Future of Banking: Zopa is a peer-to-peer lending company based in London with a radical answer to traditional banks, with over 150,000 members, growing by 2,500 members a month. Zopa matches people with cash to lend with those who want to borrow. Several of the people who set up Zopa were in involved in the early stages of founding the online bank Egg. Zopa is active in UK, US and Italy with launch planned for Japan. (Article written in 2009)

The process runs in a way similar in some respects to e-Bay. Someone who wants to lend explains what they want to use the money for, the interest rate they would like to pay and how long they need the money for (3 or 5 years). Lenders then run a reverse auction, so the person who is willing to lend at the lowest cost wins the deal.

Borrowers are rated in various risk categories, which helps lenders decide how low to go in offers they make. Most applicants are turned down by the vetting system.

The agreements are legally binding and bad debts are chased by being sold on to debt agencies, for whatever they can recover in addition to their own costs. The risk profile of the average borrower is worse than in the general population but default rates on loans have been lower than expected. Losses have to be priced by lenders into the rates they charge, which in April 2009 were as high as 12% for a five year loan. Both lenders and borrowers are charged fees.

Strength and weakness of Zopa model

So what is the Zopa banking system really about? In theory there is little difference between lending someone £2,000 on Zopa and buying a car for £2,000 on e-bay. In each case there is a buyer and a seller who are matched during an auction. In an ideal world, both come away from the deal feeling happy about the outcome. The challenge with Zopa is that the deal is based on a double promise:

1) The interest will be paid in full and on time for 36 or 60 months.
2) All the money will be returned by the end of the agreement.

The problem is timescale for completion of deal

The problem is timescale. On e-Bay the problem is immediate: you paid for the goods but will they actually be delivered, and will the quality be as promised? But at least it is something that happens fast. With Zopa you are taking a bet on:

1) Honesty of the borrower
2) Solvency of the borrower - will their situation change? Even if well-intentioned, will they be able to afford to repay plus interest?

Why default rates may remain low

So far, default rate on loans has been less than 0.5%, and losses to any lender have been limited on single deals by spreading larger loans around so the risk is shared between many lenders.

Why should the default rate go on being lower than banks usually see? One reason may be the stronger relationship between the borrower and lender. In a traditional bank, the borrower may feel many light years away from any personal lender, if they decide to default on loan payments. With Zopa, borrower and lender are likely to have exchanged some personal information.

Lessons from micro-loan schemes in India

We have seen the impact of relationships in micro-loan schemes that have grown so rapidly in places like India. I have seen for myself how a group of up to 14 women may club together in a joint savings and loans scheme so that each is pledged to underwrite each other's loans. If one borrower goes down, they are all affected.

And the money they borrow is from others in their own street, village or community. In these schemes, among very poor people, repayment rates for 12 month loans is often near 100%.

How big could Zopa grow?

So how big could Zopa grow? Could Zopa become a significant threat to traditional banks? It all depends on default rates over the next 18 months. If they remain low, despite the global economic crisis, despite rising unemployment and other pressures, then we can expect many more lenders to entrust some of their cash to the system.

Need for regulation on Peer-to-Peer lending

Zopa is already in talks with the UK Treasury on various issues and it will be interesting to see how regulators want to handle Zopa and other peer-to-peer lending groups in future. At present this kind of activity is not properly regulated by the Financial Services Authority. If it were, it might encourage much greater confidence in the system.

But the Zopa model will require a very different kind of regulation than has been created for other financial institutions. The most important things are

1) Ensure that no Zopa-like scheme can be used to hide a pyramid selling scam, and that all finances in the system are handled in a proper manner.
2) Ensure standards for vetting new borrowers continue to be rigorous and consistent.

Zopa competition from e-Bay or Google?

But if these things are in place, if defaults remain low, Zopa could become very successful indeed - and provoke a lot of competition. Zopa is still small enough to be outwitted by another competitor with big muscle and an existing brand - a company like Google or e-Bay for example. It will be impossible for Zopa to protect their model with patents. Their strength will be in the size of their membership, track record and volumes of deals per month. Strangely, their best bet is probably to grow fairly quietly until they reach critical mass, and then to make a pig push with a big injection of venture capital.

Critical mass? Probably over a million members.

It will also be interesting to see what happens if large lenders start becoming active in this market. It is doubtful that borrowers will feel the same sense of connection with - say - a large pension fund.

Thinking of opening a Zopa account to lend money? You may earn a far better return than a bank deposit account, but do be sure you understand the risks which may be significant, and don't invest more than you can afford to lose.