Open Letter #1 to Prosper.com

From Fred93
04/20/2007

DON'T MISLEAD PEOPLE

That simple idea is behind most financial regulation. Most regulation of lending is about not misleading borrowers, a great many of whom are not financially sophisticated. That's what the truth in lending act is all about, for example. Most regulation of securities is about not misleading investors. That's what's behind disclosure rules, insider trading rules, rules for calculation of fund returns, etc.

In your day to day operation you have to comply with 1000 detailed rules, but if you back up out of the trees and view the forest, its mostly about not misleading people.

It's the correct ethical standard.

So why am I telling you this? You're thinking Prosper doesn't mislead people. We're the good guys. Below I'm going to describe seven ways that Prosper misleads.

1. Manipulated Group Ranking

Prosper allows its agents (group leaders) to manipulate their ranking, to make it appear that the payment performance of borrowers in their group is better than it actually is, thus misleading investors.

I know you might say "but wherever the money came from, the payments were made, so the lenders are whole, so what's the problem?" To understand the problem, I take you back to a famous American: Charles Ponzi[1]. Charley invented the "Ponzi scheme", an unsustainable investment that's made to look real by paying out to old investors the contributions of later investors. This works for awhile, as the size of the pool grows, but it always becomes eventually unsustainable, and all the investors lose.

At least one extremely large Prosper group(s) is a Ponzi scheme. They're maintaining their five star rating by paying community payments using the group fees from new loans. This is unsustainable, because group fees cannot sustain community payments at the rate that Prosper loans are going bad. This unsustainability means the community payments will stop. Investors (lenders) who used the star ranking as an indication of the quality of loans in this group will have been misled.

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[1] http://en.wikipedia.org/wiki/Ponzi

Prosper must not support Ponzi schemes. You really can't allow that to be part of your business. For shame.

2. So-called Rewards

Prosper misnamed a fee that borrowers pay to group leaders, calling it "rewards" instead of a "fee". As a result, a substantial fraction of borrowers do not understand that they are paying this fee. Lenders, shocked at this brazen misrepresentation, have termed this language "Orwellian[2]".

The following post was written almost a year ago, tells us how two respected lenders felt about the subject back then. The same sentiment has been repeated by many lenders over and over again in the following months.

Epictetus | Posted: May-30-2006 06:30 AM | Report | Quote

Advanced Member

Group: Members
Posts: 3,739
Member No.: 81
Joined: Feb-22-2006

QUOTE (cellardoor @ May-30-2006 05:17 AM)

> 6.Prosper's poor description of the group system for new borrowers
> 7.Prosper's poor choice of ranking methodologies for new groups
> 8.Prosper's ill-chosen naming convention: group rewards, rather than group fees.
>
> Any of the last three can and should be changed by Prosper.

Yes, with the last - "group rewards" - being absolutely Orwellian.

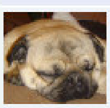
At this point (if not from the beginning), you nearly have to think that it is *intentionally* misleading.

PM | E-Mail

http://forums.prosper.com/index.php?showtopic=2615&view=findpost&p=23722

A more recent comment:

cubbiesnextyr | Posted: Yesterday, 4:00 pm | Report | Quote



Advanced Member

Group: Members
Posts: 2,033
Member No.: 1,543
Joined: Jun-15-2006

QUOTE (zierious @ Apr-6-2007 05:44 PM)

> Anyone else think calling group leader fees a reward rate is misleading?
>
> The term sounds as if Prosper decided the group leader with the highest fees was the best and deserved the most compensation.

Decidedly. Why they don't just call them fees is beyond me.

It's a Group Leader Fee! It might be a reward to a GL, but when you're reading it from a borrower's POV, it should say fee.

http://forums.prosper.com/index.php?showtopic=22957&view=findpost&p=280282

In August of 2006, there was discussion of fixing this misrepresentation. Shira asked for lender's input, got input, and then did not use it. She received many comments. I ran a poll, with the following results:

