TRANSCRIPT

Senate Committee on Banking, Finance & Insurance

Ronald Calderon, Chair

Person-to-Person Lending

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State Capitol, Room 113

SENATOR RONALD CALDERON: Come to order. We should be seeing some more members pop in and out. It's a very busy day for us.

I'd like to welcome Senator Cox. Thank you for being here, Senator.

I'll offer you some comments in just a moment. But first, I do want to extend a welcome to everybody that's here, all the witnesses that are here joining us today, and we are fortunate to have the chief executives and key executive staff from two of the largest person-to-person lenders in the United States with us this afternoon so it should be a very informative hearing.

We're also joined by a small business woman who has grown her, but big in stature, who has grown her business using money borrowed through person-to-person lenders; we're joined by the Department of Corporations—Commissioner Preston DuFauchard is sitting here with us—and the two consumer advocates who will share their thoughts on the future and the potential of P2P lending, as they call it in the industry.

As you'll hear in more detail from Prosper and from Lending Club, person-to-person lending websites put borrowers and lenders together. It's a very unique process and there's no cost to apply for a loan on these sites; there is no hidden fees. Sounds like a commercial, doesn't it? But it's true, and that's what's so unique about it, and the loan terms are very easy to understand. Lenders only lend at rates that they're willing to accept and borrowers only borrow at rates that they're will to pay, so it seems like a pretty good, pretty good arrangement. Borrowers with compelling stories about why they need money can tell their stories. And on P2P sites, lending is about the person seeking the loan and not just their credit score.

Now at the present time, the major P2P lending sites offer unsecured loans ranging from $1,000 to up to $25,000, and the loans are three years in length. They're fixed rates; they're fully amortized with no prepayment penalties. And unlike the mortgages of the recent past, borrowers understand the terms of their loans. There's no bait and switch, no steering, no YSPs, no negative amortization. P2P lending is still relatively a small industry. It's about $200 million annually but it is growing quickly, which we'll hear today. And we're looking at P2P lending today because it's become one of the few affordable sources of liquidity and a financial marketplace that has been largely frozen for the past two-and-a-half years. Person-to-Person lending also deserves our attention because California plays a very key role in the emerging P2P industry.

Northern California is home to the two largest P2P lenders in the U.S., both of whom are here with us today. Now I would like to ask Chris Larsen who is the CEO of Prosper; Sachin Adarkar, Prosper's general counsel; Ed Giedgowd, former general counsel and current member of Prosper's advisory board; John Donovan, the chief operating officer of the Lending Club; and Jason Altieri, Lending Club's general counsel. I would ask you to come up to the witness table at this time. And as we are doing that, are there any members of the committee that would like to make any comments?

Mr. Price?

SENATOR CURREN D. PRICE, JR.: Mr. Chairman, first of all, thank you for holding this informational hearing. We know how important business lending is, and personal lending. We know access to capital has been an ongoing problem, an ongoing concern, especially for small businesses, minority businesses. And so I think it's worth certainly further investigation of this new emerging market and hope that we can understand how it can help facilitate businesses accessing capital that might not otherwise have some resources, so I'm anxious to hear the story.

SENATOR CALDERON: And I'd like to give the members, both companies, a chance to, at this point, explain their basic business models, give you a chance to ask them how those models work, before we ask them to talk in more depth about the role in the future of their industry and about any regulatory issues that they might want to discuss.

So first, I'll ask Mr. Larsen and then Mr. Donovan to describe their sites, give the committee an opportunity to ask some questions. After both companies take us through the basics, then I'd like to go back to Mr. Larsen and then Mr. Donovan and ask them to elaborate just a little bit more on some of the other topics that they came here to discuss.

Mr. Larsen?

MR. CHRIS LARSEN: Right. Chairmen, Members of the Committee, thank you so much for allowing us to speak to you today, on behalf of consumers and small businesses who now more than ever really need access to fair rates and pro-consumer terms and also on behalf of individual lenders who want to participate directly in getting the American and California economies moving again.

Again, my name is Chris Larsen. I'm the CEO and co-founder of Prosper.com and, again, we also have Sachin Adarkar, our general counsel, as well as Ed Giedgowd, who is our former general counsel and an advisor to the company. They'll be happy to answer any questions that you might have.

Prosper.com is America's largest peer-to-peer lending market with over 920,000 members. About $195 million has been lent in about 33,000 loans, small-dollar loans, so far. We're California based and we operate in nearly every state. The idea behind Prosper is essentially to create an eBay for lending. Prosper allows borrowers to make loan listings, much like they would on eBay, if you prefer loans between about $1,000 and $25,000. The listings include both traditional credit as well as social data, like a description of what the loan will be used for, a budget perhaps, as someone trying to pay off a credit card debt, maybe a picture of the small business that you're trying to finance. Prosper guides the borrowers in what is an appropriate rate to ask for, based on the riskiness of their loan. But ultimately it's the borrower who sets the maximum rate that they're willing to pay. Prosper's job is really to identify, to verify the identities of borrowers' pool credit and risk rate the listings using our proprietary risk models and also check income in some cases. We then allow Americans, family members, friends, to bid on those listings in amounts as little as $25.

The final borrower rate and the lender yield are set in a competitive auction, much like eBay. The more lenders that bid on a listing, the lower the rate will go. However, Prosper protects lenders from bidding a rate that would be inappropriate for the risk that they're taking. So, for example, on an excellent AA-rated loan, for example, the rate can't go lower than about 3 percent. On a higher-risk loan, the rate can't go below about 17 percent. The bid for it was…

SENATOR CALDERON: I'm sorry. What was that?

MR. LARSEN: Can't go below about 17 percent. That would be in a case where the loan would have about a 15 percent default rate. Risk-free rate is 2 percent, and that's how we protect the lenders.

So the borrowers are really encouraged to get their friends and family to bid as well. And generally, that's viewed positively by other lenders on the marketplace because it does provide, if you will, a social or a peer-pressure element that helps repayment. So, for example, when a friend bids on somebody's loan, the default rate can be as much as half lower than it otherwise would be.

Loans today are all three-year, fixed-rate, fully amortizing, unsecured loans with no prepayment penalty and typically vary from a minimum of about 4 percent to a maximum allowed of 36 percent. Loans are reported to the credit bureaus so they're a great way to help build credit even when the loans are made amongst family and friends. Typical uses for these loans include replacing high credit card debt—it's about 50 percent of the loans made—funding a small business, student lending, home improvement loans, as well as automotive financing. Because lenders can be just about anybody—friends, family, or strangers—and in the case of a small business, can even be suppliers or even customers—Prosper really provides the tools then to help lenders make what can be purely financial bids or really socially oriented bids. And more than likely, it's a combination of the two.

So, for example, how we help with the tools when someone's making a bid on a listing, we're going to provide the estimated loss rate for that particular loan, and you can use that as guidance or you can use purely social reasons to make the loan. This makes it fairly easy for lenders to earn a target rate of return. So, for example, if you want to make 8 percent on a loan and the loan has an estimated default of 3 percent, you know that you have to bid about 11 percent to get the proper risk return.

Another helpful tool is called portfolio plans, and that's where about 60 percent of our loans, loan bids, originate. A portfolio plan is really an automatic bidding tool that enables lenders to easily put money to work by targeting bids on loans that meet a specific credit criteria or a social criteria. So, for example, I can automatically bid on all AA-rated loans in the marketplace where the yield was at least 8 percent. A typical lender makes bids of about $40 and they typically have about $3,500 on the marketplace. So that allows them to have pretty good diversification, much like a bank would have.

Prosper handles all of the loan administration tasks, including loan repayments, collections; we also insure privacy and borrower compliance, lender compliance are met. The borrowers do have to meet basic requirements, including having their identity and their bank accounts verified. So the idea again behind Prosper is really easy—using technology to allow people to become their own bankers for reasons that they determine—social purposes or just enabling to make a good financial return as really an alternative asset class.

We believe that the peer-to-peer lending industry represents a fundamentally different way of banking where the spread between what people make on their deposits and what they pay on their loans goes directly to consumers rather than to a credit card or a company or to a bank. So in the end, we think it could represent the end of the dual pricing system of banking which basically is predicated on the idea that I need to convince my depositors that their money is only worth X today, about 1 percent, and then turn right around and convince borrowers, who may in fact be the neighbors of those depositors, know that their money is actually worth about 19 percent, and that's what I'm charging you on a credit card. So P2P lending really allows the price of what money is traded for to be traded transparently with the benefits going directly to people rather than the banks or credit card companies.

