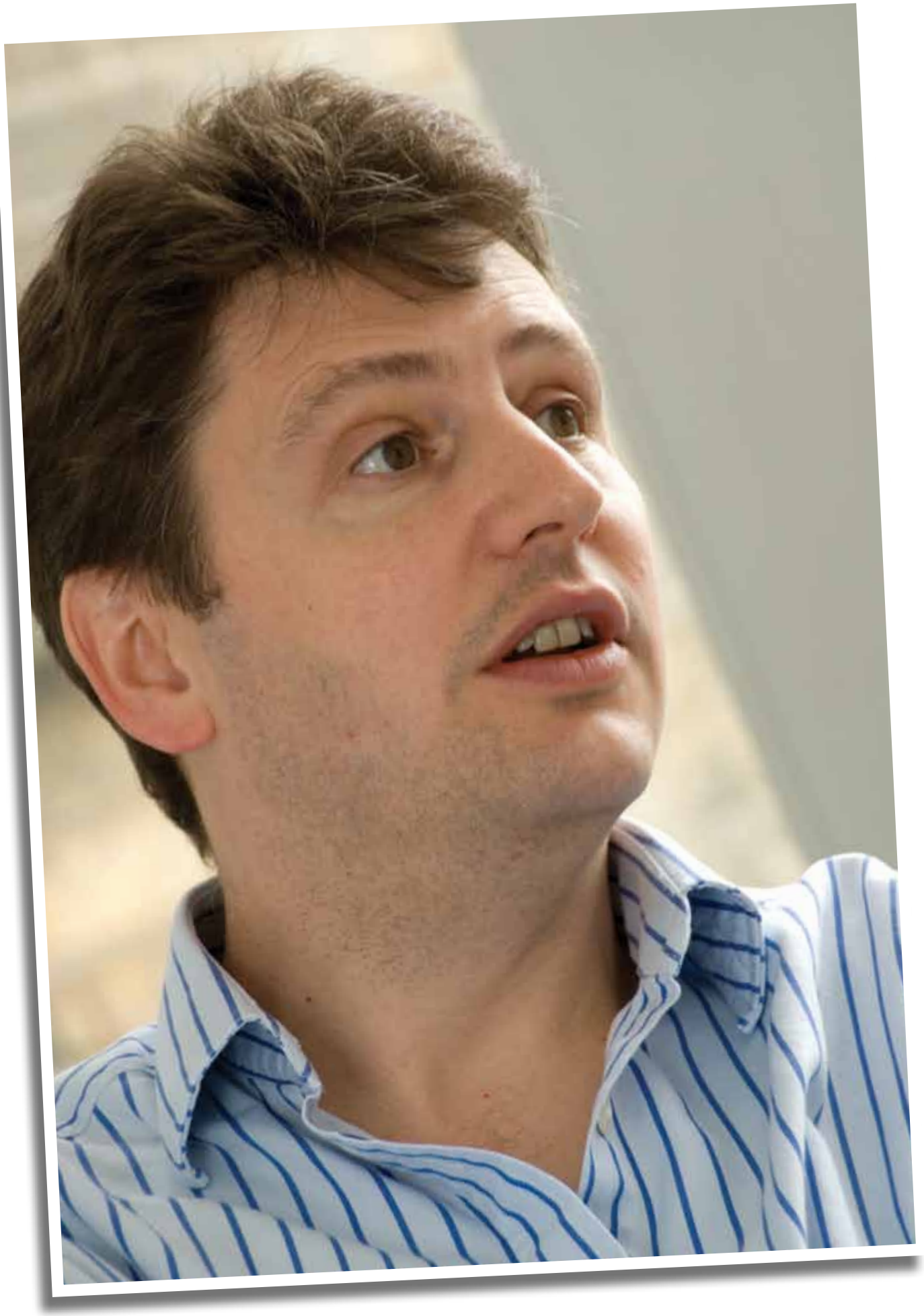

Anatomy of a 'mad, grand idea'

Launched in 2005, Zopa is the UK's first peer-to-peer online lending marketplace. It cuts out the banks by putting lenders and borrowers in direct contact with each other. GILES ANDREWS, CEO of the award-winning enterprise, talks to *Argent's* Jacqui Canham about the subversive success of this archetypal challenger brand.

"I was approached by three guys with this mad, grand idea. It had enormous potential but I had to ask: 'If it's so bloody fantastic why hasn't anyone done it before?'

