Financial System Inquiry – SocietyOne Submission

SocietyOne is pleased to make the following submission to the Financial System Inquiry.

SocietyOne is Australia's first fully compliant Peer-to-Peer (P2P) Lender. We have entered the market as we see enormous opportunities to provide investors with better returns and better deals for borrowers. The opportunity exists to provide investors direct access to large, profitable pools of credit worthy borrowers via efficient online platforms, and in return share the cost savings with borrowers.

In essence we don't see the existing regulation as a barrier to entry. Rather we see opportunities to compete based on providing better products and services to customers.

We believe that new models such as P2P lending are more efficient for particular market segments of investors and borrowers, and encourage the Australian Government to assist in the task of raising awareness by recognizing the industry. We encourage governments to go further by following the example of the UK Government and invest side to side with other investors, and to provide tax incentives for superannuation funds investing in P2P loans.

As such we argue that P2P lending is one of the ways the government might achieve the twin objective of increasing competition whilst not increasing systemic risk.

An overview of our submission is as follows:

A perspective of the Australian financial system

- Using banks to create liquidity is inefficient in some instances
- Banks have been able to generate super profits
- Investors have few investment options in Australia

P2P lending is an emerging opportunity that provides an alternate solution

- Risk discrimination and transparent pricing sits at the core of a P2P lending system
- Loan terms are directly matched – no leverage in the system or need to create liquidity
- P2P lending provides significant benefits to both borrowers and investors
- Overseas experience suggests that P2P lending can achieve large-scale adoption
- Positive credit bureau is an important enabler of competition
- P2P lending fits within the existing regulatory framework

Recommendations:

1. That the Australian Government take further steps to reduce asymmetric credit data that favor incumbents as a means of enabling greater competition by:
   a. Making positive reporting mandatory for all credit providers
   b. Increasing the scope of the data collected
2. That the Australian Government should assist to raise awareness of P2P lending by endorsing the industry.
3. That the Australian Government should follow the example of the UK and invest side by side with other investors in P2P loans.
4. That the Australian Government should provide tax incentives on superannuation funds invested in P2P lending.

Overview

The financial system is crucial to the success of Australia. A well functioning system enables capital to flow to where it's needed, and in return lenders are able to provide an equitable return commensurate with the risk involved.

Providing investors with equitable returns provides incentive to save surplus funds. The investment of savings enables those funds to be borrowed by people seeking to acquire assets or smooth their own spending patterns.

On the contrary, if investor returns are not equitable they are less incented to save and there will be less capital shared within the economy.

If borrowers are not able to access capital, or not offered capital at interest rates that reflect their risk profile, then activity will be curtailed.

Hence a fundamental requirement of the financial system is equitable value exchange between investors, borrowers and intermediaries to promote the sharing of funds.

Within this submission we will highlight the opportunity that P2P lending provides to increase the level of capital shared within the financial system.

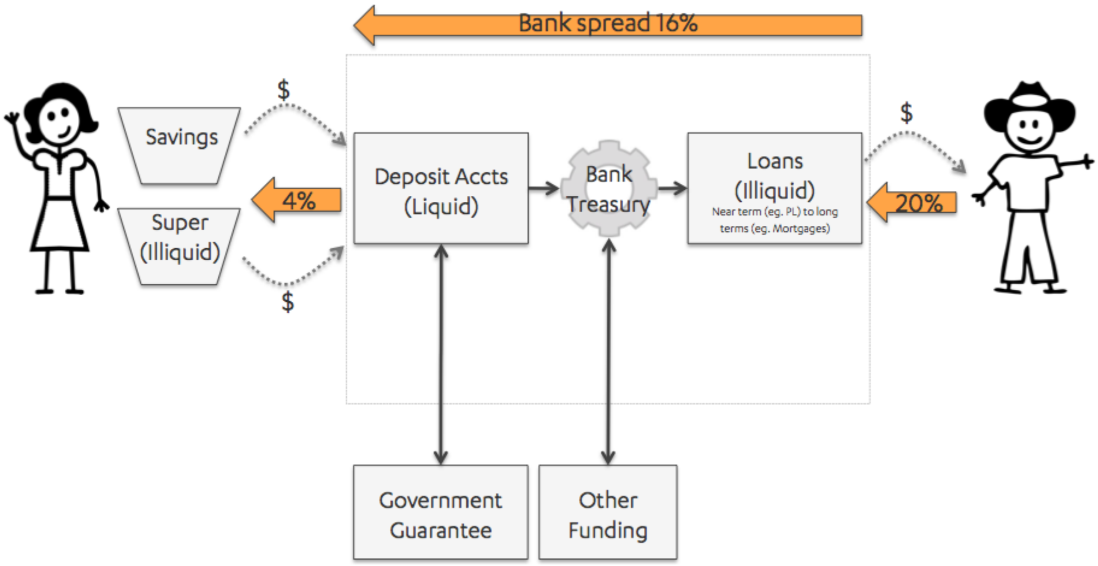
We highlight the importance of making credit data uniformly available to credit providers, and make specific recommendations about how Government can raise awareness of P2P lending by endorsing the industry, and even investing side by side with other investors.