And I should point out, and one last point I wanted to make is, Prosper has evolved pretty dramatically over the years. P2P lending really started as an open platform where most borrowers could make loan requests and any lender, for social or financial reasons, could make a bid. From that pure sort of form of lending democracy, it's evolved into, I'd say much more of a controlled environment where the platforms restricts less credit-worthy borrowers who might be too risky for making listings. And frankly, that's in response to the credit crisis. It's in response to a natural evolution of sort of the Web 2.0 movement. This is what the P2P link was built on, that transformation of Web 2.0, which has migrated, I would say, away from sort of that unbridled freedom, more towards, I think, appropriate level of safety and paternalism but also free and open markets.

For example, borrowers now must have a minimum credit score of 640 to make a listing, whereas in 2006, there was no minimum credit scores. In 2007 and 2008, the minimum scores were about 520. The result of these changes and enhancements has been pretty constructive, I think, for lender returns which are now tracking yet an estimated rate of about 10 percent when you take out fees and estimated defaults. So at the same time, though, I think credit-worthy borrowers are still able to get very competitive loans at very pro-consumer rates.

So it's a little summary of the company. I'd be happy to answer any questions later in the testimony.

SENATOR CALDERON: I'm glad we know ________________________.

MR. JOHN DONOVAN: Sure, great. And thank you—and thank you, Chairman, for taking the time for this, and Senators, and Eileen, for putting all this together. It's really appreciated. I know that you guys are very busy.

SENATOR CALDERON: Before you start, I'd like welcome Senator Price and Senator Kehoe. _____________ (Inaudible comments)

MR. DONOVAN: Thanks. So, you know, Chris gave a very good description. I mean, certainly, a lot of the comments on the two-party system is something that we're talking about, disintermediation of current banking system to allow more transparency, to allow more clarity.

My background is in the credit card industry. I worked for MasterCard for 18 years, so Renault, the founder, has pretty much said, okay, so you feel guilty about that—that's why you've moved into this industry. And to a certain extent, I think that's accurate. What we're doing is offering an alternative, a very simple alternative. Three are installment loans. So what you know is, that when you take one of those loans, at the end of that time period, you've paid off that debt. So, you know, you can do it on credit cards; you can do other things. But, you know, the reality is, it's a very straightforward product and it's very clear to consumers. If you want to get out of debt—and that's the majority of why people take those loans from us, is to get out of debt. This gives them a very easy path to do that.

We've done research with our borrowers in terms of, Why do you do this? Number one reason, debt consolidation. When we look at how they benefit, 85 percent of our loans are issued with an interest rate that is less than 15 percent, okay? Compare that to the credit card industry, which I'm very familiar. In looking at government data, the GAO did a study in 2005. And what they found is that 57 percent of credit card accounts that pay interest—so those were accounts with a balance—are charged more than 15 percent. So it's a very different opportunity. You'll know yourself. I mean, as we were going for funding, we talked to investors who say, well, hold on. I can get a credit card at 5 percent. Really? Make a phone call. Go and see what you actually get offered and then see what happens when you start to carry a balance, and certainly that's something that you and a lot of other folks are looking at right now in terms of how those rates change. We can't change the rate after that loan is issued.

On the other side, on the investor side, the average returns right now for our investors are around 9 percent. And to put that in perspective, two-thirds are earning between 9 and 15 percent. I also looked at the numbers nationally and for California. California represents about 20 percent of our investors, and they were almost identical. So, you know, again, it's a very new industry but, you know, what we're seeing is overall, you know, lenders—investors with negative returns represent less than 2 percent of the funds on the platform, so it's new. Seventy percent of the loans we've issued have been done since January of 2009. We've issued about $85 million in loans.

As we go and look at the space, I mean, basically what we're looking at are opportunities to provide more loans to borrowers and more avenues to attract investors with a safe platform. I think Chris really covered most of the other specifics. Thanks.

SENATOR CALDERON: Any questions? Senator Cox?

SENATOR COX: As a lender, I decided I wanted to lend $1,000—just as an illustration—so I get that into the system somehow, either by check or cash or credit card—and then I'm responsible for hooking a transaction up? Explain to me how that works. I'm looking out there. I kind of look like the way Mr. Larsen's social aspect looks, his profile, so I'm willing to lend him a little money but I want…

MR. DONOVAN: Sorry. How does it work.

SENATOR COX: Say again.

MR. DONOVAN: So you want—what are the…

SENATOR COX: I'm trying to figure out how the system works. And then finally, what is the interest rate and when am I going to get my money; at the end of 36 months if it doesn't default? Does one lender lend an individual all the money they need or do you package it?

MR. LARSEN: So the way it works on Prosper, and pretty much on Lending Club—I think we're pretty much the same in this regard—is that if there's a loan request for $1,000, let's say, you as a lender don't have to put up the $1,000. And in fact, we think you shouldn't put up the $1,000. More typically is, somebody bids $25 and that $1,000 is actually coming from—in that case, about 40 different people—and so what you as a lender will typically do is make maybe a hundred of those $25 loans, fractions of loans, to a hundred different people. In that way, you're able to get a well diversified holding of loans which then is…

SENATOR COX: So I'm probably not going to lose my entire investment. I'm probably going to lose, if I lose, I'll lose a fraction of it?

MR. LARSEN: Correct, and that's kind of the way the system should work.

SENATOR COX: And when is the interest paid at? At the end of the 36 months?

MR. DONOVAN: So it's a straight amortizing loan. So if you were looking at someone borrowing, let's say, $5,000, that would roughly be $150 a month. So you would have a portion—let's say you invested $25 in that loan. You'd have a very small portion. Every month when that person makes a payment, we're waiting until the funds are good—we're making sure they clear—and then we're crediting you with that small payment. So let's go back to the beginning. You take $1,000; you put it onto our platform. We're going to pull that from your bank account in most instances. But you can also send a check; you can wire the money; a lot of different ways that people get us the money. We make sure those funds are good; we allow the investors to go in. In both instances, we have a diversification engine. So we help you; we're helping the process where you can see the notes and you can choose the investments that you're going to make. But it will be across in that instance, probably 40 loans, and that would be, you know, $25 times 40 would be your $1,000. You're investing in those different loans. A month later, when the first payment starts, you're going to be getting, in the case of $1,000, let's say, it's, I don't know, $80. You're going to be getting that $80 which will include principal and interest which will come into what we call a wallet.

Now you can choose to take the money out, bring it into your own bank account, or you can choose to reinvest, and about 70 percent of the money on our platform gets reinvested. Typically what we're seeing, our investors are coming in and putting in additional money. But you're going to get your $1,000 back over the course of 36 months.

SENATOR COX: And what is your handling charge?

MR. DONOVAN: Great question. We charge investors 1 percent of the payments. So as a person comes in--and let's say they're making a $100 payment—we're going to take $1 from that $100 and we're going to credit you with the $99.

MR. LARSEN: And we work the exact same way. And I think, to your question of whether you have to hold the loan until the 36 months is up, actually both marketplaces have a secondary trading marketplace. So if you wanted to sell your loan after a month or two months, you can do that and another lender can buy that loan from you.

SENATOR COX: I understand. All right.

SENATOR CALDERON: Question. So where does all of this take place? Where does the investor look at the notes that he wants to invest in? Where does he—how does he see how his investment's doing and the money coming in? And then the actual borrower, do they go—is there a place they can physically go to, to apply, or is it all done online?

MR. DONOVAN: Yes, it's all on line. So in both instances, they're websites which operate in California where investors come in; they go through the process of signing up as an investor. We go through all the—you know, old fact checks, FINCEN, and making sure that they are verified identifies, same side on the borrowers where we're going through verifying the identifies, pulling the credit report. You know, we access a lot of different partners—TransUnion, Experian—you know, a variety of fraud data bases. But effectively, the website is right here in California. Those people all operate virtually, and that's one of the reasons why we can offer these loans at the interest rates and at the servicing fees that we do because we don't have 70,000 bank branches in the United States that we have to support.

SENATOR COX: P2P is under the California banking regulations, under the federal banking regulations, or under whose regulations?

SENATOR CALDERON: Department of Corporations?

MR. LARSEN: Yeah, it's really all of the above. The Department of Corporations in California, the federal banking regulators—both companies operate through an ILC Utah structure for the borrower's side, for universal rate caps. And as we'll talk about on the lender's side, it's currently regulated by the SEC and by the state's securities regulators, but there's a bill—it got through the House that would move it to the banking regulatory regimes, and we'll certainly dive into that as well if…

SENATOR COX: You mean Congress?

MR. LARSEN: Yeah, the House of Representatives. Representative Speier recently passed the bill.

SENATOR CALDERON: Mr. Donovan, Mr. Larsen mentioned that they use a FICO score of 640 in general. Is yours similar?

MR. DONOVAN: Yeah.

