CONGRESSIONAL TESTIMONY

“Bridging the Small Business Capital Gap: Peer-to-Peer Lending”

Testimony before
The Committee on Small Business
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My name is Rajkamal Iyer. I am an Associate Professor in Finance at MIT, Sloan School of Management. I would like to express my thanks to Chairman Chabot, Ranking Member Velázquez, and members of the committee for the opportunity to be here this morning.

I became interested in the peer-to-peer credit markets when I learned how these new online markets have been developed to improve access to credit for small businesses and individuals. What was interesting about these markets were that the loans were funded by a group of small individual investors as compared to sophisticated lenders. Given that one of the big problems of credit markets in general, is screening for the underlying creditworthiness of borrowers, I was interested in understanding whether small individual lenders can judge creditworthiness effectively.

Therefore, with my coauthors Asim Khwaja at Harvard University, Erzo Luttmer at Dartmouth, and Kelly Shue at the University of Chicago, we set out to understand the functioning of these markets. The context we studied was an online lending platform, Prosper.com, where individuals can lend to their peers. Individual lenders decide which peers to lend money to by using both hard and (mostly self-reported and non-verified) soft information on borrowers to determine their creditworthiness. Our paper shows that non-expert individuals do remarkably well - they are not only substantially better at predicting borrower default compared to predictions based on exact credit scores, but also do well relative to an econometrician's best predictions given the data available. In particular, the interest rate set by lenders predicts default 45% more accurately than the borrower's credit score.

Our results show that lenders in peer-to-peer markets are able to effectively infer borrowers' creditworthiness using the rich information set that these markets provide. We further find that lenders rely on nonstandard or soft sources of information in their screening process and that such information is relatively more important when screening borrowers of lower quality. Our results highlight that even markets with non-expert individuals can effectively screen for borrower creditworthiness. Given peer-to-peer markets' ability to effectively screen borrowers, and given their non-collateral-based lending structure, such markets can offer a potential capital source for small borrowers who may otherwise be limited to more costly sources of finance.

So one could ask what are the risks in these markets? One could be worried that investors are making bad loans and as they cannot judge borrower quality. Given the findings, this does not seem to be the case. What are the benefits to small businesses? Even if the interest rates offered by these online markets are similar to the those offered by banks, the growth of these markets could benefit small businesses as it could provide them with more funding options. At this point, given the nascent nature of these markets, regulating them could create impediments for their growth. Having said that one needs to keep track of how these markets evolve before designing regulatory frameworks to mitigate any possible externalities that might arise.

Thank you again for the opportunity to address the Committee. I will be happy to answer any questions.