Finally we recommend that Government show provide tax incentives on superannuation funds invested in P2P loans.

Using banks to create liquidity is inefficient in some instances

An important traditional role of banks has been the creation of liquidity by issuing liquid liabilities (deposits) and investing in illiquid assets (loans).

Diagram 1: Simple depiction of a banking system



With the development of superannuation there is now a large pool of illiquid savings currently invested in liquid assets – both savings accounts and shares.

Holding illiquid superannuation savings as liquid deposits, which are then transformed into illiquid loans is relatively inefficient due to costs such as:

- Basel 3 requirements to hold capital that increase the cost of creating liquidity
- The costs associated with the provision of the Government guarantee on deposits

A more efficient approach would be to invest directly in assets that had matching liquidity

Banks have been able to achieve super profits

The Australian banking system is ranked by the Bank for International Settlements (BIS) as the most profitable in the world based on the profitability of Australia's big four banks.

Chart 1: Profitability of major banks, as a percentage of total assets

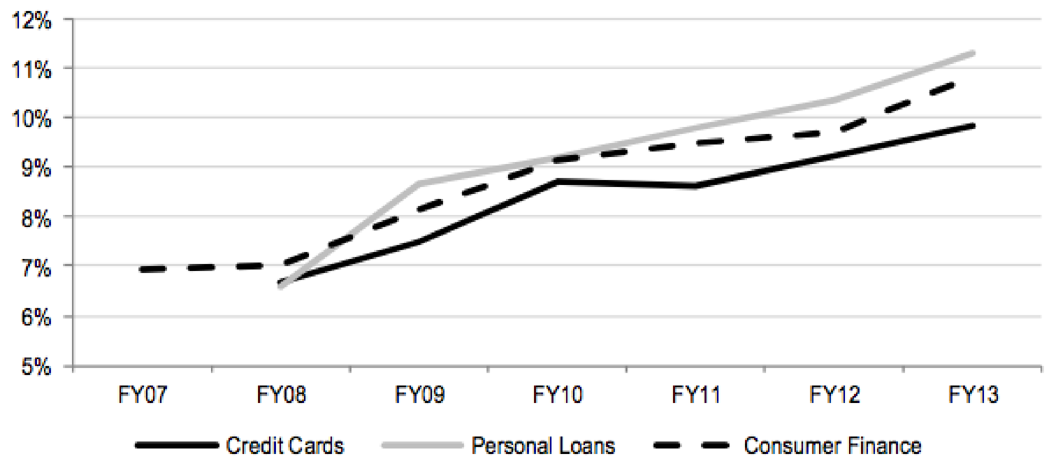
Country[2]	Pre-tax profits			Net interest margin			Loan loss provisions			Operating costs[3]		
	2000–07	2008–11	2012	2000–07	2008–11	2012	2000–07	2008–11	2012	2000–07	2008–11	2012
Australia (4)	1.58	1.07	1.18	1.96	1.81	1.82	0.19	0.33	0.21	1.99	1.20	1.19
Canada (6)	1.03	0.80	1.07	1.74	1.57	1.65	0.24	0.27	0.19	2.73	1.87	1.77
France (4)	0.66	0.29	0.19	0.81	0.96	0.90	0.13	0.26	0.20	1.60	1.10	1.06
Germany (4)	0.26	0.06	0.09	0.68	0.81	0.83	0.18	0.17	0.13	1.38	1.10	1.33
Italy (3)	0.83	–0.03	–0.06	1.69	1.86	1.65	0.40	0.60	0.95	2.27	1.83	1.63
Japan (5)[4]	0.21	0.36	0.56	1.03	0.92	0.84	0.56	0.19	0.07	0.99	0.84	0.75
Spain (3)	1.29	0.94	0.08	2.04	2.31	2.36	0.37	0.81	1.49	2.29	1.58	1.73
Sweden (4)	0.92	0.56	0.68	1.25	0.93	0.92	0.05	0.18	0.09	1.34	0.88	0.81
Switzerland (3)	0.52	–0.05	0.03	0.64	0.52	0.60	0.05	0.06	0.01	2.39	1.82	2.02
United Kingdom (6)	1.09	0.19	0.20	1.75	1.14	1.08	0.31	0.59	0.34	2.02	1.24	1.37
United States (9)	1.74	0.42	0.96	2.71	2.53	2.34	0.45	1.23	0.41	3.58	3.00	3.06
Brazil (3)	2.23	1.61	1.50	6.56	4.77	4.42	1.24	1.42	1.46	6.21	3.79	3.33
China (4)[5]	1.62	1.56	1.83	2.74	2.32	2.39	0.31	0.30	0.25	1.12	1.02	1.01
India (3)[6]	1.26	1.34	1.45	2.67	2.35	2.90	0.88	0.46	0.60	2.48	2.52	2.25
Russia (3)	3.03	1.46	2.39	4.86	4.70	4.09	0.87	1.90	0.36	4.95	2.72	2.78