SENATOR CALDERON: Your requirements?

MR. DONOVAN: We have a minimum FICO score of 660.

SENATOR CALDERON: 660.

MR. DONOVAN: When we started in '07, it was 640. We've raised it to 660 in December—November/December 2008.

SENATOR CALDERON: Do you have any idea since, you know, lenders are your competitors, what a 660 FICO score would yield a typical borrower at a regular bank, interest rate wise, just because…

MR. DONOVAN: Oh, what they would pay?

SENATOR CALDERON: Yeah.

MR. DONOVAN: Yeah, I mean, if you look at average interest rates right now on a credit card you're talking in the 20s.

SENATOR COX: But he's not asking about a credit card.

SENATOR CALDERON: No, about a…

SENATOR COX: In a bank, can you get…

SENATOR CALDERON: Can you even get a loan?

SENATOR COX: Can you get 660 and get a loan?

MR. LARSEN: For an installment loan, pretty tough. So even the, sort of, the best interest rate that the banks will show—and I think Wells Fargo—and correct me if I'm wrong—but if you look on Bankrate.com, for example, those rates will vary from 18 percent to 22 percent and higher for even the best credit quality. But that's usually 780. So for a 660, you know, you're probably paying…

SENATOR CALDERON: Hard money.

MR. LARSEN: It's pretty tough rates, yeah; whereas I think on our platforms, even though we both cut there, what we see is a huge variation between sort of a good 640 and a riskier 640. I think generally credit scores, post credit crisis, have kind of been discredited as really good indicators of credit risk.

I should add, I think, one thing. From Prosper's perspective, we're very anxious to expand beyond the 640, but I think that has to be done with a different product set but we are working on that. We think this should be a broad-based marketplace and can be—that's in a good way for both lenders and borrowers.

SENATOR CALDERON: Right, because—that's good to hear—because apparently, you've gone up in terms of underwriting guidelines from 590 to 660 when people are experiencing lower FICO scores simply because of the federal Credit Card Act. These credit card companies are lowering limits. And by lowering the limits, sometimes it takes people over their limit and affects their credit. So Americans across the nation are experiencing lower FICO scores and they don't even know it until they look for a loan. And this, as an incredible alternative, I would hope that you would take things like that into consideration. I would recommend that you do, you know, under those circumstances. Well, why did your score go down? Well, they lowered my limit and didn't tell me and I'm over my limit and so they increased my…

MR. LARSEN: So I couldn't agree more, Chairman, and I think this is actually where regulation can be very helpful. Actually, the SEC regulatory regime really hurts that capability, as I'll try to cover in some comments as well.

SENATOR CALDERON: Before I segue into our next subject, I did want to ask about—you said that these were three-year loans and that you implement privacy protections for people's information. Do you keep—how long do you keep that information after three years, past the three years? And do you market those borrowers? Once they've pay their loan off, do you continue to market them with your database?

MR. LARSEN: I'll make a comment. We keep the data for a variety of reasons to build our fraud screen, to build our default screens that help lenders judge risk. So we keep them, you know, within all the statutory rules of privacy protection, and I think we have a real good privacy regime. We worked out a lot of privacy issues over the years, here and at E-Loan.

SENATOR CALDERON: You don't sell that information to anybody?

MR. LARSEN: We don't. We opt in, have people opt in to, you know, if they want to be contacted, of course, and we will go back to them if they do want to be and ask, Would you like another loan after the loan's been paid off?

SENATOR CALDERON: Go back to it.

MR. LARSEN: So, yeah.

MR. DONOVAN: Yeah, same here.

SENATOR CALDERON: Okay. Great. Why don't we begin—now we'll go back to you, Mr. Larsen. If we can discuss what your view of the industry is currently and what its current or future role will be.

MR. LARSEN: Thank you very much.

So again, we think that the future for the industry is extremely promising. However, in order for peer-to-peer lending to really reach its maximum potential, we believe very strongly that the regulatory oversight needs to migrate away from sort of the Wall Street securities world back to, where is its heritage, which is really as an alternative to banking and really regulated by the banking regulators.

The industry has received tremendous regulatory support from the banking regulators. For example, FDIC Chairwoman Bair has voiced her strong support and has invited Prosper now twice to speak at their small dollar-lending conferences, including the most recent one in October in Washington, D.C. The Federal Reserve of San Francisco has published an exhaustive study on how peer-to-peer lending can serve as a solution to the credit crisis in the community development finance industry. Even Fed Chair Bernanke himself reference P2P lending as showing promise. Most relevantly, the California regulators, particularly the Department of Corporations, has been both thorough in their review and understanding of the industry and extremely supportive of this larger California bank-based industry.

However, not all the regulatory experience has been positive. While the banking regulators have embraced and supported the industry, the securities regulators have nearly crippled it. And frankly, there should be ten companies up here today. Unfortunately, we're the only two companies that had the capital and the resources to survive the securities regulatory process. We spent years and millions of dollars on expert legal counsel, meticulously structuring our platform so that our loans would not be considered securities. We had extensive communications with the FCC, but we still had to go dark for nine months to comply with their rules which really didn't fit the industry.

So while again that might be a great barrier to entry for us and Lending Club, it has dramatically limited the full potential of this new industry at a time when it's needed most. By now again, there should have been P2P lenders for auto lending; there should have been peer-to-peer lenders for CDFIs; there should have been peer-to-peer lenders for the underbanked; and as an alternative to payday lending, one day there could even be a peer-to-peer lender for mortgages.

So what we believe is that P2P lending, again, should return to be regulated as a banking product and, importantly, with a holistic regulator that protects and furthers the interests of both borrowers and lenders. The problem with the securities regulatory regime, with the exception of California, by the way, which is a holistic banking and securities regulator, but with the SEC, they can't balance the needs of borrowers and lenders because the securities regulators are only charged with protecting one side of the marketplace.

A good example of this is the SEC's requirement that all peer-to-peer listings be EDGARized, which means, they have to be filed in an online registration database, just like what public companies use and what multi-million dollar bond issuances use. That database was never designed to hold consumer loan data. It's an unprotected database that anyone or any search engine can access. So it really is a privacy concern for borrowers that, by the way, provides no additional transparency to investors because they already have that transparency on our marketplaces. The banking regulators who have both the borrowers' and the lenders' interests in mind would certainly have, I think, have been much more thoughtful about those privacy issues of consumers.

This is really the key issue. The SEC is just not set up to deal with protecting consumer borrowers. In fact, the SEC regulates peer-to-peer lending through their division of corporate finance. The division of corporate finance is designed for corporations, not for consumers, and they make no distinction between consumer data and corporate data.

Other problems with the SEC regulatory regime is things like, even setting the standards for how we report yields. Regulating P2P lending in that regard is not just bad for borrowers. It's actually bad for lenders/investors. It provides, again, no transparency to those safeguards for lenders. So, for example, any investor or lender who is using these platforms today should be asking, you know, what should I expect to make on the loan that I'm bidding on? The way to do that is to provide loan yields, less expected losses based on historical performance of similar loans. So, for example, if you make a 9 percent loan today that has a 3 percent expected default rate, you know, is it yielding 9 percent? No, of course not. It's yielding 6 percent when you deduct the anticipated losses. It's not accurate to show just actual losses on a portfolio. That's in fact how every consumer lender ever got into trouble and, you know, going back to many different consumer lending marketplaces.

So, for example, by growing a portfolio rapidly, you can hide past losses which will likely occur in the future. What the industry needs is really uniform measures for both borrower costs and lender costs. We believe that the banking regulators actually do that. They actually have very constructive standards for APRs and APYs. Banking regulators who regulate P2P lending, I think, would create a much more uniform standard in keeping with those consumer lending practices.

The SEC also does not provide any guidelines to determine what is “a good loan”. For example, they provide no standards for a borrower’s ability to repay maximum debt-to-income ratios, minimum credit scores. Bottom line is, the SEC is not, it’s not merit based. It’s strictly disclosure based. So even if it’s toxic, as long as it’s disclosed, it can happen. Banking regulators, and I think any of the state regulators, like the DOC, are much more focused on the merits of what is actually happening, and I think that’s a much more constructive regulatory structure,

Another point I wanted to make is that securities regulators, and I think this is the point of expanding these marketplaces to include people with challenged credit because of the environment but are otherwise good borrowers is, securities regulators actually prevent a very powerful underwriting involvement of other lenders, such as, for example, community banks, credit unions, community finance organizations, that might actually be able to tell the difference between somebody that might have been hurt in the credit crisis but is otherwise is a good borrower. Those organizations actually can’t participate in these marketplaces because of the way the SEC views them, and we believe that’s a really important part of safeguarding lenders and making sure that borrowers are—you have more borrower inclusion.

