Case

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Zopa.com: From a hot idea to an established market player?

Introduction

In 2012 one of the Internet firms grabbing headline attention in the world of retail finance was Zopa, a UK-based peer-to-peer online brokerage that coupled British residents who wanted to lend with those who wanted to borrow. Lenders proffered money not to individuals but to a pool of people grouped together because of similar creditworthiness. Launched in March 2005, Zopa started with just 300 members, but within just a few months had grown to more than 25,000 users. By the autumn of 2012 Zopa had around 700,000 members who had lent more than £250 million between each other. October 2012 was the company's biggest month ever – Zopa savers lent £8.3 million to Zopa borrowers without a single banker involved. The £8.3 million total in October was 91 percent higher than the same month the previous year.

Since Zopa was not technically a bank and did not lend money itself, the capital requirements to run the business were relatively small and the company employed just 27 people at the beginning of 2012. With an average interest rate of 6.6 percent per year, loans from Zopa were some of the cheapest in the country. At the same time savers enjoyed returns at very low risk. By far the most common reason for taking a loan was to buy a car (more than half of the loans), followed closely by home improvements. But Zopa savers also helped fund some of life's more special moments, including loans for weddings, engagement rings, and even motorbikes. Zopa had been voted *Most Trusted Personal Loan Provider* for 2012, 2011, and 2010 and *Best Customer Service* for 2010 in the Moneywise Awards.

Zopa's CEO Giles Andrews pondered the meteoric growth of his fledgling company. Some banking industry analysts believed that Zopa could do to retail lending what Skype, an Internet-enabled peer-

to-peer communication technology, had done to the telecom industry by disinter-mediating incumbents. But what was so unique about this online venture? How might Zopa challenge the global giants of the retail financial services industry? And what might be the response of the established retail banks?

The UK financial service industry

The financial services market in the UK had evolved significantly since the turn of the new millennium. The main banks had undergone a substantial degree of consolidation, especially after the global financial crisis. The financial crisis has resulted in significant consolidation of the UK retail market. Well known firms such as HBOS, Alliance and Leicester, and Bradford and Bingley had either exited the market or merged with rival firms. A large number of building societies had merged, undermining the diversity of provision in the sector. Whilst these "rescues" were necessary in order to preserve financial stability, the consequence had been to reduce competition and choice in the market. In addition to consolidation, supermarkets such as Tesco and Sainsbury's, as well as Internet banks had entered the market for financial services.

By 2012 the banking and payment system could be divided into five distinct groups:

- traditional high street banks
- former building societies
- online banks
- credit card companies
- retailers providing financial services

Although the traditional high street banks still held a majority share of the banking market, other organizations were gaining increasing shares. While historically most people had been loyal to one bank, British people were becoming increasingly willing to switch banks, or hold several accounts with different institutions. While older people still tended to stick with high street banks, both Internet and supermarket banks continued to win over young customers, by offering new technology, accessibility, competitive rates, and customer service.

Traditionally the banking and payment system in the UK was managed through the network of high street banks, which competed with each other. Customers would typically select one bank with which they would open appropriate banking accounts (for example, a current account, or a savings account). Visiting the nearest branch of that bank was an important part of the transaction process – whether paying in checks or withdrawing cash, as accessibility was of key importance. But the advent

of other forms of banking and payment systems had reduced the role of the bank network significantly, leading to a process of consolidation and branch closures.

Personal current accounts were dominated by the major banks. The five leading banks - Lloyds Banking Group, RBS, HSBC, Barclays, and Santander - had an 85 percent share of the personal current account market, and also accounted for 63 percent of the savings account market. The top five providers of unsecured personal loans accounted for over 60 percent of the lending market, with Lloyds Banking Group having almost doubled the market share of its nearest competitor, Barclays. Unsecured lending refers to loans that are made in the absence of collateral. If the borrower defaults, the lender does not have an asset as a security to fall back upon. Lenders generally provide unsecured loans for relatively small purchases for example computers, holidays, or an unexpected expense such as a medical bill. The most common form of unsecured lending in the UK was through credit cards, and by 2012 there were almost sixty million credit cards in issue in the UK compared to around 66 million in 2008 (see **Exhibit C** for more information on adults owing money on lending products).

