Money & Investing

Making Personal Loans For Fun And Profit

Victoria Barret, 12.20.10, 12:00 AM ET

As a venture capitalist, Craig Jones is praying the initial public offering market will soon spring back and let him cash out of his illiquid investments. While he waits, Jones is putting his liquid assets to work. He's committed $1.2 million, or one-fifth of his investment portfolio, in loans to fellow Americans.

A few are starting businesses, expanding existing ones or improving their homes. Most are just indebted Joes looking to consolidate debt or roll over Visa and MasterCard balances that are charging 14% into loans charging 11%.

"It's hard to find a return these days that isn't correlated to the stock market," says Jones. "I had to get creative."

He's done so via Lending Club, a company whose website has, over its three years in operation, matched 23,000 lenders with 18,500 loans. Total balance outstanding: $179 million. Lending Club was founded by Renaud Laplanche, a French native who worked as a New York securities lawyer before launching database search firm MatchPoint. Laplanche whipped out his plastic (and paid 18% annual interest) to cover the cost of computers and furniture early on. When he later related this war story to friends, some said they would have happily lent him money on less onerous terms.

"That got me thinking," he says. "Banks are middlemen."

Laplanche sold MatchPoint to Oracle in 2005, pocketed$10 million, and after spending two years at the tech giant headed off on a planned yearlong European sabbatical. He returned seven weeks later to set up Lending Club.

The service launched in May 2007 as one of Facebook's first applications, which attracted buzz and young borrowers with scanty credit histories to mine. Laplanche shifted gears and primed the pump with $12 million from angel investors and Silicon Valley Bank.

These days Lending Club is one of a handful of peer-to-peer lenders filling a gap created by tightfisted bankers. Prosper, another such venture, operates competitive auctions in which lenders bid to offer borrowers the lowest interest rates.

Lending Club categorizes borrowers into 35 levels based on their credit histories and other data. To qualify, a borrower must be "prime," with a minimum FICO score of 660, a debt-to-income ratio (excluding mortgage debt) of less than 25% and no current delinquencies, recent bankruptcies or tax liens. Lending Club rejects roughly 90% of prospective borrowers.

Creditors can choose which individuals to lend to and commit as little as $25 to loans whose total values range between $1,000 and $25,000. They can also become creditors in baskets of loans to debtors of various risk levels.

Lending Club charges borrowers upfront fees and pockets a spread between the interest lenders earn and the higher rates that borrowers pay. Revenues should triple next year from 2010's $7 million, with profits in sight.

After Jean and Erica Etjeke's Clearwater, Fla. home was nearly destroyed by a fire two years ago, the couple says its homeowners insurance check went straight to their mortgage lender. The bank was slow to dole out funds for repairs. A local bank was charging 13% interest. The Etjekes turned to Lending Club and borrowed $10,500 at 8.94%.

How do lenders fare in such transactions? Pretty well, it appears, by bond market standards. Newly issued five-year B-rated corporate debt is paying around 7.5%, with defaults averaging 3.4% over the past nine decades. In comparison, creditors can earn 14.5% annually on five year Lending Club notes of which 4.9% have defaulted over the past three years.   Strip away defaults and Lending Club’s own cut, and his creditors have earned 9.6% annually pretax, Laplanche says.

Lender David Niekerk, an Amazon.com vice president, admits he doesn't know how borrowers are using his money but says he still enjoys a psychic benefit: "I needed to fill a void, because banks weren't going to get us out of this mess."