So, for example, if an employer wanted to start making available peer-to-peer lending loans as an alternative to payday lending to their employees through kind of a small dollar offering, you know, they could vouch for those employees. They could provide guarantees and, you know, kind of vouch for their credit worthiness. That would be a great alternative. Unfortunately, in the way the SEC views those employers, they would actually designate them co-issuers of securities. That would mean that a $1,000 consumer loan would be designated equal to a $100 million corporate bond and it would require the same regulatory costs of filing securities, which would be about a quarter million dollars, clearly making that impossible and one of the main obstacles to expanding these marketplaces today. You know, we think the banking regulators would be much better at understanding the value of that kind of a product and wouldn't be constrained really by a purely legalistic determination of co-issuer of securities, if you will.

So, in a nutshell, kind of where we are now, peer-to-peer lending, we think, is an alternative to banking. It's not an alternative to corporate bonds or the stock exchanges. That's why we and others believe that the SEC's involvement in peer-to-peer lending was regulatory overreach. It nearly killed the industry—again, a great barrier to entry for Lending Club and Prosper, not good for California—and that's why we're so grateful for California's leadership in embracing peer-to-peer lending.

We also wanted the committee to know that we are working with a group of companies called the Coalition for New Credit Models. It consists of a group of financial technology innovators, including Progreso Financiero, marketplaces, like Second Market and Receivables Exchange. These are all companies that are focused on smart reforms. Its financial regulation is being fundamentally reviewed. And again, we're also very grateful to California Congresswoman Jackie Speier who was successful in including an amendment in HR 4173, the Wall Street Reform and Consumer Protection Act, which would move regulation of peer-to-peer lending from the SEC to, as it currently is proposed, the new consumer financial protection agency. We're working on a similar bill on the U.S. Senate today which looks like it has a lot of support and would respectfully ask this committee to encourage their federal colleagues to support such a move.

So again, we think there's tremendous opportunity here. We also think there's opportunity for California to become in some ways the future of Wall Street, just as it's become the future of energy with its embrace of clean green technologies. And we think California can be positioned to create a financial industry that really could be the wind and solar of the finance industry. That would be great for California's economy, and it really would be good for consumers. Thank you.

SENATOR CALDERON: Mr. Larsen, can you explain to the committee again how your company and Mr. Donovan's company was able to survive the SEC's overreach, as you describe it?

MR. LARSEN: Well, I think we were fortunate enough to—we raised $40 million, and I know Lending Club certainly raised a similar amount of money. So frankly, we just had enough money to pay the securities lawyers and get through it. But there were a number of student lenders. There was one, you know, here a local company.

SENATOR COX: Investment capital, you mean $40 million?

MR. LARSEN: Forty million in venture capital, correct, yeah, into the companies, so that really allowed us to get through it, but it's an incredible barrier to entry and really hurts innovation.

SENATOR CALDERON: Great. Thank you so much.

MR. LARSEN: Thank you.

SENATOR CALDERON: I'd like to welcome Senator Kehoe…

SENATOR CHRISTINE KEHOE: Thank you, Senator Calderon.

SENATOR CALDERON: …to our hearing today.

Do you have any comments or questions at this time before we move onto Mr. Donovan?

Mr. Donovan?

MR. DONOVAN: Thank you.

SENATOR CALDERON: How about your view of the industry's future?

MR. DONOVAN: Sure. I mean, certainly, I agree with Chris that SEC registration was a very difficult and arduous task. We started in April of 2008; we were closed for six months. Certainly we lost a tremendous amount of momentum as we were growing. It's taken us a long time to regain that momentum.

You know, one of the challenges we have is, the devil you know, can be better than the devil you don't. So right now, we know that devil. It's certainly challenging. A lot of the issues that Chris raised absolutely is something we struggle with every day in terms of how we go through. You know, you think about the concept of person-to-person lending, which is so straightforward in its essence of, you know, hey, this person is just going to lend money to another person; they're going to pay it back; we help manage that. And from that simple concept, you know, you start getting into the OCC, the FDIC, the SEC, a variety of state regulators, different challenges that we have to go through nationally.

We're certainly open to simplifying the process. Our only challenge is, How does that specifically happen? When we first started looking at the change from the SEC, it was the OCC; from there, it's the CFPA. We're open to this type of thing. We want to see what will happen. But right now, we don't have the details to understand that so it's very challenging for us.

As far as growth of the industry, absolutely—I mean, you look at consumer debt in the United States. It's $2.5 trillion, roughly a trillion of that on credit cards. Person-to-person lending can certainly be a very strong tool to offer a better product to borrowers and better returns for investors, and that's certainly what we're focused on doing. And I completely agree with Chris that, you know, there really should be a dozen companies sitting here right now and, you know, they didn't have the financial strength to—you know, we spent $3 million in SEC registration. It was not in our original business plan. We didn't go to our sources of venture capital and say, hey, invest in us because we're going to spend this money on registration.

SENATOR COX: But maybe they shouldn't be here then.

MR. DONOVAN: Sorry?

SENATOR COX: I said, but maybe they shouldn't be here then. I mean, it takes capital to participate in the marketplace. And so if you don't have enough capital, maybe you ought not to participate.

MR. DONOVAN: Right. And I think that's one of the challenges they faced. I think that it comes back to, How do you offer—how do you streamline; how do you make the lending process more efficient? And, you know, one of the things, the way we operate is, if you think of, you know, why some of the banks had significant challenges, it was a very high-leverage ratio--20s and 30s. Our is one. We're taking investor money on one side; it's going out to the borrowers on the other side and how we manage that.

But I agree with you—you've got to know what you're doing and you've got to make sure you have the right business plan to be able to address that.

SENATOR COX: How long will it be before the banks—you know, here's where we are in America today. We had a situation where all of a sudden the small garage no longer exists, so the garage turned into a small mini-market, right? And then all of a sudden, the banks decide they're no longer going to cash Friday night—our Friday payroll check.

MR. DONOVAN: Right.

SENATOR COX: So we end up with a payday, cash-checking stores, and then payday lending. So how long is it going to be before the banks decide to go back into the cycle of lending money and they take your platform, your way of doing business, and set up another little entity over on the side here? How long is it going to be before that occurs?

MR. DONOVAN: I think you've certainly seen different banks look at that and try to acquire. I think what you have to look at is the different cost structure, you know. When you look at 70,000 bank branches, when you look at that type of support, the difference that we have here is, we built these companies based on a very efficient system—digital signatures, handling it online, electronic movement of money. Can a bank certainly go and acquire that and offer that to a segment of the population?

SENATOR COX ??: Yeah.

MR. DONOVAN: But one of the things we've certainly seen is—we've talked to our customers—there's a certain amount of support for our industry because of the way that it started, because of the way that it evolved, and we're certainly seeing a lot of anti-traditional bank sentiment which is helping us grow.

SENATOR CALDERON: And it certainly would not be cost-effective for lenders to go in that direction. And at the same time, there's an environment and atmosphere of distrust towards lenders today. But the point to be made is, it's cost-effective. Oh, and then you have people lending to people, and lenders remaining in debt in that direction because they have their members investing their members money.

SENATOR COX: I guess all I was really saying is, there's American ingenuity that always seems to pop up. You close one door someplace and two doors open up someplace else.

MR. DONOVAN: Well, hopefully, we're those new doors.

SENATOR COX: No, I think you are, absolutely.

SENATOR CALDERON: So your greatest challenge basically is just, you know, being left alone so you can grow a little bit basically and _____.

Well, if there aren't any other questions, I'm going to thank both of you gentlemen for being here today…

MR. DONOVAN: Thank you.

SENATOR CALDERON: to explain your model to us.

I'm going to bring up Priscilla Edwards who actually used Prosper to obtain a small business loan, and also I would like to invite Mr. Jamie Court and Norma Garcia. We're taking Jamie out of order, because he has a plane to catch.

MR. DONOVAN: Thank you.

(Inaudible comments)

SENATOR CALDERON: Ms. Edwards, thank you for coming.

MS. PRISCILLA EDWARDS: Thank you for inviting me, Senator.

SENATOR CALDERON: Please proceed whenever you're ready.

MS. EDWARDS: Thank you.

Intellectual property is property but it's not necessarily recognized as such by, say, a general bank. Yes, there are banks that loan money for Avatar but generally not for new startup entrepreneurs. And my government tells me that an awful lot of the job industry is run by entrepreneurial small businesses. So while I worked at a law firm and I worked overtime, I was able to finance this book at approximately $80,000. When I got to the last 12, all of a sudden my printer called and said the queue is open. If you don't meet the queue, it will take you several more months. And our local newspaper, the *Marin Independent Journal*, had recommended Prosper.com in one of its business columns. And so being a local newspaper, I took their advice, and I logged on and the interesting thing to me is, I gave basically a prospectus of what I was doing, what I was up to, why I needed the money. The bid started at 25 percent, and I had the right to back out. In other words, if I was funded at 25 percent, I could say no because there was a lot of cold feet about the 25 percent on my end.