Unsecured lending providers ranged from the major banks to small scale specialist and non-specialist lenders. Additionally, in some cases, firms chose to provide white label credit cards that are distributed through other firms such as retailers. More recently, peer-to-peer lending facilitators such as Zopa had entered the market and provided a matching service online for borrowers and lenders.

Distribution channels for unsecured lending vary by business model. The branch network is the most common distribution channel for arranging loans (36% of customers went directly to their current account provider to arrange loans in 2012). Many providers also arrange personal loans online or via the telephone. A similar picture emerges for credit cards, with research indicating that 48 percent of customers applied for a new credit card in a bank branch compared to 22 percent online.

The Royal Bank of Scotland (RBS) was one of the largest UK retail banks by 2012, with more than 2000 branches that offered its almost 14 million personal customers approximately 70 different services across a range of deposit accounts, credit cards, investment products, personal loans, mortgages, and insurance. Similarly to high street banks such as Barclays, Lloyds and HSBC, approximately 55 percent of RBS's customers were over the age of 45. Some 59 percent of RBS customers were in the ABC1 segments, and more than 70 percent were Internet users.

As with many UK retail banks, RBS had strategically repositioned to focus upon advisory services, and had introduced a new customer service review that enabled its branch staff to run a comprehensive financial health check tailored to a customer's individual circumstances. To complement this advisory approach, RBS had added nearly 800 people to its branch networks, including more than 200 specially trained financial planning managers, and launched a range of new investment products to

provide its customers with more choice. The bank had also continued a branch refurbishment program aimed at making its locations more attractive, and increased the number of branches open on Saturdays. RBS had one of the largest ATM network in the country, and also offered online and telephone banking.

Net interest income as a percentage of the average balance sheet total had decreased considerably for UK banks such as RBS since the mid-1980s, but despite this trend net interest income still accounted for around 60 percent of the total income of the large UK-owned banks and remained important for the overall profitability of the industry. Other important income streams for UK banks were mortgages, credit cards and consumer credit (unsecured loans), and loans to small and medium sized enterprises (see **Exhibit A** for UK retail banks: Product return on equity for selected banking products, 2012).

The birth of Zopa

Zopa was co-founded in March 2005 by CEO Richard Duvall, strategist James Alexander business architect David Nicholson, and chief financial officer Giles Andrews. Duvall passed away after a battle with cancer in October 2006, with Andrews subsequently becoming CEO. All except Andrews were involved with Egg, the online bank. Alexander had been strategy director at Egg after joining in 2000, and previously had written the business plan for Smile, another online bank owned by the cooperative. The founders were also joined at Zopa by Sarah Matthews, previously Egg's brand development director. The company received initial funding from two private venture capital groups - Munich-based Wellington Partners and Benchmark Capital in London.

Zopa stands for zone of possible agreement, which is a term from business theory. It refers to the overlap between one person's bottom line (the lowest they're prepared to receive for something they are offering) and another person's top line (the most they're prepared to pay for something). In practice, this approach underpins negotiations about the majority types of products and services. The idea for Zopa was born from market research conducted by the company's founding team that showed there was a potential market of freeformers to be tapped in the retail financial services industry. Freeformers were defined as self-employed, project-based or freelance workers who were not in standard full-time employment. Consequently, their incomes and lifestyles could be irregular, although they may still have been assessed as credit worthy. These individuals were identified as being either underserved by, or non-consumers of, the services offered by existing financial services institutions. Examples of freeformers included consultants and entrepreneurs.