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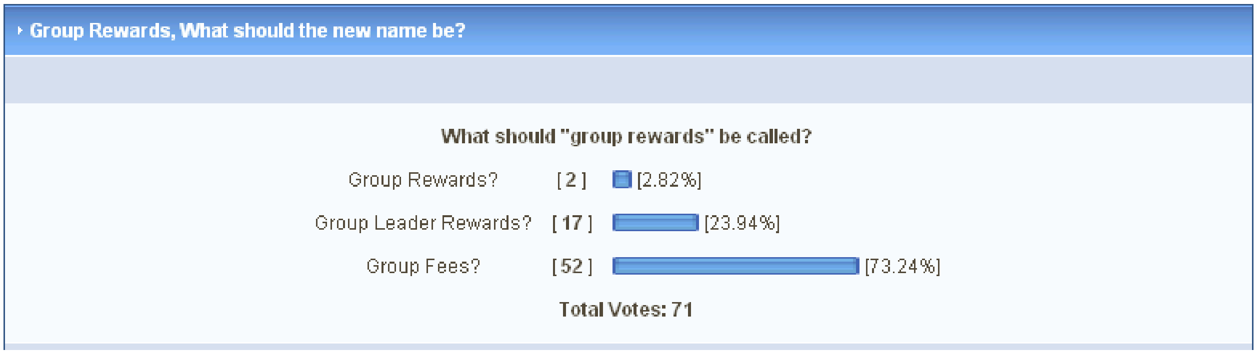
[2] http://en.wikipedia.org/wiki/George_Orwell



http://forums.prosper.com/index.php?showtopic=5882

This input was ignored. The name was changed, but the fee is still called a "reward". (I'll discuss Prosper's community relations another day.)

It used to be even worse. The early wording on the Prosper web site gave the impression that these "rewards" were somehow shared among members of the group.

To most of us, this does not look like an accident. This is so extreme that it could only have been done on purpose. The individual who made this original decision was momentarily confused about your purpose. We can forgive her. We can excuse the bad decision, but it is difficult to excuse your refusal to fix it. You must not mislead people.

In the jargon of financial regulation, group leader rewards are a "hidden fee". The principal protection against hidden fees is the federally mandated APR disclosure. Prosper wisely included the group leader reward in the calculation of APR, as required, but that doesn't mean borrowers understand. Beyond the APR disclosure, borrowers should also understand the source of the fees, because some fees (such as this group fee) are voluntary. If borrowers understood this, they would have the choice to avoid voluntary fees. If they're hornswoggled, and don't understand, then they can't make informed choices. This is true even if the APR calculation is technically correct.

Judge Judy said[3] "Don't pee on my leg and tell me it's raining."

Prosper, don't charge a fee and call it "rewards".

[3] http://en.wikiquote.org/wiki/Judge_Judy

3. Hidden Fees

The Prosper web site has a help page all about fees. Great! Important stuff. The "Prosper Fees" help pages lists several fees:

1-2% closing fee
1% Non-electronic payment charge (optional)
0.5%-1% annual loan servicing fee
Collection agency recovery fee
$15 failed payment fee
Late payment fee

And then amazingly it says "**There are no other fees of any kind.**"

But there *is* another fee. There is the group fee[4]. In fact, the group fee can be the largest fee a Prosper borrower must pay. Let me say that again. You left out the largest fee. (I know, you're gonna say hey, but Prosper doesn't charge that fee, we just collect it for the group guy. Think about that from the viewpoint of lending regulation. The group fee is a hidden fee.)

4. Hidden Fees Again

This fee is repeatedly hidden or disguised in various parts of the Prosper web site. Here's an example. Click on the BORROW tab on the Prosper web site, and you're taken to a page containing a table of interest rates.

RECENT INTEREST RATES ON PROSPER (30-DAY AVERAGE)

Credit grade		Lender rate by loan amount (click rate for more details) $1,000 - $5,000	$5,001 - $9,999	$10,000 - $25,000
AA	Group members	8.19%	9.69%	11.62%
	No group	8.23%	10.00%	10.80%
A	Group members	9.10%	12.88%	13.64%
	No group	10.34%	10.82%	13.89%
B	Group members	11.80%	13.45%	15.42%
	No group	13.09%	12.94%	17.13%
C	Group members	13.74%	15.72%	19.22%
	No group	15.58%	17.76%	19.81%
D	Group members	16.37%	19.54%	21.55%
	No group	19.22%	21.66%	27.07%
E	Group members	21.07%	23.23%	25.50%
	No group	24.18%	26.86%	25.63%
HR	Group members	22.41%	24.80%	-
	No group	25.36%	17.50%	29.00%

[4] Rewards

The table was designed to show borrowers that they could get lower interest rates if they were members of a group. Unfortunately, the interest rates in the table are not the rates borrowers pay. The table is populated with “lender rates” which do not include the group fee. While one could argue that the table is labeled correctly, it is clearly misleading. Borrowers are 99% new to prosper. When they reach this page for the first time they do NOT know Prosper jargon, and specifically don’t know the difference between “lender rate” and “borrower rate”. They will be misled.. This is very easy to fix. All you need is the desire to not mislead.