Prosper is designed to have a downward level; 351 people put in bids on my project. So if someone starts bidding at 25 percent but someone's willing to do it for 15 percent, that other guy gets kicked off because you get in there by being willing to take a lower interest amount. Perhaps they can explain that better to you. But I ended up getting a loan for approximately 12 percent, and I got it in less than a week and that was really important. And I also would like to say that…

SENATOR KEHOE: How much was it for? Sorry…

MS. EDWARDS: Approximately $12,000 for about 12 percent and within a week. And again, a bank wants to loan money on something it can bulldoze; it can rent; it can sell. Intellectual property is very ethereal to a banker. And so although the hilarity of it was, after Prosper gave me my loan, Wells Fargo suddenly manifested a very large line of credit. It was kind of funny that way. But without Prosper, this book would not exist because I had reached the end of my resources—financially, emotionally, intellectually.

I will tell you that this book has generated the following jobs in our economy in California—the animated artist was employed for four years; we hired—we tend to hire either young talent or talent that has retired but is still very valuable to the community. So we had a young animator, worked for four years on this project, under my direction. We had a man who worked, chief, our editor, who worked in the New York publishing industry for 30 years. He was a retiree; he came out of retirement to edit this book. We had Phil Disik ?? who worked for Walt Disney for 18 years who'd been retired for about ten at the point I located him to do the typesetting and book design. We did have it printed in South Korea. I wanted to have it printed in America, but my government told me repeatedly that South Korea was a major military, political, and economic ally of the United States. So with that—and they do encourage trade with South Korea, the federal government.

One of the things I was able to do, though, is to bring home a book that cost me very little and pass that onto the mother or father who's buying a book for their child because I get—50 percent goes to the retail person who carries it; 5 percent goes to the distributor. So you're looking at about $7.60, about half that, I paid debit/credit ??. So it's not like I got this great deal that I get all this big lump. But also further, I got a distributor and we traveled down to Sanger, California. There was a forklift driver; three were three people working in that office and the two men who owned that office.

Then this book is now distributed to Costco. It's also carried in various other sundry, too long to name. It's in the San Francisco Maritime Museum, the Bear Discovery Museum, the Golden Gate Book Shop. But I'm not saying this is going to pay their freight on their rent but it helps. It's product that moves. And when you put that together, that pays the rent for these people and I'm very grateful to Prosper. And I really felt it was an astonishing experience, and I felt that the lenders had very little risk when 351 people—I think only three people put up $50. So a person could take their $1,000 and could spread it out on their risk, and they're still going to get a good return on that $1,000 but it's heavily spread out. And they also have an opportunity to see what they're putting their money down on, unlike some of these securities on homes that apparently were rebundled and rebundled and rebundled and rebundled.

People actually saw my picture; they saw the cover of the book; they heard what we wanted to do with it. So I think that there is a big hole in our economic financing system for entrepreneurs that companies like Prosper fill. I really do, and that's it.

SENATOR CALDERON: Well, clearly, the rest of the nation agrees with you. I understand Obama has—President Obama has—implemented about a $25 (billion) or $30 billion block of money for small business loans because clearly the credit crunch or credit market is dying right now for small businesses.

Now my question is, Had you not had this project and you just needed the $12,000, apparently they would have lent that to you, right?

MS. EDWARDS: Yes. I noticed a large percentage of people online wanting to reduce their credit card debt. Their credit card balance was—the interest rate was too onerous and they were trying to reduce that, but there were definitely people looking for business bridge loans, things like that.

SENATOR CALDERON: Business bridge loans, right?

MS. EDWARDS: Absolutely.

SENATOR CALDERON: And have you written any other books?

MS. EDWARDS: Yes. (Laughter)

SENATOR CALDERON: You have?

MS. EDWARDS: Dare I say? *Tap Dancing for Dogs*. If cats can make it on Broadway, why can't a troop of dancing dachsunds, okay, guys?

SENATOR CALDERON: *Tap Dancing for Dogs*.

MS. EDWARDS: And I'm actually starting a television program through PBS of reading children's stories to children to try to replace the cartoon model of Saturday morning.

SENATOR CALDERON: Is that right?

MS. EDWARDS: Yeah, and that all came through this.

SENATOR CALDERON: And have you done any other loans with…

MS. EDWARDS: No. They have invited me, but what I found was, intellectual property is valuable because it is hard to be creative and now I have to wear the other hat—the marketing hat. And so I retired from the law firm in May of '09 to wear that hat, and I did very good. I got a distributor. He takes 300 at once. It's at Costco. He says it's buying into Barnes and Noble. But I do miss the creative, having more time for the creative aspect of it.

SENATOR CALDERON: Great. Well, thank you for sharing that with us.

Any other questions or comments?

SENATOR COX: May I return one of these to you so that—we just need one on this side so…

MS. EDWARDS: I would be delighted if you, unless you thought they were burdensome, then there's no—probably find someone to give them to.

SENATOR COX: It's not about being burdensome. I'm happy to take it, but I didn't want to…

MS. EDWARDS: No. If you understood what that cost me, you would understand why we call South Korea an economic partner. (Laughter)

SENATOR COX: All right.

MS. EDWARDS: And they have excellent EPA laws. I'm just going to finish with that.

SENATOR CALDERON: That's a $19 gift report.

MS. EDWARDS: No, it's not really.

SENATOR COX: I'm not sure it isn't. I think it's probably really committee background, actually, materials.

MS. EDWARDS: Right, right, for the record.

SENATOR CALDERON: This is a creative hearing.

SENATOR COX: It doesn't mean that…

SENATOR CALDERON: Creative committee, yes. Great. Well, thank you. If there's no other questions for Ms. Edwards…

MS. EDWARDS: Thank you very much.

SENATOR CALDERON: …thank you for your testimony. Oh, yes.

And now Mr. Court, if you'd like to address the committee, please proceed.

MR. JAMIE COURT: Thanks. I'm Jamie Court, president of Consumer Watchdog. And, you know, I think the background paper by the committee was just excellent in terms of the benefits to the consumers. And from our point of view, this is a real remarkable development. And, by the way, I've read a lot of background papers. I think I rarely read one that's that well written, so it's a very good product. I'd encourage you to spread it around the house.

What strikes me from the consumer point of view is, you know, we get a tremendous amount of complaints from people who are going to payday lenders. When we talk about payday lenders, we're talking about, you know, you're paying 100 percent interest, 100 percent. It doubles. Norma has worked on this issue. She can tell you about this. Credit card companies, all jacking their rates up in advance of a law Congress passed. If you're 20 percent, you're lucky; 7 to 13 percent in an interest rate, which is what we're talking about in this marketplace for a consumer to go online in a week for Prosper with a Dutch auction or with the Lending Club without that Dutch auction and get a loan to produce the type of product like a book, that is a tremendous and remarkable development. And it's not only good for the borrower in terms of the rate. It's also good for lenders because I don't know if you've tried to put money in a CD lately. This may not be as safe as a CD but, you know, an organization of our size, you know, 1, 2 percent interest, so we're talking 7 to 13 percent for the lender as well. And I think there is the only pitfalls in the model from the consumer, is that this is not backed by the FDIC. There is risk. And as long as the consumer is aware of that risk, that they could lose their money, although, with the best grades of credit here, it's like a 1 percent chance or under a 1 percent chance that you will lose your money or part of your money.

I think it's a tremendous development. And the only pitfalls are, really, a disclosure about the risk and the fact that these companies tend not to verify, as the paper stated to the committee, the employment or income information, you know, from every lender. And when they did some spot checking, they found 50 percent of the people exaggerate their condition.

But based on the FICO score and based on these other verifiable facts, I think their credit ratings are very sound and probably sounder than an economist on Wall Street, judging by what's happened to the economy. So if you're looking about pitfalls for the consumer, that's all I can see.

What I can see, though, as the future is this is a tremendous alternative to banks. When you hear the story about a woman, an entrepreneur who wanted money to put out a book, it reminds me of, you know, back 40 years to the community banker. You'd go in and you'd say—it's not what your collateral is—what do you want to produce? Your sound ?? in the community will give you the money.