Zopa's consumer research indicated a large number of freeformers in the United Kingdom, possibly as many as six million freeformers of a total UK population of around sixty million. In the words of Zopa co-founder Richard Duvall: "it's a group that's growing really quickly. I think in 10 or 15 years time

most people will work this way. It's happening right across the developed world. We've been doing some research in the US and we think there are some 30 or 40 million people there with these attitudes and behaviours." The management of Zopa believed that this emerging consumer group represented a significant opportunity for an innovative financial services provider. In the words of Andrews: "they're people who are not understood by banks, which value stability in people's lives and income over everything else." Zopa's management also believed that the considerable growth in Internet usage and online banking in the UK in recent years demonstrated consumers' increasing confidence in using the Web for financial services (see **Exhibit F** for Loans disbursed by Zopa members). The vision of creating Zopa was to leverage the Internet to create a finance option for freeformers beyond traditional banks, and to provide a virtual community that was more in alignment with the independent culture and lifestyle of this growing social group.

The Zopa operating model

People joined Zopa online as either borrowers or lenders. Once registered, lenders could loan money to a pool of people grouped together because of similar creditworthiness. Zopa assessed the credit scores of borrowers using the same Equifax-based credit ratings as used by UK retail banks and lenders, and only offered services to borrowers who achieved an A*-, A-, or B- rating. The company also engaged an identity checking agency to verify the identity of all lenders and borrowers. The company's own team of underwriters individually assessed each borrower's ability to repay, and borrowers were then entered into Zopa's own market making system which included A*, A, and B lending pools. Zopa had applied for patents in the UK for software elements of its proprietary marketplace matching platform, but recognized that the broader concept of P2P lending could not in itself be protected from imitation. Soon after the launch of Zopa, other peer-to-peer lending sites like donjoy.net in Korea and more prominently prosper.com in the US launched. Up to mid-2012 more than 45 P2P services had launched round the world.

By early 2012, less than one percent of Zopa's loans had turned into uncollectible debts which was the lowest default rate of any UK lender. Zopa CEO Andrews believed that Zopa had partly achieved such low default rates by injecting a social aspect into lending. Zopa members were able to see the usernames of other members on the site whenever they lent or borrowed. While this did not typically include the member's full name (unless they had chosen a username that matched their real name) or their address, other members could see generic details such as age, marital status, location, and loan purpose. Lenders could see how much had been borrowed, at what rate and term, and track repayments. Borrowers were able to communicate with lenders, with messages typically being used to explain more about what they wanted a loan for, or just to say "thank you" after receiving credit. For example, one member Pushkin left this message: "I am waiting for the pay out from the Halifax for the miss-selling of an endowment complaint that has been upheld. I want to do some work on my

house before Christmas." "If I borrow from real people," Andrews said, "I'm more likely to pay back than if I borrow from a faceless bank."

Lenders offered loans into a particular market that was defined by the credit rating of borrowers (market A, market B etc.), and the term of the loan (24 months, 36 months etc.) When lenders placed their money in a Zopa market, their money was lent in separate contracts of £10 each to at least 50 borrowers if they lent over £500 as suggested. The lenders offers, together with those of all the other lenders in a market, were ranked, firstly by the rate lenders had set (lowest to highest) and secondly by the time the offer was placed in the market (earliest to latest). When a borrower made a borrowing request in a market, the money was taken from each lender in rank order until the full amount had been matched. The interest rate charged to the borrower for all the loan contracts would be the average rate at which the lenders were supplying the money, so each lender received the rate they asked for.

The main benefit for borrowers was that they could borrow relatively cheaply over shorter periods for small amounts (see **Exhibit D** for repayment terms for selected loans). This was the reverse of banks, where lending typically became progressively cheaper for larger amounts over longer periods. The average interest rate on a Zopa loan in 2012 was 6.6 percent, with the cheapest below six percent – at a time when UK banks had pushed average interest rates on credit cards to their highest levels in 13 years (19.1%). This was despite the fact that the Bank of England had cut interest rates to an all-time low of just 0.5 percent. Andrews said:

> Banks are continuing to shamelessly make their customers pay for their own mistakes by charging ridiculously high interest rates to rebuild the balance sheets they destroyed with their own recklessness. Long-suffering bank customers should refuse to be taken for a ride a moment longer and should shift their borrowing and saving to where they get a radically better deal - the "banker-free zone" of Zopa.com.