Source: Table: BIS table V.1, 83rd Annual Report, 1 April 2012 – 31 March 2013
Number in parentheses are the number of banks included in 2012.

The relative profitability of Australian banks as seen in Chart 1 comes from the combination of high net interest margins, low loss provisions and better than average operating costs.

A recent JP Morgan Australian Banking Sector report on the bank profitability titled 'Getting Personal: Small Balances. Big Profits' identifies that net interest income derived from bank consumer finance portfolios increased year on year in the period 2008 to 2013 from around 7% to almost 11%.

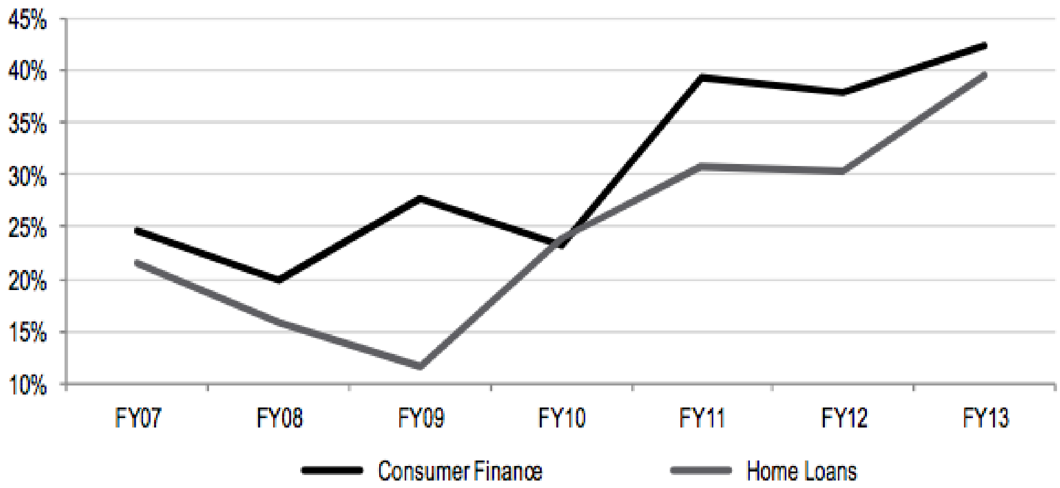
Chart 2: Consumer Finance net interest margin – Credit Cards vs Personal Loans



Source: CBA, J.P. Morgan estimates

At the same time consumer finance credit losses have declined since 2009, resulting in strong ROE growth.

Chart 3: ROE – Consumer Finance vs Domestic Mortgages



Source: CBA, J.P. Morgan estimates

Investors have few investment options in Australia

Australia has a very large superannuation sector by international standards. Superannuation in Australia grew at 16% per annum overall in 2013, and amongst SMSFs at 15% per annum[1].

