Different Facets of Peer-to-Peer

The financial system has evolved in sync with the evolution of human society. From the primitive man with scarce resources, limited demands and barter system in use, there being no requirement of money, to the introduction of monetary medium of exchange.

With the introduction of money, the traditional financial system of taking loans from moneylenders came into practice thereby introducing banks and other financial institutions in the economy. traditional system of taking loans from money lenders came into practice thereby introducing banks and other financial institutions in the economy. A new type of digital financial system, FinTech, has also emerged. Among the various models of FinTech, one is Peer-to-Peer (P2P). This model provides a platform for the underserved section of the society and high net worth individuals in facilitating loans by the latter section of the society to the former. The article describes how the model works, in a useful way; its limitations, recent developments and also how regulation can bring improvements in the existing model. Recently, some undisclosed amount has been raised by P2P, the same has also been discussed in the article. Read on to know more…

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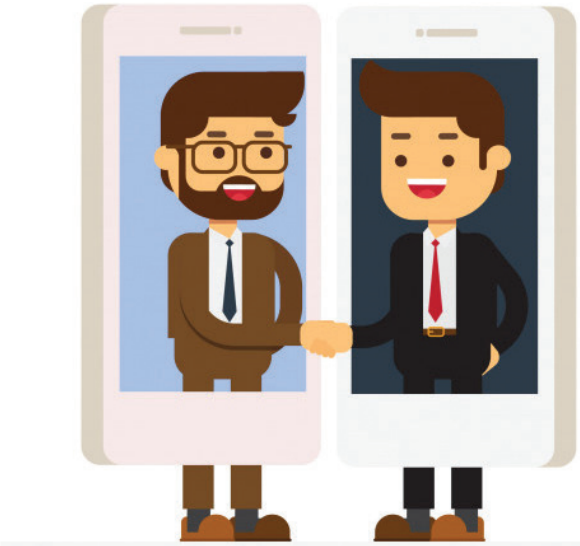

Introduction

FinTech is the abbreviation used for the term Financial Technology. It refers to collaboration between financial companies and technology that has transformed financial receipts and payments transaction system. Such collaboration has led to many innovations in the financial sector and various models have been developed to further availability of loans; be it for a business or for an individual. One such model is Peer-to-Peer (P2P) lending and borrowing system.

A bank is different from a P2P company. The latter are matchmakers, i.e., they match borrower with lenders on a purely fee based model. P2P companies offer online platforms that match lenders and borrowers to facilitate unsecured short-term loans. The interest rate levied is higher than what is offered by the banks and other financial institutions. The interest rate is decided mutually (depending on the level of risk) by borrower and lender. Generally, a borrower has to pay a minimum of 11% per annum interest rate and the maximum rate can reach 36% per annum depending on the creditworthiness of the borrower. While the interest rate earned by the moneylender comes approximately to 48%, the interest amount for both the parties is processed through P2P Company.

Brief History of P2P

P2P lending started in 2006 when Prosper Marketplace and Lending Club brought a niche business to enable investors with surplus funds to lend capital as loans to millions of borrowers with low creditworthiness, who were finding it difficult to get loans from the traditional banks. On the one hand, lenders started earning higher yields than market rate and on the other hand, borrowers were happy to get loans despite their average credit score. Thus, this alternative investment platform is mutually beneficial to both parties and presents new avenues for growth. The P2P lending industry has grown year after year and has turned into a multi-billion dollar industry. The easy lending and borrowing speed up the process of development and expansion of industries, which also contributes in increasing the number of jobs.

Benefits

P2P does the work of scientifically matching the requirements of lender with the profile of the borrower to facilitate easy approval of loans at negotiable interest rates. Investment through P2P platforms is safe, although it does involve a certain amount of risk, but that can be reduced through diversification. On a P2P platform, lenders can invest in different loans. With its varied benefits and flexibility, P2P has taken the financing sector to the next level.

P2P is especially beneficial to small scale industries (SSI) and individuals as it aids in timely loans, which are not easy to obtain in traditional banking system due to lack of security. Along with easy loans, P2P provides all critical information through charts and tables and also allows tracking of applications. Such access to information keeps customers satisfied as they stay informed about the latest developments in their cases. Since P2Ps are the match makers, no capital adequacy is required. Hence, many new start-ups have also come into this arena. P2P provides all facilities online without any intermediaries, thus eliminating tedious paper obligation, which consequently mean a reduction in processing charges.

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By opening up an alternative avenue, P2P offers helping hand to those in need. Unable to avail traditional borrowing facilities, the underserved section of the society can avail loans and fuel small businesses.

The revenue of P2P platforms depends on the volume of loan originated. They do their best to maximise lendings, and in process, at times, ignore proper evaluation of credit scores of the borrowers. They lend money determining the creditworthiness of the borrowers at their own discretion, being indifferent to the possibilities and consequences of financial defaults.