For Zopa lenders, higher returns were possible than through traditional savings accounts or term-deposits. In November 2012, average interest on UK bank savings accounts was just 0.87 percent, with average returns on one, two, and three year term-deposits were 2.19 percent, 2.49 percent, and 2.6 percent respectively – all below inflation. In stark contrast, the average return enjoyed by Zopa lenders over the previous year after Zopa fees and bad debts had been 5.4 percent. Lenders could choose the balance of risk against return they required (see **Exhibit B** for more information on savings product ownership and see **Exhibit E** for lending returns at Zopa compared to returns from select competitor savings accounts).

Zopa: How it works

1. Zopa looks at the credit scores of people looking to borrow and determines whether they're an A*-, A-, or B- rated borrower. If they are none of these, then Zopa is not for them.
2. Lenders make lending offers – “I would like to lend this much to A-rated borrowers for this long and at this rate.”
3. Borrowers review the rates offered to them, and accept the ones they like. If they are dissatisfied with the offered rates on any particular day, they can come back on subsequent days to see if rates have changed.
4. To reduce any risk, Zopa lenders only lend small chunks to individual borrowers. A lender lending £500 or more would have their money spread across at least 50 borrowers.
5. Borrowers enter into legally binding contracts with their lenders.
6. Borrowers repay monthly by direct debit. If repayments are defaulted, a collections agency uses the same recovery process that the high street banks use.

Zopa charged borrowers a fee of up to £190, averaging about £100, and lenders a 1.0 percent annual service fee. So, a borrower taking out a loan of £5,000 would be charged say a £100 fee. This borrower fee was added to the loan amount, bringing the total borrowed up to £5,100. But with the fee deducted up front, the borrower would get £5,000 paid into their bank account. A lender lending £1,000 at seven percent would earn £70 of interest each year if the money was always lent out and paid back. They would pay a fee of one percent, or £10, in total. Zopa deducted the fee from the holding account balance on a monthly basis, once the lender had received the monthly repayments from their borrowers. Zopa also earned money through referring people who could not borrow at Zopa (due to a poor credit rating) to other loan providers and charging a premium for a faster service.

If a borrower repaid his debt earlier than the original contract period anticipated, the lender would pay no additional fee on the portion of the loan that has been repaid early. Since it launched in 2005, more than 45 percent of the loans due to be repaid had been repaid early (either partially or completely) and all without the borrower paying any kind of additional fees or charges for doing so. This was in stark contrast to UK banks, not one of which offered a personal loan without additional early repayment charges, often of one or two month’s additional interest. If a borrower defaulted, a collections agency would undertake to recover any money outstanding, and the lender would not be charged a service fee for the amount defaulted. Should the agency be unable to collect the outstanding loan after 120 days, the lender agreed under the conditions of Zopa membership to pass the debt to the collections agency for no price but with all the proceeds recovered passed back to the lenders less the collection costs. The borrower would not be able to borrow again and would have

their Zopa membership suspended. Furthermore, Zopa would pass their details back to a credit referencing agency. This approach to loan default was no different to that taken by existing retail banks – Zopa borrowers who failed to pay were pursued through the same mechanism as banks and received a black mark against their credit histories.