If you go online with Prosper, you're looking in the eyes of people because there are pictures of these people online. You're hearing their story; you're hearing what you're investing in. And you're saying, I've got $1,000. I'm going to give $100 here; I'm going to give $100 there. This is my rate of return, but I'm also doing social good. This is really beyond financial good, and there are a lot of people looking for an alternative right now to the traditional Wall Street banking capitalist system, which has gone awry, and this industry, as much as any, may be, may be the only industry, I see, is a potential future if it could be encouraged, if it could be nurtured, if it could grow. And, of course, it needs to be regulated.

How it's regulated is a question, you know, I think, that you really have to consider. One thing, when we're talking about the pitfalls, there is a concept in social media, you know, on the internet, called Wisdom of the Crowd. It's also sociology which is that, if, you know, if a crowd of 100 people, if you ask them something, will probably know more than the expert. Their general wisdom is greater.

Now one thing that's going to happen, if this industry grows and you get, you start to have people lending, is there's going to be information about borrowers and lenders that makes this even more credible and the risks disappear based on that wisdom of the crowd. It is a whole other concept—social investing, social financing. And so one of the things I find, just from the history of this, this issue, is it's literally a crime, that when we're at the height of the biggest credit crisis in America since 2008, the SEC closes down hundreds of millions of dollars of available credit—hundreds of millions of dollars. This was an industry that was supposed to go from, I think at the time, it was $600 million to $10 billion, was the estimate, in a few years, and they shut these folks down to say, this is a security under laws that were enacted in 1933 and 1934.

Now I'm a consumer advocate and I believe in regulation, but I don't believe that laws from 1933 and 1934 can fit the internet which was developed 70 years—you know, it was prospering 70 years later. I think, if there was ever a model for regulation for this industry, it is the consumer financial protection agency, that is embodied in a bill that passed the House of Representatives and a bill that's trying to get out of the Senate today because this is the type of novel new product that takes deliberation by a commission that doesn't fit the model of SEC laws, that doesn't necessarily fit the model of banking laws. There's some overlap. But clearly, if you're going to put credit on the street, if you're going to protect the consumer, you need a discussion about what type of new product this is.

And I can tell you, I think—and I'm sure there's no evidence of this—but it just seems to me that one of the reasons the SEC stopped this is, it's got to be the banks did not like this. This is a very big challenge in the long term to the banks. And while you're saying, you know, a couple of hundred million compared to the major banks in America, not a big deal. Down in the future, if this industry grows, this could be a very big challenge and the regulatory process has to be thought out.

I'll end by just saying that I think that the California legislature, while this is an issue beyond really California—it's a national issue—it could have a role in encouraging the growth of peer-to-peer lending with responsible regulation. And I don't know if it's a resolution; I don't know if it's something that can be done through marketing to small businesses that need credit, but I do think that this is an out-of the-box industry that deserves some attention by the government and the state in which it's grown. And I believe that, you know, we're talking about wind and solar being the future of traditional energy. This is really the wind and solar for the banking crisis. This is the social financing of tomorrow, just like social media development. You know, the same principles behind social media are at work here.

So, for instance, if you have a friend who you're lending to through Prosper—and I assume through Lending Club—because it's peer to peer, you both get a better rate. This is a more solid loan. This is connecting people in ways that—a bank, because it's a bank, is not able to make those connections and build communities and build social relationships. And the future of this is, you would have affinity groups of people who want to invest in communities or people who are trying to build businesses or people who are trying to build homeless shelters or people who are trying to build something for society, and this is a facility for that in a way that, you know, a bank will never be. So what I would urge you to do is think about this, not only in terms of consumers being able to get a better rate, which I think is really important, but also, as an industry, that if it does spur a billion, two billion, three billion, also serves an unbelievable social good in connecting people and connecting projects. And I think the growth area—you mentioned small business loans—is really encouraging more small business loans through this type of peer-to-peer to lending and seeing if that's a way that investors can put into small business. So thank you very much for your time.

SENATOR CALDERON: Thank you, Mr. Court. I do believe that about 20 to 25 percent of the P2P lending is small business.

MR. COURT: Yeah. And I think, that with the federal government wanting to put more money into small business, it certainly would be wonderful if we could find some conduits to—I mean, $200 million for an industry sounds like a lot but it's not a lot. But the promise of $200 billion—you know, there's got to be something to jumpstart this industry and to put it on people's maps. And it could just be marketing. I mean, it may just be marketing because—and marketing that could be backed by the government because it does a social good, and I think that's where California can encourage it and I think that's where the federal government can encourage it if the federal government's encouraged to do so.

SENATOR CALDERON: Thank you, Mr. Court.

Are there any questions from any members?

Yes, Mr. Price.

ASSEMBLYMEMBER PRICE: This may have been covered in one of the other presentations. But is P2P lending most prevalent in California, or are there other states that are…

MR. COURT: The lenders, the two big lenders, are based in California and London ??. But in terms of the customers, I don't know the answer to that.

SENATOR CALDERON: Yeah. We could bring up Mr. Donovan or Mr. Larsen, if you need that.

Do one of you want to respond?

UNIDENTIFIED SPEAKER: (Inaudible comments)

UNIDENTIFIED SPEAKER: You need to come up to the…

UNIDENTIFIED SPEAKER: Oh, I'm sorry.

MR. DONOVAN: Thanks. Great question with that. The industry starting in California, absolutely. We're certainly seeing a much higher percentage of Californians who are participating both in the investing side and borrowing side. But then it really follows population trends. You know, we see Florida and New York, other large states that have large participation.

ASSEMBLYMEMBER PRICE: But currently you find it advantageous to be operating from California as opposed to another state or it just…

MR. DONOVAN: Oh, absolutely.

MR. COURT: …got started here?

MR. DONOVAN: VC funding, coming in and getting started as a company, we actually looked, when we were originally starting, hiring people in New York because of just the financial industry. And you can teach finance to some of the internet folks. You can't really do the reverse. We found much better talent out here in terms of programmers—everything. Really, it was not a question. And honestly, we were looking at having a California and a New York office when we first started.

MR. LARSEN: I would agree with that. I think it's fundamentally an advantage to be in California, just with the fresh ideas, obviously the technology, talent, but also I'd say, on the regulatory understanding of things are innovating and changing quickly. I'll give you an example. So the Department of Corporations, the day that we launched—we had a *Chronicle* article—that very day, we got a call from someone at the Department of Corporations—you know, hey, what's this all about?—and actually showed up in our office that day in San Francisco and did a very thorough review of it and then, you know, really got to know it, and they came out and I think were very supportive.

I'll contrast that to the SEC. The SEC, after all that money and all that time, still have never visited either one of our companies. So that's the kind of regulatory, sort of understanding, that you need to really say, Is this a good innovation or a bad innovation? And once they discern it's a good innovation, then support it and be nurturing.

SENATOR CALDERON: Senator Cox had a question.

SENATOR COX: I had to refresh my memory. I had gone through and read this report, as you correctly point out, is an excellent background paper.

I'd be interested, Mr. Larsen, Mr. Donovan, to get your thoughts today. I heard what Mr. Court said, talking about the aspect of perhaps some regulations. That isn't what we hear about California. California, from the standpoint most business people think we're overregulated as opposed to be being under-regulated.

Are there one or two things that you think need to change relative to regulation? Because I'm certainly one member of this committee that doesn't want to put a burden on a new business, that all of a sudden you decided, hey, that wasn't such a great idea and we didn't really get any help out of it, to begin with. The consumer didn't get any help; the companies didn't get any help. But it did in fact expand the bureaucracy. So I am interested to know whether or not there are one or two or three rules or regulations that you think need to be implemented because my experience is that we, generally speaking, aren't helping small business with the regulations that come out of Sacramento.

MR. LARSEN: I think that's an absolutely correct question to be asking. The biggest challenge, I think, innovators have now is, you know, Are you going to move jobs overseas? You know, is China or India so much more competitive than we are from a cost structure that you could sort of have that headquarters here but everybody else is sort of working overseas? So things like, you know, payroll taxes—you know, we're in San Francisco. We pay pretty good payroll taxes in the city. Obviously, we'd love to see sort of breaks for the smallest companies while they're sort of getting their head of steam up. I mean, we're both still burning resources as we're building these platforms. So, yeah, I think key things we would look at is kind of distinguishing differences between the companies that are established and making money. Certainly, can carry some, you know, maybe afford more. And really, all the burdens you have for new companies getting started—and that was the thing about the SEC, by the way, was, I just think there could have very easily been sort of an office of innovation that could have, sort of, intercepted it, which effectively is sort of what the DOC did. But, you know, I would credit that to—and that's probably not even an issue of regulation and paperwork so much as the leadership understanding. And that, ultimately, is also very important. But I agree with you. I want California to be competitive and…

SENATOR COX: So are there two or three things you think need to be put into regulations for your industry, or would you just assume have the state of California stay out of your business for the time being?