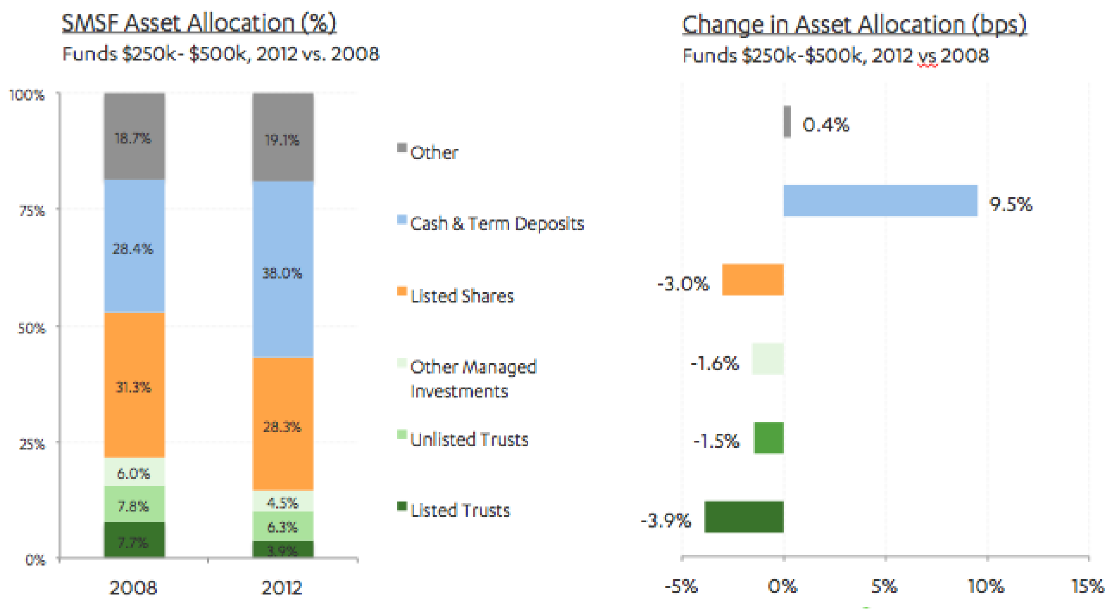
Australia in comparison to the US has far fewer investment options, particularly in the category of fixed income. The US for example has a well-developed bonds market.

By comparison, Australian Terms Deposits and Government Bonds make up effectively the entire fixed income category. When adjusted for inflation these investments options have provided very low nominal returns post GFC.

Despite low returns superannuation funds have increasingly flowed into Cash and Term Deposits since the GFC.

Chart 4 below highlights the flow of funds to Cash and Term Deposits amongst SMSFs with funds in the range of $250k-$500k from 2008 to 2012.

Chart 4: SMSF Allocations (%) Overall and Percentage Change (bps) between 2008-2012
SMSF Funds with assets $250k-$500k



Source: ATO

Amongst these SMSF accounts 38% of funds were in Cash and Term Deposits in 2012. With prevailing interest rates in the range of 0-3.5% on these funds during this period, the effective returns are close of zero when adjusted for inflation.

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[1] APRA Annual Superannuation Bulletin, June 2013

The OECD report on Global Pension Statistics ‘Pension Markets in Focus 2013’ (chart 5 below) ranks Australian 25th of 29 countries on nominal 5-year average annualized returns over 2008-2012.

Chart 5: OECD Ranking of Global Pension Performance

In per cent

Country	5-year average return	
	Nominal	Real
Turkey (1)	11.6	3.4
Denmark	8.5	6.1
Mexico (1)	7.7	3.2
Netherlands	5.6	3.5
Iceland	4.2	-2.9
Hungary	4.1	-0.4
Germany	3.9	2.4
Norway	3.6	0.9
Korea	3.2	0.1
Slovenia	2.7	0.6
Chile	2.7	0.1
New Zealand	2.7	-0.1
Canada	2.7	1.1
Italy	2.6	0.4
Czech Republic	2.2	-0.1
Finland	2.0	-0.2
Luxembourg	1.9	-0.3
United Kingdom	1.7	-1.5
Belgium	1.5	-0.8
Greece	1.3	-1.3
Spain	1.1	-0.9
Switzerland	1.1	1.0
Poland	1.0	-2.3
Austria	0.9	-1.2
Slovak Republic	0.4	-2.3
Australia	0.1	-2.6
Portugal	0.1	-1.6
Japan (2)	-1.1	-0.7
Estonia	-1.8	-5.2

Source: OECD Global Pension Statistics

This highlights that despite having one of the largest superannuation sectors in the world Australia, the Australian financial system is failing to deliver acceptable returns to investors.

Hence we believe there is a large opportunity to offer Australian investors, and superannuation investors in particular, higher yielding fixed incomes. We note that this is the same driver that has driven P2P lending in overseas markets.