5. Group Leader Misrepresentations

Prosper allows its agents (group leaders) to misrepresent themselves in many ways. I started this item with the thought that I would give examples, but one could write a book about this. If I dive into this here I might never resurface, so I’ll just rub up against this topic and then move on. I’ll try to avoid talking about the latest much-discussed group. The misrepresentations are everywhere.

I thought today I’d just pick a random group and see what he says:

https://www.prosper.com/groups/group_home.aspx?group_short_name=bestloans
“Not only will you be listed with the 1st and BEST but you can improve your credit score so you can reach that DOUBLE "A" status when you get a loan.”

So he apparently is saying that when you get a loan thru him, he can change your credit score, eh? Great. Prosper, this is your agent. This is the face on your company.

I’m not listing this item just to complain about this particular group. There are hundreds of these.

6. Returns

Prosper’s LEND page displays the following banner.

Unfortunately, the truth of this statement is at best questionable. The median ROI of prosper lenders is now around 5%. (as estimated by lendingstats, which has the estimated ROI calculation with the best methodology so far[5].) You will find the details in a nice chart here: http://forums.prosper.com/index.php?showtopic=21567 .

[5] Lendingstats presently overstates lender’s ROI, because he counts only principal (doesn’t yet count interest) lost when a loan defaults, and he doesn’t account for lost interest on cash in Prosper accounts waiting to be bid, waiting for listings to end, waiting for verification. With these effects, his numbers would probably be 1% to 3% lower.

In the world of investment regulation there are rules about what a company can say about investment returns in its advertisements. I know … you didn't give a number, so you think you avoided the rules, but remember the forest. You should hold yourself to the same standard: Don't mislead.

In fact, you should give thought to publishing investment returns which are compliant with established standards. How about AIMR? Like it or not, you sell an investment product. Prosper is not Ebay. (More about that in a later writeup.)

7. The Nature of Groups

Prosper misleads both borrowers and lenders about the nature of groups. It is as if Prosper is of two minds. Chris Larsen waxes eloquent about the community aspects of groups, while another face of Prosper views groups as only a lead generation mechanism.

Here's Chris Larsen, quoted in the BusinessWeek article:
http://www.businessweek.com/technology/content/feb2006/tc20060213_147523.htm

> "Credit markets have destroyed the sense of commitment and shame if you don't pay," says Larsen. "So we try to make sure buyers are tightly associated with a group, whose reputation is directly impacted by one person not paying. That should dramatically lower default costs."

Chris means well, but what he's saying and Prosper have nothing in common.

First, while there may be 1 or 2 groups out there somewhere in the 3600 Prosper groups which actually has the dynamic he envisioned, 99.9% of them do not. Most are groups of people who don't know each other at all. No commitment. No shame.

The Prosper web site uses the example of "firefighters". Surely, at the 10,000 foot level "firefighters" share some sort of bond, right? Well yea I guess, but that may doesn't any benefit to loans on prosper. The guys in a "firefighter" group don't necessarily know each other! Most firefighters don't know most other firefighters.

What does prosper do next? Prosper makes these people all anonymous! The borrowers pick screen names, and you hide their identity. So even if they knew each other before joining, they are disconnected by Prosper's anonymity. Even if two borrowers who knew each other disclosed their screen names to each other, Prosper shields information about the status of a loan from other borrowers. There is no shame. Nobody's gonna know.

This all boils down to the fact that on Prosper there is no shame. It might be true that shame can make people more conscientious about their loan payments, but it doesn't happen on Prosper. The group system fails to implement the vision.