Zopa's customer research revealed that many of its lenders and borrowers were united by a desire to distance themselves from conventional institutions. Indeed, non-institutional lending and borrowing was already present in the United Kingdom, with a survey of consumers by the Financial Security Authority revealing that 11 percent of respondents regularly borrowed money from family, friends, or someone else in the community. Of those people with informal loans, 16 percent also had a personal loan from a bank or building society, 11 percent had a student loan and seven percent had a car loan, indicating that they were not necessarily borrowing informally because they were unable to access any other type of credit (although they may have been unable to access *additional* credit). "I spend a lot of time talking to members and have found enormous goodwill towards the idea, which is really like lending to family members or within a community", said Andrews .But he added that some of the lenders were simply entrepreneurs who had the funds, understood portfolio diversification and risk and were lending on Zopa alongside other investments. In addition to its commercial elements, Zopa's website provided a user blog, lender and borrower profile pages, and community chat rooms for members. Some Zopa members had even met off-line at pubs and cafes in their local communities.

The launch of Zopa was quite different from other dot-coms at the turn of the millennium. Many companies at that time invested large amounts in offline media such as TV and print to rapidly grow awareness and to explain their proposition to customers. Instead Zopa had followed a different communications strategy, which relied on word-of-mouth and PR with some online marketing activities where the cost of customer acquisition could be controlled. The launch of such a model and the history of its founders, made it relatively easy to gain the attention of relevant newspapers and magazines such as *The Times, The Telegraph, The Guardian, The Financial Times*, and *The Economist* as well as broadcast media such as *BBC*. Besides press PR activities, the main marketing activities that Zopa used were search engine promotion and affiliate marketing. It was not until January 2011 that Zopa launched its first TV advertising campaign with two ads featuring real, unscripted customers saying what they thought of the Zopa service in their own words.

Looking to the future

Andrews had been delighted with the progress of his fledgling company since Zopa's launch in 2005. The company had attracted the attention of media from around the world, and while not all coverage had been favourable most had pointed out the fact that Zopa rates for the best-rated A category

borrowers were better than any commercial loan offered by a bank, and for lenders rates were better than any savings account. Member numbers continued to grow strongly, and the total value of loans brokered by Zopa increased daily. By 2012 Zopa's loans accounted for between one percent and two percent of all new personal loans made in the UK each month. And the rate of new memberships has been accelerating lately which could be a sign for reaching a tipping point. "The perception of banks is that they are weak and I can't see that changing anytime soon. Peer-to-peer lending already accounts for over one percent of the personal loan market and there's no reason why in a few years we can't see that at 10 percent. We're predicting at least a doubling of the industry in 2013," told Andrews *The Independent* on December 18, 2012. Adding to that, Jacob Rothschild, part of the banking dynasty, had taken an undisclosed stake in Zopa. And last but not least Zopa had received £10 million in government money to lend out to small and medium size business, which were especially struggling to get loans from the banks in 2012. Zopa continued to maintain the lowest default rate of any unsecured loan book in the UK at less than one percent. But as with any conscientious CEO, there were several questions that played on the mind of Andrews. Was Zopa on a path to disrupt the retail banking industry, as some industry observers had speculated, or might it about to be overtaken as others rushed into the new peer-to-peer lending market? How might Zopa maintain its first-mover advantage? And how might the established retail and online banks respond to this new challenge?

Exhibits

Exhibit A: Product return on equity for selected retail banking products (in %)

Product	UK	Germany	France
Credit card	19	6	41
Small business loan	15	8	1
Mortgages	14	1	6
Overdrafts	30	11	32
Personal loans	13	2	6

Source: Chumakova, D. et al. (2012). *Day of reckoning for European retail banking*. McKinsey & Company Report.