MR. LARSEN: Yeah. You know, frankly, we're not—you know, so many banks are asking for handouts in Washington and we're not. We just want to be—it's not that we want to be left alone. I think it's we don't want to be casualties of regulation that is incorrectly applied to a new thing. That's kind of what I think you saw at the SEC. Like I say, it was incredibly damaging to the industry, and it could have very easily not been that case. It could have been—it is a new thing; how do we work with this; what's appropriate; what's not appropriate? Merit based rather than just, say, dogmatic view of the Securities Act of '33, I think, is a point Jamie makes. That is really an outcome of a dogmatic read of, you know, 70-year-old rules that don't apply in a new world. And what it needs is smart regulators, frankly, again, like I think how the DOC approached it.

SENATOR COX: Mr. Donovan, he hasn't given me an answer yet.

MR. LARSEN: Sorry.

MR. DONOVAN: Yeah, you know, when I look at this, it's really two levels. One is kind of a day-to-day, hand-to-hand combat. And looking at all the challenges we have at the state level, the Department of Corporations has been incredibly helpful in talking with other states and helping us with that hand-to-hand combat which I don't think there's really anything at the state level that can be done.

When we look at the SEC, I mean, that's where I get back to the devil you know versus the devil you don't. Any clarity that we could get, you guys probably have more visibility on what is going on in D.C. We're still looking for specifics in terms of, so great—this is a part of the CFPA. What does it actually mean in terms of how it's going to impact this industry? Is there anyone that can really help us? And honestly, this hearing is incredibly helpful for us to be able to say, you know, the state of California takes us very seriously. They're looking at this. They want to foster this industry. They're asking how they can support it. I don't have that list of three for you.

The hearing itself is great. Anything that you can do through your, you know, federal contacts, in terms of what's happening with that bill—how is it going to specifically impact us?—we'd love to know. We jumped in with the SEC because we had to. Now we may jump into something else. I honestly don't know how it's going to impact me, and that scares the heck out of me.

SENATOR CALDERON: Have you folks testified in D.C. on the banking, in the Banking Committee?

MR. DONOVAN: I have not.

MR. LARSEN: We haven't testified. We had probably about 150 meetings in the House of Representatives and the Senate over the last year.

SENATOR CALDERON: You've had 150 meetings?

MR. LARSEN: About 150, yeah.

SENATOR CALDERON: All in D.C.?

MR. LARSEN: Yeah.

SENATOR COX: And who in Washington, D.C., is championing your cause.

MR. LARSEN: So it's been obviously Representative Speier and Representative Barney Frank and…

SENATOR COX: And she's a powerful advocate?

MR. LARSEN: Yes, yes. She's very effective. But we also have bipartisan support. So, you know, Senator Shelby has also been very helpful. So I think you have pretty broad agreement on that aspect of alternatives, and we're definitely very interested in a bipartisan approach.

SENATOR COX: I need to go to another committee hearing. Sorry.

SENATOR CALDERON: Thank you, Senator Cox, for your time.

SENATOR COX: Thank you for your testimony.

SENATOR CALDERON: You know, maybe the Senate Banking & Finance Committee would consider a resolution that we all sign onto and send it over to D.C. just to encourage our federal partners to make this a priority.

One other question I had is, the ceiling of $25,000, is that key to your success in your model, or are you limited—are you limited by SEC or anything else from going higher than that?

MR. LARSEN: No. It was really kind of just the start of the marketplaces. I think we both…

SENATOR CALDERON: Do you foresee that might go—that level might increase a little bit?

MR. LARSEN: I believe so.

MR. DONOVAN: Absolutely.

SENATOR CALDERON: Okay. Okay. If there are no other questions, thank you all.

Norma Garcia, please come forward and state who you're here representing and what you'd like to address to the committee.

MS. NORMA GARCIA: Good afternoon, Chairman Calderon and Members of the Committee. I'm Norma Garcia, senior attorney with Consumers Union. Consumers Union is the nonprofit publisher of *Consumer Reports Magazine*. I'm very happy to be with you today to talk about this very important topic.

In April 2008, *Consumers Union* examined the issue of person-to-person lending in the context of advising consumers on how to acquire capital to start a new business. Considering person-to-person lending as an option was one of several solutions recommended by Consumers Union as an alternative to obtaining financing from a bank. While this advice was limited to the context of financing a business, there are clearly many other reasons why consumers could seek person-to-person lending as an option for financing.

And these days, that can be any dream, from starting a new business, such as the writer who was here talking about her idea, to getting funds to send your child to college with the increasing prices of tuition today. And given today's economic realities, the ability to access reasonably priced credit from a traditional bank may be difficult at best, even for the most creditworthy individuals.

Homeowners who once depended on the equity on their homes to obtain equity-based financing, many of them are now finding themselves underwater and unable to tap into their home equity to finance their dreams. And other borrowers without a home to offer as collateral may also find it difficult to secure reasonably priced credit to pursue their dreams.

Person-to-person lending is an attractive option for borrowers seeking sources of capital at the best rates possible with a quick turnaround and with low fees. For investors, peer-to-peer lending offers the possibility of a comfortable return on their investment, easy access to a pool of borrowers, via an internet platform, and an opportunity to decide how investment dollars are allocated across loans. These are all positives. And no doubt, this is an area of great innovation, that when done right, when done properly, offers benefits to both borrowers and investors. Person-to-person lending, however, is not without risk and there can be considerable risk with these types of transactions, and it's wise for consumers to understand what these risks are before they get involved. Along with these risks, there are some significant issues to consider, and I want to raise one which I have not heard anyone speak of today that I think is very important.

As we see this innovative product grow, in terms of scope and social recognition, we believe that there is a potential for bogus internet P2P lenders to set up shop and basically impersonate legitimate P2P operators. This can pose problems for the public in many ways. First of all, bogus internet P2P operators can easily solicit borrowers to share their personal information with the expectation of getting a loan funded. That personal information can be used to commit identify theft and fraud. A bogus operator can also solicit investors, set up fake stories for loans to fund, obtain funds, and never fund any loan and abscond with the investor's money. In this scenario, everyone but the bogus operator loses. Potential borrowers have their hopes dashed and stand to lose financially through identity theft, investors run the same risk of identify theft and the theft of their invested funds, and legitimate P2P operators run the risk of reputational damage as word spreads about an increased risk with internet-based P2P lending. Well, there's some possible solutions to try and avoid this, and these solutions need to be considered also in the context of nurturing innovation and protecting consumers.

First is, we need to make sure that only legitimate internet-based P2P operators are in the marketplace. Consumers Union recommends that any for-profit P2P internet-based lender doing business in California, that this entity be required to obtain a license to facilitate and/or service P2P loans sold over the internet. We recommend a taking existing best practices and making them mandatory as a floor for anyone engaged in for-profit P2P lending in California, whether they're regulated by the Department of Corporations, the SEC, or the potential CFPA.

These practices are practices that are already happening in the marketplace. One is to limit the dollar amount of the loans available. Twenty-five thousand dollars is a reasonable cap. That's a cap that could be adjusted annually to account for increases in cost of living. We like the fact that Prosper has voluntarily limited its interest rate capped at 36 percent, although certainly lower interest rates are better. The 36 percent rate cap is innovative and something that we think is worth looking at.

We like the idea of limiting the number of outstanding loans a borrower can have at one time so that they're not overleveraged. We want to make sure that the loans are still available to borrowers as unsecured, fully amortized, three-month duration loans with monthly payments due in equal installments and no prepayment penalty for early repayment of the debt. We think it's important to minimize the risk to borrowers and lenders by making sure that only legitimate operators are in the market. We want to make sure that borrowers are qualified and that those qualifications are verified by the P2P operator. In this regard, existing verification practices should be improved before they can be considered as minimum standards. All borrower information should be verified. And if this is not feasible, a much larger sample of borrower information should be verified with a second screening process to make sure that borrowers are not, potential borrowers are not, misrepresenting their data. Borrowers must be at least 18 years old, possess a bank account, and a valid SSN. And we think it's important to enforce a suitability standard imposed on investors by the DOC.

In conclusion, Consumers Union's non-commercialization policy prohibits the endorsement of specific commercial products or services. So in offering these comments, it's important to understand that they should not be construed as an endorsement of any of the products being discussed here today. We thank you for this opportunity to offer this testimony, and we remain available to assist in any way to help this product remain a viable product for consumers and protect consumers in the marketplace. Thank you.

SENATOR CALDERON: You have any questions, any of the members?