Second, while Chris waxes about groups with tight-knit community, the rest of the Prosper management is driving in a completely different direction. They act like groups are Prosper's lead generation department. On the Prosper help section, I clicked on “group resources”. The first time I did this I honestly expected to see things that would tell a group leader how to help borrowers. That’s not what I found.

What I found were advertising materials. Here’s an example: A poster you can Xerox and staple to telephone poles.

Community? No. Guerilla marketing perhaps, but not community. Frankly we’ve got enough crap stapled to telephone polls already.

Next look at Prosper’s instructions for new group leaders.
https://www.prosper.com/help/topics/groups-become_group_leader.aspx

What are the most important tasks of a new group leader*?*

> *First, you should update your group's home page as much as possible…*
> *Second, get out there and recruit borrowers! Since you will earn money when borrowers in your group listings that get funded, you should be knocking on the door of anyone…*

Most important tasks. Not helping borrowers understand their budget, or write listings, or checking up on borrowers as time rolls along. No. Update your home page, and get out there and recruit!

Does this sound anything at all like Chris’ vision? No. Before you say I took that out of context, note that it says “most important tasks”. It’s not just Prosper saying this is some stuff you need to do. It is Prosper saying this is what is *most* important. This misalignment could not be more extreme.

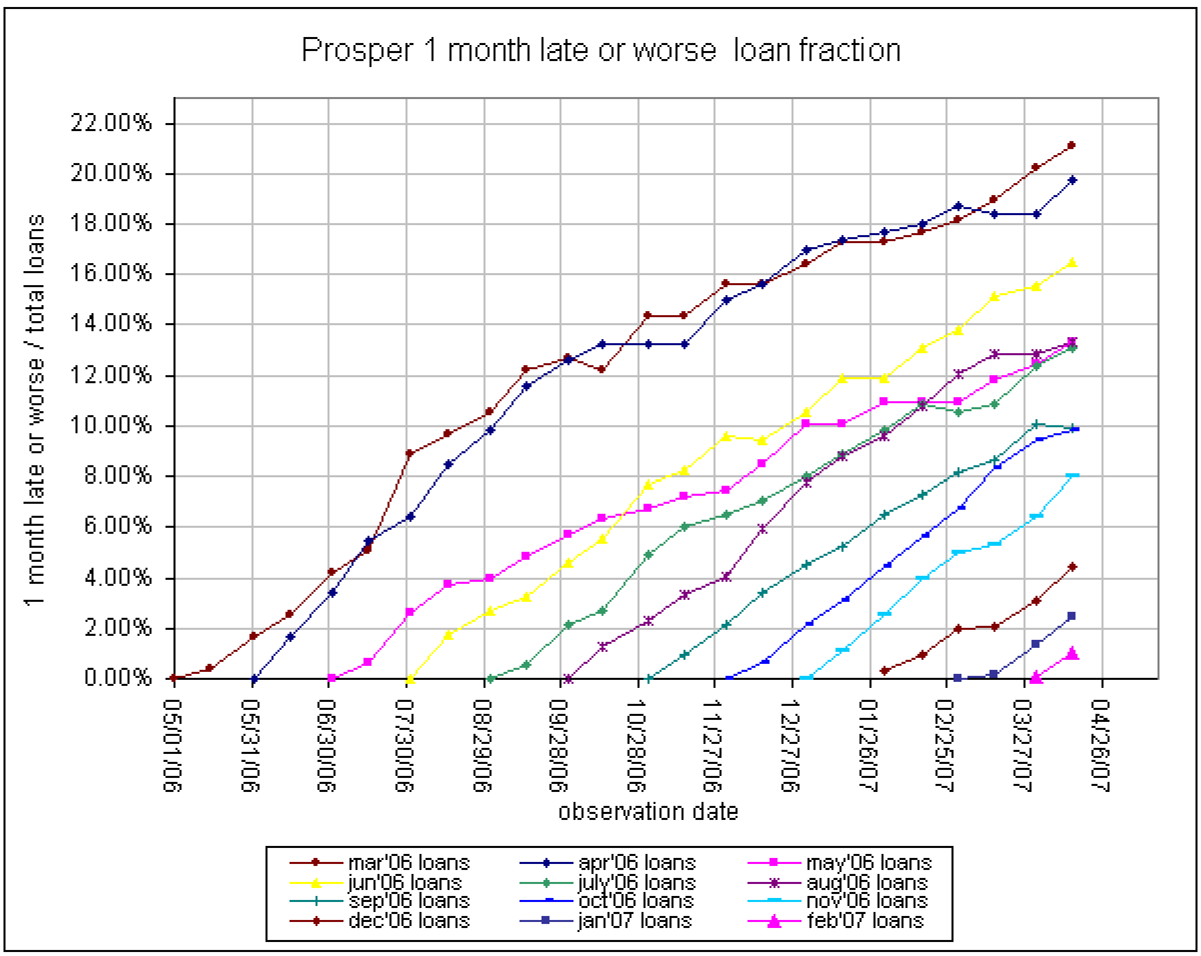
We are told often by Prosper that group membership may reduce interest rates and reduce defaults, but how can that be, if the group is there only to capture leads? Do the folks who write this stuff read the Chris Larsen interviews?

