Fintech- Disruption in Consumer Finance Peer to Peer Lending

The world of finance and lending has not been left untouched by the revolution in technology and in this internet age, we have something known as Peer to Peer lending, which is slowly but surely emerging as an alternative to the traditional lending by banks and financial institutions. In Peer to Peer lending, also known as P2P Lending, the borrowers and lenders meet online and all the transactions are conducted over the internet. This form of lending and borrowing has several advantages over the traditional form and the author has discussed these in detail in the present article along with other aspects of P2P lending. Read on to know more….

What is Peer to Peer lending?

In simple terms, with Peer to Peer lending - the activity of lending which hitherto has been predominated by banks, is now being made accessible to ordinary retail investors. Peer to Peer lending is an alternative consumer financing model where the bank is cut out and savers (lenders) and borrowers are directly connected through an online platform. The P2P industry marks a dramatic shift from traditional lending process practiced by banks. It gives lenders unprecedented access to consumer credit while enabling borrowers with a smarter, more affordable route to loans and credit.

Lenders, motivated by the possibility of higher yields on investment, deploy their funds directly into small ticket size loans on P2P platforms which helps them build a large loan portfolio, minimising risk of loss. Borrowers, meanwhile, can avail a loan for various purposes, ranging from credit card consolidation to planning a quick family vacation. P2P platforms thus leverage upon lower costs associated with their digital presence, lean teams and minimal compliance costs to fundamentally 'price out' the bank at its own game.

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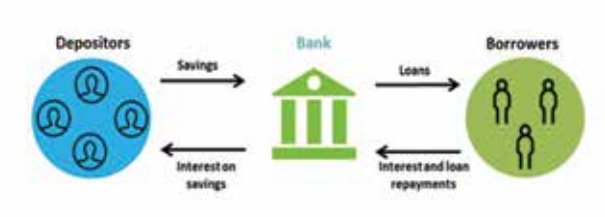
How traditional banking works



How P2P lending works

Source : Deloitte report on marketplace lending

Why is consumer finance ripe for disruption?

Financial services industry is possibly one of the oldest industries globally where capital has been managed and distributed through banks and financial institutions. They have undergone cycles of downturn and massive growth and continue to service millions of individuals globally. Though banks have significantly diversified their product offering and grown their balance sheets over the last several decades, there are two distinct areas where they continue to demonstrate their inability to service customers effectively.

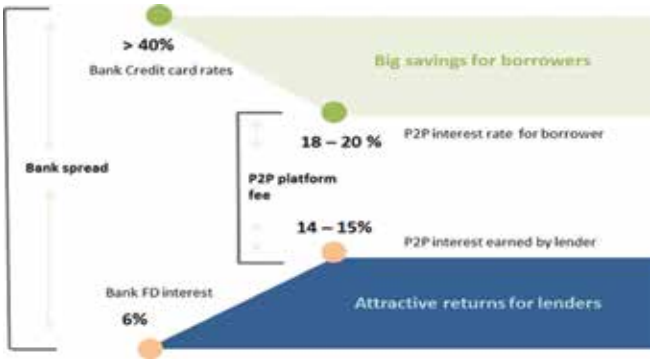
- **Traditional, outdated approach towards risk assessment**
  Firstly, as far as consumer lending is concerned, over the years, banks have become rigid and failed to distribute credit equitably to all - their traditional model of assessing risk has automatically excluded several creditworthy borrowers - the likes of your neighbouring small time restaurant owner who needs working capital to buy extra inventory for his kitchen or a fresh out of college working professional who requires a quick personal loan. Their tendency to focus only on 'top of the pyramid' customers has resulted in an over-reliance on outdated credit appraisal methods which have not kept pace with customer aspirations.

- **Lack of innovation and nimble processes:**
  Secondly, the ubiquitous nature of their operations have led to restrictive cost structures which have ultimately prioritised 'profiteering and fees' over 'innovation and problem solving'.

As a result, the role banks play in our daily lives has diminished. For example, outside of the need to have a savings account for fund inflow, most other activities such as payments, investment tracking etc. happening today are managed through integrated third party apps/platforms (eg: Paytm). Banks have left behind gaping holes in processes which a new generation of companies - termed 'fintech' is ultimately racing to fill. These companies, armed with nimble processes and focusing on superior customer experience are slowly beginning to shake up an aging industry.