Exhibit B: Savings product ownership, by gender, age, socioeconomic group, and region, November 2011 (in %)

	Any savings	Savings or term deposit account	Cash ISA*	Stocks and shares ISA**	Other national savings and investments product	Post office savings account
All	**66**	**54**	**25**	**15**	**14**	**9**
Men	65	54	25	16	13	7
Women	67	54	25	14	15	11
Age:						
18-24	55	42	17	2	5	9
25-34	61	51	18	10	8	8
35-44	64	54	21	13	13	10
45-54	64	57	22	19	13	7
55-64	73	58	39	26	20	9
65+	74	57	33	18	21	11
Socioeconomic group:						
AB	80	70	40	30	22	10

Exhibit B: Savings product ownership, by gender, age, socioeconomic group, and region, November 2011 (in %) (continued)

C1	73	61	30	19	18	8
C2	63	50	21	13	13	9
D	54	45	17	6	6	5
E	49	35	10	2	5	13

* An Individual Savings Account (ISA) is a financial product available in the UK, designed for the purpose of investment and savings with a favorable tax status.

** A Stocks and shares ISA provides favorable tax status and has money invested in qualifying investments consisting of any combination of stock market equity investments, public debt securities such as government or corporate bonds, or cash "awaiting investment."

Source: Numbers were generated using the rating engine Mintel, http://www.mintel.com/ (accessed November 23, 2012).

Exhibit C: Proportion of adults owing money on lending products, by gender, age, socioeconomic group, and working status, October 2011 (in %)

	Credit or store card	Bank overdraft	Personal loan*	Car finance	Student loan**	Other**	Any
All	32	11	9	6	4	6	44
Men	34	12	10	7	4	4	46
Women	30	10	7	5	5	8	43
18–24	24	16	8	3	17	3	44
25–34	43	16	16	6	10	6	61
35–44	48	17	13	13	2	12	64
45-54	37	10	8	9	-	8	49
55-64	25	6	5	4	-	5	34
65+	12	1	1	1	-	2	15
AB	38	9	7	8	6	4	48
C1	35	13	11	8	8	5	49
C2	35	11	9	6	2	7	48
D	30	11	9	6	1	8	42
E	16	6	5	1	1	9	27

Source: Numbers were generated using the rating engine Mintel, http://www.mintel.com/ (accessed November 23, 2012).

Exhibit D: Repayment terms for selected loans of £3,000 over 36 months, by APR, November 2012

	APR* (%)	Monthly repayment (£)	Total repayment (£)
Zopa	9.2	95	3,425
Rate setter	9.3	95	3,431
Hitachi personal finance	9.6	96	3,444
Ocean Finance	9.7	96	3,449
Sainsbury's Shopper Personal Loan	12.8	100	3,592
Clydesdale Bank Personal Loan	12.8	100	3,592
Yorkshire Bank Personal Loan	12.8	100	3,592
First Direct Loan	13.9	101	3,644
Santander Personal Loan	14.9	102	3,690
Post Office Personal Loan	14.9	102	3,690
Tesco Loans	15.9	104	3,736
M&S Personal Loan	16.9	105	3,782
Co-operative Bank	18.9	108	3,874
Smile Personal Loan	18.9	108	3,874
AA Personal Loan	18.9	108	3,874
Lloyds TSB Personal Loan	19.9	109	3,920
Ulster Bank Loan	19.9	109	3,920
NatWest Personal Loan	20.9	110	3,966
Royal Bank of Scotland Online Loan	20.9	110	3,966
Bank of Ireland Standard Loan	21.4	111	3,989
Bank of Scotland Personal Loan	23.9	114	4,104
Halifax Personal Loan	24.9	115	4,149
Everyday Loans	49.5	146	5,252
Aspire Money	62.1	161	5,797

* Refers to set APR or advertised/typical APR offered; although some providers only have one set loan rate, others offer different rates based on credit rating; only those with a good or excellent credit rating (estimated to account for up to 25% of consumers) will be eligible for the best (i.e., lowest) rates; a typical APR successful applicants receive is 66%.

** no redemption penalties charged.

Source: Numbers were generated using the rating engine *Moneysupermarket.com*, http://www.moneysupermarket.com/ (accessed November 23, 2012).