Prosper is of two minds when it comes to groups. Its time to put the two minds back together. (Its like the meek captain Kirk and the evil captain Kirk in a famous Star Trek episode.) Until you do, Chris’ oft’ quoted vision misleads both lenders and borrowers.

8. Default Rates

John Witchel was recently asked by commenter on his blog about default rates. His answer was long-winded. I'll summarize. He said it was too soon to tell, and that Prosper's default rates might be better than Experian or the same or worse than Experian. Whoa! Where has this man been? What's he smokin'?

John is wrong. We have substantial data now. It is true that not many loans have actually defaulted yet, because Prosper is very young, and also because Prosper has delayed the default action on many loans for several months. Investors, who are investing REAL MONEY don't have the luxury to wait several years until we can divide defaulted loans by total loans to get a meaningful number. We don't have the luxury of sitting in academic isolation and pondering the theoretical possibilities. Our investing need drives us to estimate default rates now from the rate a which loans are "going bad". A lot of loans have gone bad, so this is pretty easy.



You can see from the chart above that about 20% of the Mar'06 loans have already gone >1 month delinquent. (I'll call that "bad".) Although Mar'06 seems like a full year ago, remember that we are observing with a 2 month lag, because the first payment is due 1 month after origination, and you can't be 1 month late until another month has passed. So the stats for Mar'06 are actually 1 month shy of a year. Anyway, it looks like the loans that have gone bad (with "1 month late" as the definition of "bad") in the first year will be about 20% for the Mar'06 loans. Now we don't know exactly how many of those will go on to default, but the Prosper/Penncro collections performance stats give us a pretty good idea. The collection stats show that about 12% of loans that have gone 1 month late have recovered. If that means 88% of loans that go 1 month late are gonna default, then we can multiply the 20% at the tip of that Mar'06 curve by 88%, and estimate that about 17% of those Mar'06 loans will default due to failure to pay during the first year. That's a <u>17%/year default rate</u>.

If you use the Experian-provided default rates to estimate the default rate of the Prosper portfolio, you get about 8%. (Just weight 'em by the fraction of loans in each grade.)

17% is a lot bigger than 8%, so the default rates of Prosper loans sure look a lot worse than the Experian numbers. Given that, how can John say might be better might be worse?

There was a nice article about Prosper in the Baltimore Sun.
http://www.baltimoresun.com/business/yourmoney/bal-bz.ambrose01apr01,0,2164198.column?coll=bal-home-columnists

This article quotes Chris Larsen... "Larsen says the default rate - payments 120 days past due - is about 0.50 percent. But that will likely climb as the three-year loans mature, he says."

Well, that is misleading. Remember, Prosper loans are goin' bad at a rate that predicts a 17%/year default rate. Now ya' know 17% is way different than 0.5%, which is why I find the quote misleading. (Of course we all have great hopes for the future, but the default rate is not going to be 0.5%.)

It is correct to say that about 0.5% of all loans originated so far have already defaulted, so that might be what Chris actually said. However, that's not a default *rate*. I also don't think that its a meaningful number, as it mixes loans of all ages, including a large number of loans so young that they couldn't possibly have defaulted yet. Makes no sense to compute a ratio of defaults to things that could not have possibly defaulted. I urge clarity on this point.

Why does it matter? It matters because lenders are investing REAL MONEY here. If you don't take this issue seriously, you're not taking these investors seriously.

Conclusion

That's the first installment.