How exactly is P2P lending better than a bank for lenders and borrowers?

- **P2P lending democratises finance: An individual lender's appetite for risk is matched with borrower's credit requirement:**



*Interest rates mentioned are per annum.

A bank fixed deposit investor simply gets a flat deposit rate in return for investment and has (i) no visibility over the underlying risk of investment and (ii) has no ability to improve return on investment. This is because banks manage their own loan books and the investor has no say in controlling the flow of capital. The flow of capital is ultimately determined by the bank's credit policy.

In P2P lending, platforms list loans on the P2P marketplace and let the lenders decide on (i) the loans they want exposure in, (ii) the amount of exposure (iii) interest rate mix and (iv) the time period of investment. As a result, lenders with divergent risk appetites are able to invest in the loans which closely mirror their outlook towards risk and return. This

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ability to customise one's investment in P2P lending ensures that the lender's capital is matched with the right investment opportunity.

- **P2P lending platforms enjoy an efficient, low cost operating model:**
  Banks have large operational expenses primarily due to the extent of their size, regulatory requirements and compliances. In order to make a loan, banks need to first raise deposits, maintain a large liquidity buffer and adhere to regulatory compliance on capital reserves. In addition, banks hold all their loans on their balance sheet and hence there is a significant cost attached to loan provisioning for defaults, delayed payments etc. These costs put together ensure that banks cannot operate below a certain threshold of loan pricing - and this realisation ultimately kills innovation at banks.

P2P platforms, meanwhile, operate completely online - resulting in low operational and customer acquisition costs. Their ability to price loans dynamically using alternative credit points ensures that despite the higher yields paid to lenders on loans, their fee income is commensurate to their lending portfolio. P2P platforms also follow an 'asset-light' approach and do not hold any of the loans on their books - which ensures a pure marketplace approach to credit.

These cost reductions help P2P platforms to transfer the entire benefits of the interest spread in the form of higher returns to the investors and cost savings to the borrower.

- **P2P lending offers superior customer experience:**
  Banks are infamously known for the extent to which they are dependent on paper based processes and manual decision making. This significantly affects their processing time for loan applications - leaving borrowers, sometimes for days together, in the dark on whether they will hear back from the bank. A physical distribution led model also results in the customer having to travel to the nearest bank for even basic banking functions. Physical verification processes, lengthy documentation results in a poor customer experience - especially for the borrower.

In P2P lending, everything right from customer acquisition to loan servicing happens online through the platform. Borrowers largely benefit from this digital process as there is information symmetry through the entire process. For lenders, automated dashboards to manage and scrutinise loan performance along with 24x7 access to the P2P marketplace are significant advantages.

A short history of global P2P lending market

P2P lending has truly emerged as the dark horse to take over the mantle of consumer lending from banks in the near future. What began in 2006 as a nascent industry has today transformed into a $30 bn industry. Platforms like Zopa (UK), Lending Club (USA) have benefitted from the internet boom, issued more than $20 bn in loans and gone public with their IPOs. Several other platforms like SoFi, Avant etc. have pioneered a new approach to consumer lending - leaving banks far behind in the race to acquire young, new to credit customers. With markets like South East Asia, India and Australia gradually warming up to this model, the P2P industry is expected to grow at >45% annually and reach a remarkable threshold of ~$350 bn by 2025.

Retail investor confidence in P2P lending has peaked with lenders seeing P2P lending as an attractive avenue for high yields in the short term. There is mounting evidence to demonstrate that investors are shying away from low yielding bank deposits and putting their capital to work in P2P platforms. Here they are compensated with attractive interest income.

The ability to reduce risk and principal loss through diversification of investment is another significant advantage which has fueled investor confidence. With regulators globally warming up

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to the industry, there is now much needed clarity about the role of P2P platforms as 'facilitators' who manage the flow of capital and curate a sophisticated, transparent marketplace investing.

Source: Liberum Capital

Another significant development globally has been the sharp interest institutional investors (hedge funds, wealth management firms, banks etc.) have shown in the P2P asset class. They have been willing to invest in a substantial portion of consumer loans on P2P platforms both as direct investments and via securitisation. For banks, P2P lending offers a smarter way to take exposure on consumer credit as they can invest in these loans without having to incur origination cost or assessment cost.