In regards to the risk of fraud, potential fraud, on the internet, obviously, and I'm sure you would agree, that that exists, whether P2P lending exists or not. And I do—I do like the significant anti-fraud protection that this industry has designed or implemented with their internet system, and I think they've taken some precautions there. I appreciate your comments in terms of the potential for a lot of other, a lot of other illegitimate businesses or people up there misrepresenting themselves. And I would obviously encourage P2Ps to always be mindful of that risk. But having said that, thank you so much for your…

MS. GARCIA: Thank you.

SENATOR CALDERON: …testimony.

And I would like to bring up a very patient man, and that is, the commissioner of the Department of Corporations, Preston DuFauchard. You have some comments for us, and I appreciate your waiting around for this opportunity.

COMMISSIONER PRESTON DuFAUCHARD: Thank you, Chairman Calderon and Committee Members. I appreciate being invited, and I really appreciate your implementing this hearing. As was said earlier, I think it's very important. With me today is Ivan Griswold Ivan is an attorney in our Securities Regulation Division and has been very helpful in dealing with a lot of the P2P issues that have come to the department.

And I'll be very brief in my comments, but I did want to give you a little bit of my perspective on this industry, which is evolving, just as the industry is, and to take you through some of that evolution and perhaps distinguish what we've been doing versus what the SEC is doing, and I'm not here to defend the SEC. I think they do terrific work for what they do, but what they have done is essentially try to fit a little bit of a square peg into a round hole, as was eluded to earlier. And in part, what we've been able to do, we've been able to effectuate, as a result of sort of scope of regulatory oversight that we have, because we do regulate lending as well as the securities area in the state of California.

So I'd like to start off by talking about how this came to my attention, this whole industry came to my attention. It was really as a result of a finance lender's examination. Prosper got a finance lender's license from the department. I think it was in 2005. And one of our examiners went out. And while we issued the license based on a business model, I don't think you can really understand what this business was all about until it was actually up and running. So an examiner went out. They are not like a traditional finance lender, and they had questions about the viability of what Prosper was doing in its business model because it didn't fit with any of our other finance lenders.

So I had—so Mr. Larsen was right. We did come up, when they went online, and said, hello, explain this to us.

But I had to wrap my mind around what they were doing to make sure that the license we had issued them was appropriate for their business model. So we had some in-depth conversations about what their business model had entailed. At the same time, we had gotten an application from Lending Club. And so until I got comfortable with Prosper, I had sort of put the Lending Club application on hold. And once we did get comfortable with Prosper, we permitted Lending Club to go through. And interestingly enough, although the questions I had at first were about the Finance Lenders License, it quickly shifted to the securities area because the notes that Prosper was issuing were, you know, evidence of a financial transaction that fit all of the definitions of a security under the federal laws and under California laws.

I was comfortable with Prosper's business model when it first came to my attention because there was no secondary trading allowed in those notes. So, in other words, the loans were funded, the notes were sold, and they were retained by the investors.

Once they wanted to change their model to allow trading of the notes on a secondary market, it really did require registration with the SEC and qualification with the state of California. So Lending Club got their registration with the SEC, I believe, first and they came into California. We reviewed their application. We were one of the first states to approve them to come into California to sell the notes, and they proceeded to do business.

The SEC took a look at Prosper and I think was a little bit unhappy with the fact that they had engaged in this operation without coming to the SEC first, and I had some conversations with people in the SEC. And the SEC at that point in time had a lot on its plate. You know, Bear Stearns went under. There were some other things that were higher priority for the SEC to deal with at the time than Prosper. I did encourage them not to close down Prosper's operations while they were reviewing their application. They did what they did, you know, so it shows my influence there at the SEC (laughter) more than anything. But in any event, Prosper did eventually get—meet all the SEC criteria. They met our criteria in California, so they're perfectly acceptable as a company to do business in the state. We have some suitability requirements.

So, you know, I met with Prosper's counsel and they said, well, the public is protected. The question is, Who is the public; is the public the borrower; is the public the investor? Really, it's both ends of the equation. So we have suitability standards in place, as the background paper mentions, for Prosper and for Lending Club to make sure that no investor invests, sort of overextends themselves, over-commits themselves, financially to these transactions. I don't think that's happening.

We have an annual review in the sense that each of the companies is required to renew their application annually. So if there are problems that arise with the business during that year when they are okay to operate, we will pick that up when they renew on an annual basis.

As far as going forward is concerned, you know, I think Mr. Larsen and Mr. Donovan's point about SEC regulation really is a question about the value of registering their reports with EDGAR. I mean, I think, from a regulatory perspective, it's probably more costly than the benefits warrant for that type of registration model. There is a lot of discussion in Congress these days about, you know, smarter regulation.

I think what we have been able to do at the department is be a little bit more fleet of foot, more adaptable. And, you know, even though we operate under a regime that's—the securities laws in our state were implemented in 1968—we were still able, as I said, as a result of a scope of regulatory vision, we were able to be a little bit more adaptable to the business model than the SEC. There are discussions about, you know, smarter regulations. And perhaps Mr. Larsen and Mr. Donovan will be successful in their efforts to get a smarter regulator at the federal level. I don't think the SEC is, under their current model is, the appropriate thing. It is too expensive and, like I said, I don't think it yields the adequate benefits. I think the SEC is a terrific regulator. We work with them on a regular basis, so this is by no means a criticism for the SEC's good work. It's just that in this instance, it's not a model that was meant for this type of a business…

SENATOR CALDERON: Have you had formal discussions with them about our particular, at least for our needs here in California, how the regulatory standards are…

COMMISSIONER DuFAUCHARD: When Chris Cox was the chairman of the SEC, I wrote to him about this as an issue, and I urged him not to close down Prosper as a viable entity, as a platform, during the time they were undergoing SEC registration. So I had—and I've had other conversations with various people at the SEC about this business model and the—interestingly enough, the current head of the SEC corporate fund—yes, Meredith Cross is someone who I've been speaking with, and she cannot opine on this but she was very helpful before she joined the SEC in representing Lending Club as outside counsel. So we had at the SEC in today's regime, at least, one person. Although she is walled off from doing anything, I think with Lending Club, she's somebody who understands the industry a lot better than anyone who was there before.

SENATOR CALDERON: Would you support—and by support, I mean, in terms of making a recommendation to the SEC—would you support the lowering—I guess—what was it? A $40 million business worth? What is it that qualifies the Lending Club and Prosper with the SEC that the other ones, the other companies, couldn't qualify for? You mentioned a $40 million figure. Was that net worth?

COMMISSIONER DuFAUCHARD: I don't think it was—you can correct me if I'm wrong. I think it was just the cost of lawyers and accountants in order to register with the SEC. In other words, these were transactional costs that were externalities or whatever associated with the registration. And the question that I have, when I've posed this to some people at the SEC is, Is that registration effective? What are the benefits it generates, or is it just too costly? And I've had discussions informally with SEC's staff about that as an issue, yes.

You know, and if the question is, would I be willing to do something more formal along those lines…

SENATOR CALDERON: Right.

COMMISSIONER DuFAUCHARD: …I would certainly consider that.

SENATOR CALDERON: That's good to know.

There's no one else here to ask questions, so at this time, I'd like to thank you for your testimony. And if there's anyone here that would like to comment on our public comment portion of the show, anybody here? Okay. Well, thank you all.

I'd just like to make some closing remarks. First of all, I'd like to thank everyone today that participated and for a lot of you for coming back because we tried to do this hearing back in October but we are in the midst of our budget negotiations and you've all been very patient, and I do thank you for returning because it's an important issue.

I'm encouraged about what I heard today, very encouraged with our commissioner that he's supportive of the industry. I think P2P has brought a level of humanity back to financial services, something that's been slowly—or sorely—lacking recently. I know that my district office and my committee office are receiving numerous calls from people about credit card rates being increased, credit limits being reduced—I'm personally experiencing that—and banks being unwilling to discuss loan modifications with homeowners. I'm sure that other members have had the similar experiences. So it's encouraging to see the financial services providers bringing people together and offering a source of credit that isn't available out there for a lot of us.

This is an industry with a lot of positive potential but one whose full potential will only be reached if it continues to grow. And as I stated earlier, I believe that's one of your biggest challenges, is being able to do that, and we're supportive of that, of that cause. As P2P grows, we need to ensure that P2P business models protect people, as was testified to today, both borrowers and investors. But we, as policymakers, we also have to have a responsibility to make sure that we don't stunt the industry's growth through overregulation or inappropriate regulation. So the future of this industry lies not only in the growth but also in its continued innovation. And my colleagues and I need to work cooperatively with the P2P lenders to find a way for that innovation to thrive.

So with that, I want to thank you all for coming, and the Banking, Finance & Insurance Committee is officially adjourned.

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