Actually, it's the socialisation of an old idea. People lending and borrowing amongst themselves has been going on for centuries. This is the modern-day version of a credit union.

Our approach is partly explained by our name. 'Zopa' is a business negotiating term – the 'Zone of Possible Agreement' is the overlap between one person's bottom line (the lowest they're prepared to accept) and another person's top line (the most they're prepared to give). If there's no Zopa, there's no deal.

Our lenders say what rates they want, our borrowers decide how much they're willing to pay, and they use our technology to make and manage the agreement. The aim is to offer better rates all round – and, for many, there's the added satisfaction of by-passing the banks. So far, our members have lent £130m between each other.

Two questions started it: Why do corporates get much better deals than consumers? And why's eBay doing so spectacularly well? This intrigued the experienced investors backing us who've also invested in companies like eBay, Betfair and Lovefilm. We knew the bond market was the dominant source of corporate funding. To exist, they need a liquid market of investors who want a good return, and a trusted third party to provide credit ratings for the borrowing companies. We thought: "Can we create that sort of marketplace for consumers?"

Then we considered the success of eBay. In 2004, it was the largest marketplace on the internet in terms of users and transactions, and you couldn't explain that incredible growth just on the back of value. There had to be something else going on. Clearly, people like the interaction with each other – plus the almost subversive thought that they're going to get a better deal working with individuals than through traditional retail channels.

We thought, if we could combine the dry economic side with the fun of people working together online, we might come up with something interesting.

"It's not trivial"

"It's not daft"

"We saw our main set-up challenges as regulation, technology and winning the confidence of consumers.

We spent a lot of time, effort and money engaging with regulatory issues (and regulators themselves, where possible) and working out a path consistent with existing regulation. As the first people in the world to do this, it wasn't a trivial task.

Currently, the Office of Fair Trading supervises all our consumer credit, and we're a member of the anti-fraud association CIFAS. We were originally regulated by the FSA because we sold an insurance product, but when we stopped selling that, our activities fell outside their remit.

There would need to be a new law to create a new regulatory category and we're pushing for this. At consumer level, peer-to-peer lending is a separate asset class but, at the moment, you can't put it into an ISA. This is something else we're keen to rectify.

Our aim with technology was to build a platform that's sensibly priced. There was a lot of investment for this up-front, largely from venture capitalists, and we now have a platform that works, is managed in-house and is part of our intellectual property.

It isn't massively complicated but it does handle an awful lot of transactions. One of the ways it works, for instance, is by automatically diversifying the exposure of our lenders, which lowers their risk. So, if you want to make £1,000 available, our technology divides it up into lots of smaller units of perhaps £10 or £20 each and spreads it among different borrowers appropriate to your requirements.

CLEARLY, PEOPLE LIKE THE INTERACTION WITH EACH OTHER – PLUS THE ALMOST SUBVERSIVE THOUGHT THAT THEY'LL GET A BETTER DEAL WORKING WITH INDIVIDUALS THAN THROUGH TRADITIONAL RETAIL CHANNELS.

"It's not hidden"

"We want consumers to trust us as a marketplace manager, and accept it's not daft to lend someone money and expect it back over three years.

Yes, it's riskier than putting money in a bank because there are no government-backed guarantees. That's why, as a lender, you make much higher returns. But we try to be as transparent as possible and explain all the risks. Our default rate is less than 0.8% on all the funds lent since launch, and we tell lenders what default they can expect on their portfolio so they can factor this into their calculations.

We might say, for example, that, at our safest market price, you can expect an annualised loss of half a percent. So, if you want to make a 7% return, you simply lend at 7.5%. When people see that we deliver within that range, and they look back at our track record, it builds trust.

We make our money through fees. Borrowers pay a fixed fee of £130 up front and, for lenders, there's a 1% annual fee based on the amount they've lent out, payable monthly. That's it. Everything is transparent and there are no hidden charges. We have a good track record in managing credit: some of our original team worked at a senior level at online bank Egg and in risk at Abbey.

"Despite our track record, lenders are still keen to know what safeguards there are in place for them.

Borrowers are thoroughly vetted and assigned to one of five markets – A+, A, B, C or Y – depending on their credit risk. You have to have at least three years of UK credit history to be accepted and anyone with a bad credit rating will not be considered. Lenders can then decide what type of borrower they want to lend to and this is arranged electronically and anonymously.