Why is P2P lending significant to India's consumer finance landscape:

- New innovation critical for credit starved economies like India

In India, until the advent of the new millenium - lending was dominated by nationalised banks. With RBI opening up NBFC licenses, the race to the top has broadly been between the NBFCs armed with larger appetite for risk and private sector banks who have swiftly built large loan books - though a large portion of it is centered around corporate lending. These NBFCs and banks have developed a one size fits all approach to consumer finance and although microfinance players have expanded formal credit access to rural households-there is still enough demand that is either not met or is poorly serviced.

In this context, P2P lending becomes very important as an alternative source of finance since it offers quick, convenient loans to borrowers who value fair terms, digital processes and flexible credit products. Borrowers are able to get instant decisions and approvals in P2P platforms through a completely online process which takes into due consideration credit quality, repayment willingness and authenticity of the loan applicant. P2P platforms are not crippled by internal restriction on minimal capital allocations or liquidity pressures as the funding side is open to lenders. This ensures that borrowers have 24x7, 365 day access to the funds which they require.

Though banks and NBFCs are here to stay, P2P lending will continue to thrive and innovate to serve the credit needs of consumers through newer, more dynamic models of originating loans, assessing risk and product development.

- P2P lending - an asset class which adds value to the investing ecosystem:

  In India, there are several different asset classes for the investor to consider. The key essentials of building a good investment portfolio center around the investor's risk tolerance and preferred investment time horizon.

P2P lending is emerging as an attractive investment option for investors looking to earn steady, above market returns in a short time frame of 2 to 3 years due to the following reasons:

1) P2P lending has the ability to beat inflation in a short term horizon (max 2 or 3 years)
2) Stable cash flows with high compounding potential
3) Ability to choose risk profile by building customised loan portfolios
4) Option to start investing with a small amount of cash

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Here is a quick snapshot of available investment options for a retail investor today:

Fixed Deposits: A bank fixed deposit is one of the lowest yielding investments one can enter into today. At ~6% p.a. return, the investor is poorly compensated. The inflation adjusted return is even lower and with tax to consider, a bank fixed deposit offers almost nothing on the investment.

Real Estate: The Real estate market has been extremely choppy in the last few years with some markets having experienced a permanent downturn. With construction costs going up and builders experiencing a sharp fall in demand for home ownership, the market is unlikely to revive in the short term. With real estate yields at historically low levels, capital appreciation on investment is going to be a tough proposition.

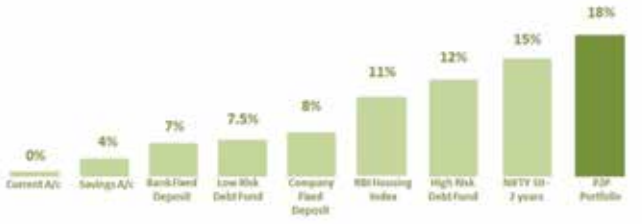
Gold: Gold, as an asset class continues to be unproductive. Gold does not provide interest income or periodic cash flows - the only hope is that it can be sold at a higher price than it was last bought. Main attraction is that it is a liquid asset.

Mutual Funds: Mutual fund industry has grown rapidly in India and has a few obvious advantages which has made the product popular among investors. However, one must be cautious about over-leveraging ones portfolio with mutual funds which is why alternative asset classes like P2P lending becomes important. Low risk debt MFs hardly beat inflation and offer a post-tax return of ~8 % p.a. which is also not guaranteed. The capital gains element of debt mutual funds has also incentivised fund managers to enter into risky speculation on interest rates which have led to a large number of fund houses posting poor returns earlier in the year.

Direct Equity investing: Stock investing is no doubt rewarding but the risk of loss is also equally high. Direct stock investing is thus strictly only for investors with a large appetite for risk and those who want to stay invested for the long term (10+ years). In addition, direct equity investing takes up resources - it requires enormous amounts of time for research which retail investors do not typically have.

The Reserve Bank of India ("RBI") is a step away from regulating the nascent sector and bringing it under its purview. With about 20 companies actively operating in the space, the regulatory framework is expected to focus on promoter integrity and experience, prudent risk management practices and transparent information dissemination to lenders.

How the returns look like in P2P lending:



For the lender, P2P lending offers an asset class that provides attractive risk adjusted returns with low volatility. One of the biggest value propositions for the lender in P2P lending is that it provides reliable 2-3 year cash flows through loans which are accurately graded, priced and de-linked from market corrections.