Exhibit E: Lending returns at Zopa compared to returns from select competitor savings accounts, November 2012 (in %)

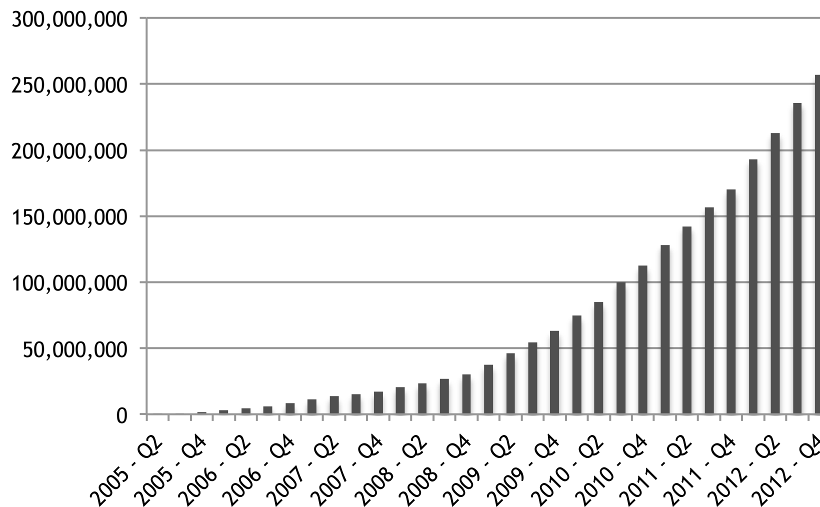
Provider	Product	Rate AER*
Zopa	Average return on lending**	5.4
Nationwide	Easy access with bonus	2.20
Derbyshire Building Society	Easy access with bonus	2.20
ING Direct	Easy access with bonus	2.00
Citibank	Easy access with bonus	1.32
West Brom Building Society	Easy access no bonus	2.26
National Savings & Investments (NS&I)	Easy access no bonus	1.50

* Bank rates AER gross (before tax)

** Rrate is before tax and after charges and actual average annualized defaults over last 12 months.

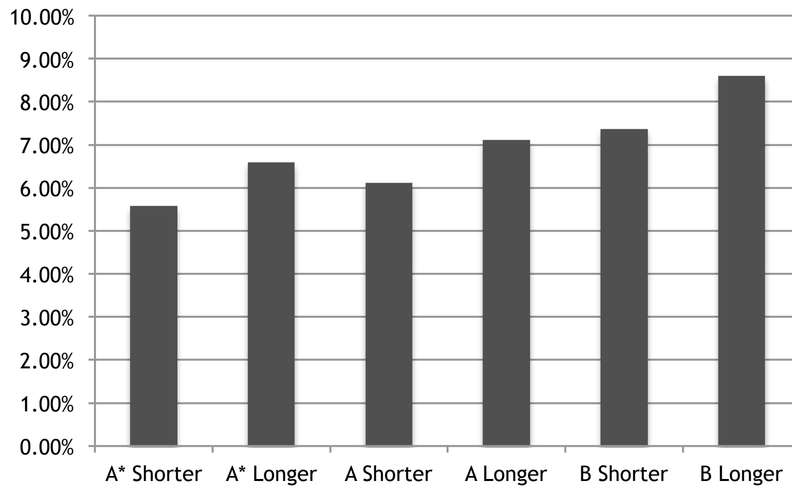
Source: Numbers were generated using the rating engine *Moneysupermarket.com*, http://www.moneysupermarket.com/ and *Zopa.com*, http://uk.zopa.com/ (accessed November 23, 2012).

Exhibit F: Loans disbursed by Zopa members



Source: Zopa (2012). Peer-to-peer finance celebrates its 7th birthday as UK banks inflict the highest lending rates in recorded history. http://www.zopa.com/press/2012/p2p%20finance %20celebrates%20its%207th%20birthday.pdf (accessed September 23, 2014).

Exhibit G: Average rates of the last five completed loans



Source: Data taken from Zopa company documents.