THE MARKET IS LESS THAN HALF AS BIG AS FIVE YEARS AGO. BUT, BECAUSE WE'RE SMALL AND REASONABLY AGILE, WE CAN REACT TO THIS KIND OF THING QUICKER THAN BIGGER INSTITUTIONS.

We also collect lenders' payments or chase up late payments. Most late payments are some kind of administrative cock-up and easily sorted out. However, if we can't get hold of someone or they're in some sort of trouble, we pass the debt on to a debt collection agency.

In the worst-case scenario of Zopa going bust, the contracts between lenders and borrowers would still stand. We simply act as an administrative agent, so it doesn't affect the legal status of the contract, and a debt collection agency would continue to go after bad payments. This is all clearly laid out on our website.

"The banks know all about us but ignore us completely. It's a classic question: what does any incumbent do with a disruptive challenger?

They might ignore it and hope it goes away, but by the time it's proving that it's simply not going to go away, it's too late. We have a 2% share of the UK unsecured personal loan market. That's not a trivial amount, and it must be approaching the point where any sensible competitor would be paying attention.

But banks can't compete on price because we have a far more efficient model with lower operational costs and no regulatory capital. Their borrowing rates are so much higher that to discount them to our level would involve them losing a great deal of money in a profitable part of their business.

And, of course, we're now challenged ourselves by new entrants to our sector – four launched in the second half of last year. They certainly create brand awareness and validate the sector in which we were all on our own for quite a long time. But it's not an easy business to operate and the credit management side in particular needs expertise and heavy investment. I'm not sure how much due care and attention all the new entrants have put into who they're lending to. I suspect they may end up suffering.

On our discussion boards, there are threads for all four competitors. As early adopters of peer-to-peer lending, our customers are quite passionate

WE JOIN THE BANKER-BASHING, BUT THERE'S A LARGE GAP BETWEEN PEOPLE COMPLAINING ABOUT THEIR BANK AND ACTUALLY CHOOSING AN ALTERNATIVE. WE'RE KEEN TO OVERCOME THIS INERTIA.

supporters of what we do and keen to evaluate the alternatives. They think some of the new entrants are doing well, but others they think are doing spectacularly badly. We've got a head start on our rivals in terms of scale and trust, and we need to maintain that.

"We've never done much marketing. Part of the strength of our model is that it naturally grows by word of mouth.

Remember, our purpose is to be a very low-cost, small-fee operator, so we don't have vast sums for marketing. The only bit of traditional marketing we've done was a short TV campaign earlier this year, with mixed results. However, we've been lucky enough to be written about in the Press quite often and invited to talk in the broadcast media.

And, in the years since we launched, I think two things have fundamentally changed the consumer perception of our business. One, we've delivered great returns to lenders which tally with, or are better than, those we told them to expect. Lender returns have remained around 7% since we launched and are sometimes more. In 2008/9, for instance, returns came in around 8.5%.

And two, the business has clearly become viable. It's has grown 50-100% a year since 2008, and we look to achieve the same again or accelerate this year. We now have substantial revenues, and I think any concerns lenders may have had in the early days have reduced.

"Ironically, our growth has come at a time when the market for unsecured personal loans has been dramatically shrinking.

Thanks to the economic downturn, the market is less than half as big as it was five years ago. And there's been a fall in general applications from UK consumers as people get more into debt. We've obviously had to change our credit models and risk criteria in accordance with economic conditions.

But, because we're small and reasonably agile, we can react to this quicker than bigger institutions. One of the positive effects of the credit crisis, for instance, was that it fundamentally changed the behaviour of banks. It widened bank spreads hugely, so the gap between what they paid savers and what they charged borrowers more than doubled. And a lot of banks simply stopped lending. These things combined made pretty good conditions for an entrant like us, unconstrained by capital. We didn't run out of money to lend as they did in 2008 because our returns started going up.

As for the damaged perception consumers now have of banks, it's hard to say whether this has helped us. We do join in the banker-bashing when we can, but there's quite a large gap between people complaining about their bank and actually choosing an alternative. We're keen to overcome this inertia consumers have about banks, and we'll do that by offering a consistently better deal.

"It's not easy"

GILES ANDREWS left Oxford University after studying psychology and became a car dealer – the nearest he came to fulfilling his childhood dream of being a racing driver.

After attending business school, he set up a consultancy providing strategic advice to corporates about the motor industry and fundraising advice to start-ups.

Armed with this fundraising expertise, he became Chief Financial Officer at Zopa and later CEO of the enterprise which has won multiple awards both as a lender and a business innovator.

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