Peer to Peer (P2P) lending provides an alternate solution

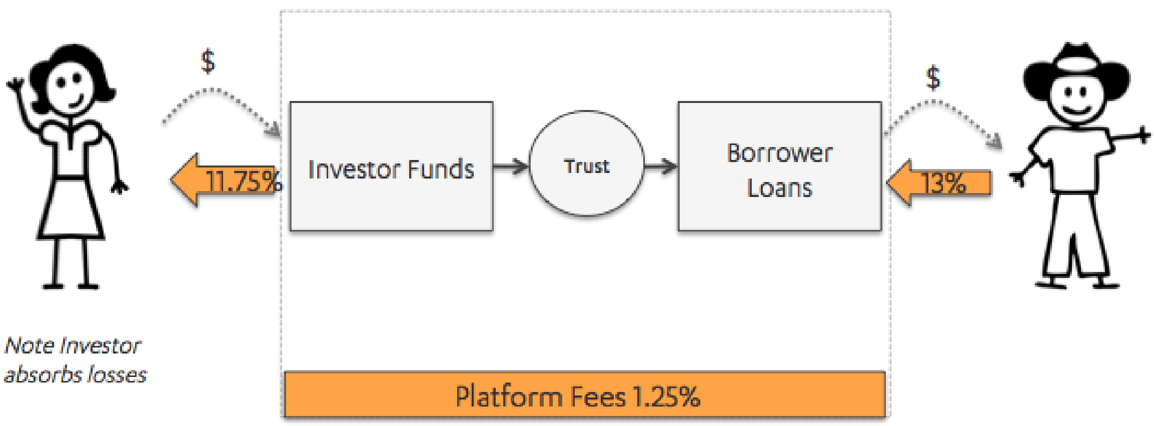
An alternative option is to facilitate investors to invest directly in assets with matching liquidity profiles via an open credit exchange.

P2P is a viable alternative that allows investors to lend money to unrelated individuals without the need to go through a traditional intermediary. The process takes place on an online platform that performs the functions of borrower and investor registration, credit assessment, loan auctioning, loan origination and customer servicing. The P2P platform provider charges a fee for providing these functions. The vast majority of the interest rate charged to borrowers goes to the investors.

By way of example, SocietyOne takes 1.25% p.a. commission fee from the interest paid by borrowers and passes the remaining to investors.

Investors wear credit losses, so in that sense have capital risk. This risk is managed by allowing the investor to see the (de-identified) risk assessment of the borrower and creation of diversification by allowing investors to take small interests in many loans.

Diagram 2: Simple depiction of a P2P lending system



Risk discrimination and transparent pricing sits at the core of a P2P lending system

Risk based pricing models when connected to an open credit exchange are likely to promote policy objectives such as transparent price discovery for borrowers and investors, and efficient functioning of markets, such as consumer lending and small business lending.

Risk discrimination is at the core of a P2P lending system.

Like banks, P2P lenders utilize statistical credit risk scorecards and assessment processes to estimate the credit risk of a loan applicant.

However, unlike banks, P2P lenders make a loan applicant's risk profile available via an auction process (in a de-identified form that so that the borrower's personal details are invisible). In this way the system can be thought of as market driven risk based pricing.

We highlight that P2P lenders globally have been prominent innovators in financial services in the use of data, statistical credit scoring and streamlined decision processes to assess risk more accurately, quickly and cost effectively than incumbents[2].

The P2P lending model works efficiently when there is fair value exchange between borrowers and investors. P2P lending is inherently transparent as a result, and the primary role of the P2P lender is to provide accurate risk assessments of borrowers to facilitate both sides of the market to transact.

The P2P lender may provide maximum and minimum price guidelines to ensure that pricing is fair, but ultimately loan pricing is set by supply and demand. Investor choice is guided by their expected return net of defaults, as well as other factors they consider important to their specific investment strategy – such as loan term, repayment schedules, risk appetite, loan type and purpose, socio economic preferences such as geography, industry, etc.

SocietyOne's ClearMatch creates individual loan schedules for each winning investor based on the interest rate bid. In this way the borrower gets the absolute best price the market is willing to offer.

Loan terms are directly matched – no leverage in the system or need to create liquidity

An important aspect of P2P lending is that the loan term is directly matched between a borrower and an investor. Specifically under the loan contract the borrower agrees to make principal and interest repayments according to a pre-set schedule. An investor funding a loan receives their share of the loan repayments as per the same schedule. Hence there is no leverage in the system or need to create liquidity.

[2] Refer to the appendix material "Examples of innovation in credit risk, big data and streamlined decisioning – US SME P2P lenders Ondeck and Kabbage"

P2P lending provides significant benefits to both borrowers and investors

The ability for investors to build their own custom loan portfolio based on their personal investment objectives, yielding fixed income returns typically in the range of 7%-15% is perhaps the single most attract feature that has underpinned the success of P2P internationally. In the US the two largest P2P lenders Lending Club and Proper are currently on track to originate a combined total of $6 billion in consumer finance loans in 2014[3].

