the opportunity to get a respectable return on investment with relatively low risk. (CommunityLend charges a fee of about 1% or 2% of the loan.)

Interest rates range from the mid-single digits to the low teens, although the maximum allowable will be 29% for borrowers with risky credit ratings.

"We are not deliberately trying to compete with the banks," says Mr. Henderson. "We believe we've got a better, more transparent business model, and in light of all the things that have happened in financial services, we believe transparency and simplicity are very important," he says. "Things need to be clear."

Peer-to-peer lending is still small, with less than US$1-billion in loans outstanding. But that is growing at a rate of about 30% a year.

But the ride has been far from smooth. The U.S. Securities and Exchange Commission recently forced Prosper to shut down briefly so it could set up a process to register its loans as securities.

Under new U.S. legislation, responsibility for the sector will likely be handed to another regulator with a potentially less restrictive view than the SEC.

Zopa is facing similar difficulties in some European markets, but is still experiencing huge growth in the U.K.

Formed in 2006, CommunityLend wisely delayed its launch to sort out regulatory problems before they happened. A big issue was determining which regulator was responsible. Once it was determined provincial securities regulators would be carrying the ball, the company had to figure out a way to bring its systems into compliance with securities rules.

"We started out thinking of ourselves as a technology company, but the legal costs have been significant," says Mr. Henderson, declining to say how much was spent.

The delays and unexpected costs have been a disappointment but the good news is that "we've got a model that works and everyone is comfortable with," he says.

Advocates say the industry fills an important, unmet need, which is providing credit at a competitive rate to people who need it or run into difficulties getting it by conventional methods as banks tighten up on credit in the wake of the financial crisis.

But critics worry the business model will be hamstrung by problems that are only starting to surface. For example, peer-to-peer lenders' information on borrowers is not nearly as complete as what the banks can get. And investors who lend through companies such as CommunityLend are unable to price risk accurately.

Indeed, U.S. online lenders were hit with a spike in defaults as the economy started to deteriorate, leaving many investors with unexpected losses. The industry has taken steps to address the problems by offering stakes in bundles of loans, thereby allowing investors to diversify risk.

In the early days, anyone with a bank account could sign up as a lender but the rules are changing. CommunityLend will accept only sophisticated investors who understand what they're getting into.

Mr. Henderson is betting it's only a matter of time before the system catches on in this country.

"Generation X and Generation Y, they expect to be able to do everything online. In terms of growth, no one really knows, but we see large volumes coming through our system over time," he says.