Though default risk has to be accounted for in P2P lending since returns are not guaranteed, the ability to fractionalize one's investment by buying small units of several loans ensures that capital is suitably distributed to absorb risk of loss. Lenders are able to align return expectations with their appetite for risk real time before lending and this is hardly possible in other investment avenues. In addition, an interested lender can open his P2P account within minutes, transfer funds and start funding loans in minutes. Post loan funding, the first repayment is received within 30 days. This makes the entire investing process seamless.

With low yielding asset classes like fixed deposits, commodities and real estate slowly losing favour with investors - P2P lending is likely to emerge as the top contender in the 'short term debt investment' space for both retail and HNI investors. Once the RBI regulations (presently in draft form) are formalised and published, the asset class will go mainstream and become on par with other products like mutual funds, bonds, equity etc.

What should you be aware of/need to know before you undertake a P2P investment?

- **Regulations are coming**

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P2P platforms to get registered as a 'new class' of NBFCs. Regulatory approvals will be a huge advantage and will further propel the growth of the entire P2P industry and the larger fintech ecosystem in India.

- **P2P platforms participation in Credit Bureau reduces repayment/default risk**
  Though P2P platforms offer sound credit screening and risk assessment process – ultimately lenders take the risk of default of the loan. The RBI draft consultation paper clearly articulates that platforms cannot give any *'guarantees'.*
  Credit Bureau came to India in 2008. Since then 4 Credit Bureaus have emerged in India – CIBIL, CRIF Highmark, Equifax and Experian with CIBIL being the most popular. One should note that as per RBI guidelines all Banks and NBFC's are required to report all loans disbursed and repayment behavior to all the 4 Credit Bureaus on monthly basis.

Once P2P platforms start reporting the loan to the Credit Bureau it acts as a notice to all other financial institution of the indebtedness and repayment behavior of the borrower for their credit assessment. So, someone who doesn't make timely repayments on a loan taken from a P2P platform, faces the immediate penalty of getting his/her credit score downgraded which in turn seriously impacts the borrower's ability to access credit from other institutions in future.

So before you make a P2P investment, double check with the platform if they report their loans into the credit bureaus.

- **How P2P platforms regulate the flow of funds between the lender and borrower?**
  P2P lending, being completely digital, might lead one to believe that the fund flow is happening directly between the borrower and the lender's bank accounts. Such a process is misleading as it creates information gaps and leads to an inefficient credit delivery process with borrowers having to manage several small credits from multiple lenders.
  Most P2P platforms in India have managed to innovate to find a solution to this problem and are beginning to use an Escrow Account. An Escrow Account or a holding account becomes necessary to seamlessly manage the fund flow in a P2P environment. The Escrow does the work of holding the lenders' funds, transferring funds to the borrower and collecting monthly repayments. The Escrow also ensures that the lenders' funds is always at arm's length and cannot be misappropriated by the P2P platform.

Just like Mutual funds are subject to market risk, returns in P2P lending are also subject to underlying loan performance. Hence, it is critical for investors to understand their risk appetite before investing and make an informed decision.

- **Make sure you ask P2P platforms if they assist in the loan recovery/collections process:**
  Since the lender is allocating his funds into loans, there is a chance that a few monthly payments from borrowers might be delayed by a few days post the official due date for repayment. As a lender, you do not have the resources to negotiate or chase borrowers for repayment. This is the job of the P2P platform - to ensure that authorised collection agencies are engaged and money is collected from borrowers as soon as possible.
  So, thoroughly check and ensure that your P2P platform provides a support framework for collection of delayed payments from borrowers before you invest.
- **P2P lending is not a guaranteed product - so please consult your financial advisor before undertaking an investment.**
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Conclusion:

P2P lending, in many ways, is expected to provide a more efficient solution to both credit and yield seekers in India. By leveraging on growing urbanisation trends and a digital approach to consumer finance - P2P lending will ultimately deepen credit penetration in India. Tech enablers like India Stack, e-signing, Big Data etc. will be handy tools which help P2P platforms optimize on their 'asset-light' lending framework. With P2P lending a borrower will be able to apply for a loan and get the money in the bank account - all in the span of a few minutes while commuting from office to home.

In the process, lenders have a great opportunity to participate by investing in an asset class which has been the sole privy of large banks for long. The opportunity to earn stable, hassle free interest income awaits savvy investors who wish to participate in building a new era of consumer finance in India. ■