In addition, investors have direct, unsubordinated investments in high quality loans with returns that are largely uncorrelated to the cash rate. They obtain stable cash flows aligning to the loan repayment schedules that can be harvested or re-invested into new loans.

For borrowers the benefits are better interest rates due to the efficiency of the system, and a fast and simple user experiences due to the use of online platforms and digital processes.

Overseas experience suggests that P2P lending can achieve large-scale adoption

We highlight comments by Bank of England executive director Andrew Haldane stating that P2P lending through online sites has the potential to eventually replace old-fashioned banking[4]

We also highlight the US based P2P lender Lending Club as proof the P2P lending can achieve significant scale in practice.

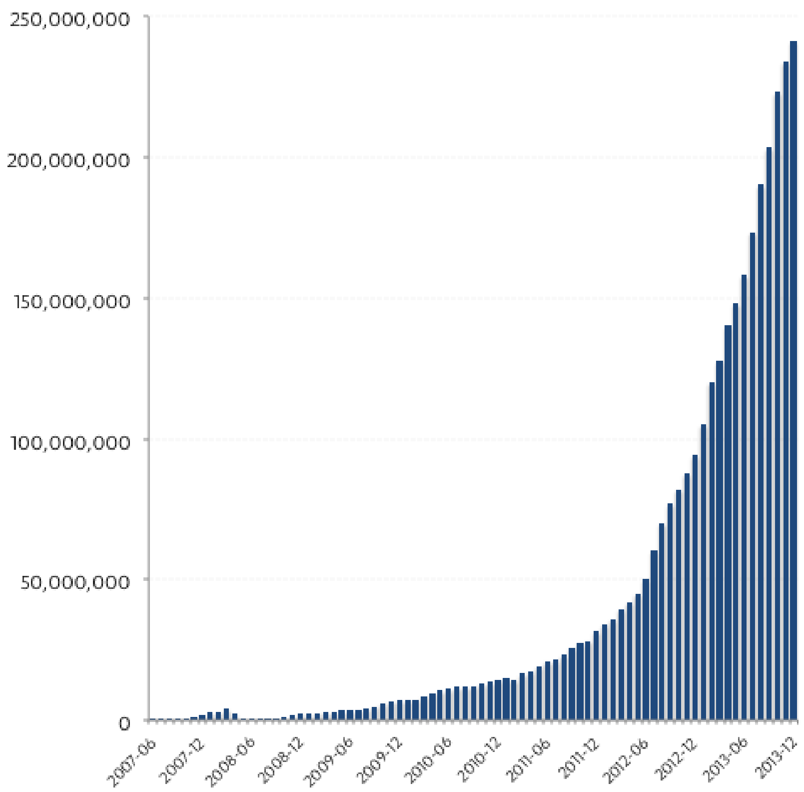
Lending Club launched in 2007 and has grown steady since to the current loan origination volume of $260m per month, growing at 187% per annum[5] (ie. they might expect to originate $4b in loans in 2014).

Chart 6: Lending Club monthly loan originations ($), 2007-2013

[3] Historic origination data sourced from lendstats.com; current combined Prosper and Lending Club monthly originations as at Feb'13 is $337m and the annual grow rate is 180%

[4] 'Towards a common language', speech by Andrew Haldane

[5] Lending Club download data, www.lendingclub.com

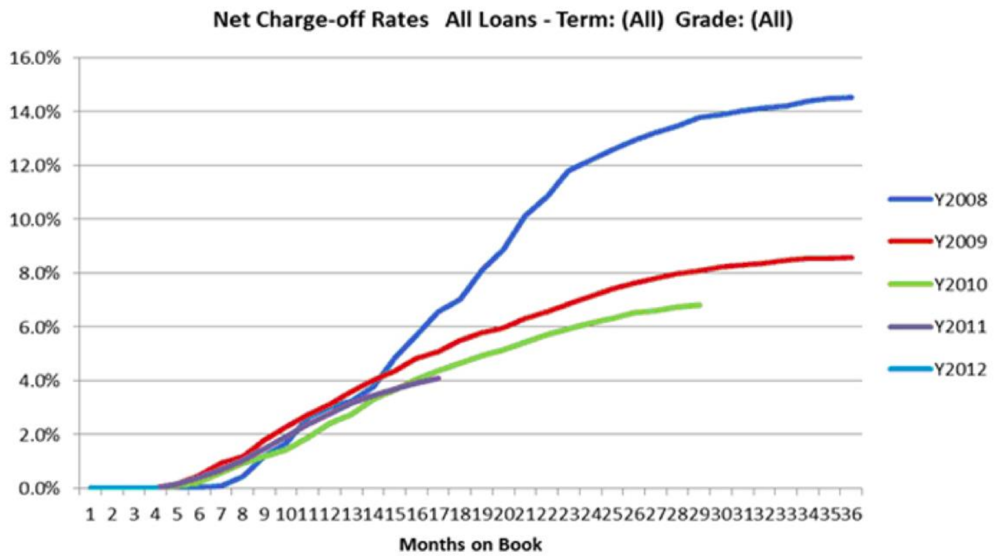


Borrower interest rates range from 6% (A grade) to 26% (F grade), with default rates in the range of less than 2% (A grade) to 10-15% (F grade). As a result investors typically achieve returns in the range of 5% to 15%[6].

Core to the success of Lending Club has been their ability to provide consistent and reliable credit risk scores on loan applicants. Chart 7 below highlights that the credit performance of the Lending Club portfolio has been increasing uniform and inline with US bank default rates. As a result, investor demand for loans, which originally tended towards lower risk A/B grade borrowers, has spread across the whole spectrum of borrower credit grades.

Chart 7: Lending Club net charge off rates by vintage, 2008-2012

[6] Data sourced from Lending Club website and download data



Source: Lending Club 10-K filing with SEC for fiscal year ended Dec 31, 2012

Investor demand, largely driven by superannuation accounts, has been growing rapidly and is now at the point that even with origination volumes around $260m per month there is more demand for loans than supply. Lending Club has recently commenced small business lending and is reported to be looking at further market segments.

Positive credit bureau is an important enabler of competition

We briefly highlight that positive credit data is an important enabler of competition in global financial systems. Positive credit data reduces the overall system losses, provides a more even playing field between incumbents and new entrants and facilitates credit worthy consumer to have better access to credit.

We also highlight that the benefits of the new positive reporting legislation will only truly occur when the entire market participates. To that extent we encourage Government to take steps to ensure 100% participation.

We also note that the range of data fields being reported in Australia is 'thin' by international standards. The most obvious missing field is the balance of a credit account. This enables potential credit providers to access an applicant's actual level of debt commitments and calculate common assessment ratios such as debt to income ratio. Hence we also recommend that the data attributes being reported is reviewed and widened.

P2P lending fits within the existing Regulatory framework

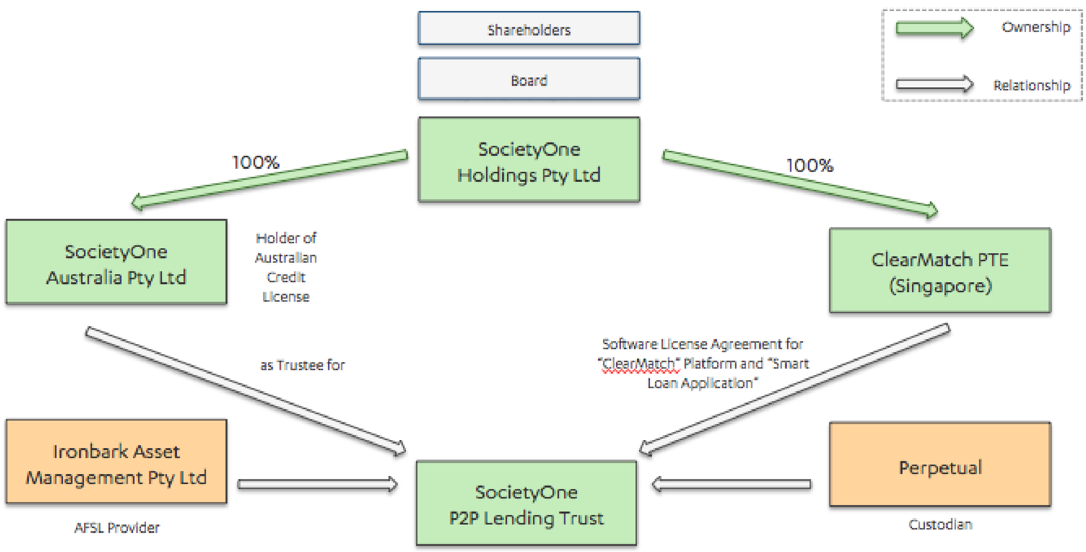
SocietyOne has successfully set-up a P2P lending business within the existing regulatory framework.

We don’t believe the current regulatory framework is a barrier to P2P models. On the contrary we believe that the current regulatory framework provides appropriate protection for consumers and guidance for P2P lenders.

SocietyOne has taken the specific steps to fit within the regulatory framework, such as limiting investment to sophisticated investors until such point the loan book has sufficient maturity, and making clear disclosures about the investor risks associated

SocietyOne has also created the SocietyOne P2P Lending Trust to facilitate the operation of the SocietyOne P2P Lending Platform. Investors who wish to participate in the SocietyOne P2P Lending Platform as “lenders” first become Members of the Trust.

Diagram 3: Overview of SocietyOne’s operating structure



This trust structure, as shown in diagram 3, has been chosen with three aims:

1. To ensure that Members are not considered themselves to be lending to consumers because otherwise each Member may require an Australian Credit Licence
2. To use a flexible and transparent structure so that individual Members can be individually economically exposed to loans.
3. To Establish a bankruptcy remote vehicle - to protect the Member’s against the Trustee's or Company's insolvency prior to making loans or on the repayment of loans.

SocietyOne holds an Australian Credit Licence and undertakes the credit assessment of potential borrowers, allocate them to the SocietyOne P2P Lending Platform, makes the loans to the relevant borrowers using funds provided by Members and manages the loans throughout their term.

As the SocietyOne P2P Lending Platform is intended to be a peer-to-peer framework, SocietyOne will only make loans if Members elect exposure to those loans within the parameters of the Lending Platform.

Recommendations:

1. ***That the Australian Government take further steps to reduce asymmetric credit data that favors incumbent banks as a means to enabling greater competition by:***
    a. ***Make positive reporting mandatory for all credit providers***
    b. ***Increase the scope of the data collected***

    Under the current regulations credit providers can elect whether or not to contribute positive credit data to Credit Reporting Agencies. We note that the major banks have not yet committed to provide positive credit data, and that until they do there is little benefit to the wider credit system.

    SocietyOne strongly supports the introduction of positive reporting on the basis it enables more accurate credit risk scoring, reduces system credit losses overall and support the move to transparent risk based pricing.

    We also note that the positive credit data specified for collection under the current regulations is significantly less comprehensive than in other markets such as the US. In particular we argue that credit balances should be included at a minimum.

2. ***That the Australian Government should assist to raise awareness of P2P lending by endorsing the industry.***

    We see this as the first step in government helping to raise awareness of P2P lending

3. ***That the Australian Government should follow the example of the UK Government and invest side by side in P2P loans with other investors***

    In doing so the government would directly support borrowers, greatly assist in the task of raising awareness of P2P lending, whilst earning an investment return at the same time. The UK experience illustrates the enormous benefit to both the P2P lending industry and the economy.

4. ***That the Australian Government should provide tax incentives for superannuation funds invested in P2P lending***

    Again we reference the UK where it was announced in the most recent budget that P2P lending investment could be included in tax-free Individual Savings Accounts (ISAs).

We see an enormous opportunity in that Australia has one of the largest superannuation pools in the world, but also amongst the lowest rates of investor returns.

P2P lending is a suitable category of investment option for many superannuation funds due to the ability to match liquidity/term requirements, achieve a relatively high rate of fixed income return and build a custom portfolio based on an individual's investment strategy.

Increasing the flow of superannuation funds through P2P lending will not only provide solid returns for investors but also facilitate increased sharing of capital within the economy

Appendix: Examples of innovation in credit risk, big data and streamlined decisioning – US SME P2P lenders Ondeck and Kabbage

US start-ups such as Ondeck and Kabbage are opening up new finance options for credit worthy small business typically seeking funds to purchase equipment or fund expansion.

Banks are yet to find an efficient means of assessing these businesses, and typically underwrite these businesses based on personal credit scores and availability of collateral. As a result approval rates are low and the loan process may take weeks.

Innovative new market entrants such as Ondeck and Kabbage are increasingly developing software that takes business transaction data together with wide ranging 3rd party data such as bureau scores, legal notices, online reviews, and online merchant inventory (Kabbage) and then utilizes statistical models to assess loan applications in minutes.

Prove of the validity of these approaches is that both these businesses are gaining market traction: Ondeck issued $400m of loans in 2013, whilst Kabbage issued $360m; both are growing at >100% p.a.

At the same time loss rates have been low, with Ondeck[7] loss rates reported at around 5% p.a and Kabbage at less than 2% p.a[8].

As a result Ondeck and Kabbage are increasingly providing small businesses with access to funding.

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[7] Need A Business Loan? Impress The Algorithm, Not The Loan Officer, http://www.forbes.com/sites/jjcolao/2013/03/27/need-a-business-loan-impress-the-algorithm-not-the-loan-officer/

[8] Small businesses turn to alternative lenders, http://www.usatoday.com/story/money/business/2012/11/13/unconventional-business-loans/1650637/