Default and Risks

Lending varies from time to time, unprofitable businesses sustain themselves by taking advantages of the times when the loans are cheap, but there are periods when the interest rates are high and credit becomes expensive. P2P is not free from failures. Investors face the risk of losing their capital if their portfolio borrowers fail to pay installments. As many P2P platforms provide no guarantee, there is a risk of losing large sums of money if borrowers default. To take an example, the default rate at one of the Indian P2P company is 1.94 %. A high default rate can make the customers distrustful of the system, which is a major obstacle to the growth of the P2P platform. In the United Kingdom, Zopa, a P2P in UK had 4% default rate in 2016 - a volume comparable to what experienced during 2008 financial crisis, when 4.16% of the company's loan book defaulted. Zopa had revised up its estimate for the 2017 loan book from 4.52% to over 5% and 3.32% for 2018.[1]

According to a U.S. business-focused, English-language

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[1]. *Financial Times 22-03-2019, "Peer to Peer Pressure does the risks: outweigh the rewards "by Nicholes and Kate*

international daily , 'high rate of defaults hit P2P lending sector' in February 2017. Investors in the P2P lending sector have seen their returns suffer due to high rate of borrower defaults among start-ups. But this happened in 2017, now position has changed drastically.

Sometimes, P2P platforms are steered by young entrepreneurs who may lack knowledge in banking and finance and the experience to fully vet buyers and sellers. This makes it possible for a fraudster, looking for an opportunity to launder money, to enter the market. Also, as all transactions take place online, the P2P organisation may not be able to see when their customers seem unusually nervous. In absence of in person cues, P2P platform may look for suspicious transaction patterns, for example people filter their illegal profits by breaking them into small loan amounts (also called smurfing) so that the loan amount remains below the required amount (maximum amount required by regulatory authorities), for example, in India, each investor can invest only up to ₹ 10 Lakh ($15,350) across all P2P platforms and the amount invested with a single borrower cannot exceed ₹ 50,000. For example, if an investor invests ₹ 50,000 in different borrowers at the same P2P platform and also in different platforms in the same week, such an activity could be considered highly suspicious.

Similarly, a borrower can con an online lender. For instance, cases have been observed in China where a borrower created a profile on P2P platform using fake identity and applied for loan. Many individuals misuse the P2P platforms to convert their illegal money into legal income. There have also been cases of issuing to unscrupulous individuals.

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As a financial technology, P2P is gaining attention all over the world, but it also seems to be becoming an attraction avenue for money laundering and data breaches. Due to increase in digitalisation, confidentiality of data is exposed to increased levels of risk. Through just an app, it is easy for P2P to collect a much wider set of data than its traditional counter parts do operating through retail branches and online banking.

Though the P2P industry handles transactions worth millions of dollars every day, there is still lack of transparency and regulations and undisclosed sources of funding. There are no specific rules governing the processing fees charged by P2P for their services. In Indonesia, a borrower received only Rp 650,000 out of the total loan of Rp 1 Million. The rest was absorbed in the administration fees of the P2P. This happened because some unregistered firms have unexpected clauses and rules. In the above example, the borrower debt soared to Rp 25 Million. Several installments were paid, but in case of a missed payment, the borrower was threatened by the P2P. Similar treatment from the company was reported by four other borrowers. Thus, sometimes due to lack of clarity and unreliable partners, these easy to access loans can prove to be unsafe.

Raising of Undisclosed Amounts

It has been observed that over the last few years, some of the P2Ps have often raised undisclosed amount from a named source or alternatively, they have raised a particular amount from an undisclosed source. "Paisa Dukan", an Indian P2P lending platform, raised undisclosed amount from "JITO Incubation & Innovation Foundation (JIIF) in July 2019. In April, 2019, London based Welendus P2P lending platform raised an undisclosed amount. (India web 2, "London based Lending Welendus to enter India as it raises Fresh Capital, April 18, 2019). Of course, funds raised are said to be used for future expansion into India.

Although, the purpose of raising undisclosed amount is said to support financing, hiring experienced key personnel or to strengthen its technology besides adding unique loan offerings for their investors. However, this claim does not answer the question that why does the amount raised is kept confidential creating situation of lack of transparency regarding the embezzlement of money.

Although there is no doubt that the P2P lending market

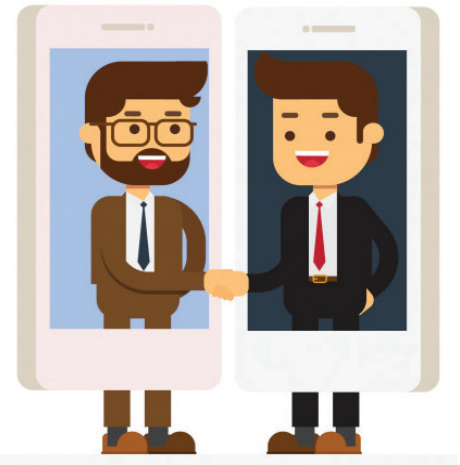
has shown a high potential for growth, yet several P2P businesses were forced to shut down - either due to high default rates or fraud or due to misuse of funds. In the beginning of P2P lending in US, Prosper and Lending Club were also shut down. There was a big collapse of China's P2P market due to huge default rates and frauds. According to Shanghai based researcher Yingcan Group, more than 400 P2Ps lending platforms collapsed between June 2018 and August 2018. Till 2015, about 4000 P2P platforms were active in China, and the P2P business was estimated at $130 billion. One of the top players was Ezubao that was established in 2014 and rose to a worth of about RMB 50 billion. It offered high returns of 9-15% with no limits on maximum amount or duration of deposit. Trouble started with Ezubao investment scheme, which turned out to be a Ponzi scheme and duped more than nine lakhs investors. This created a chaos in the market and led to similar defaults in China. In May 2019, Bondmason, a UK based P2P, shut down its business due to its inability to comply with regulatory and client acquisition costs. Quakle, another UK based P2P, collapsed within a year of its launch (in 2014) due to nearabout 100% default rate. Loan Meet, an Indian P2P founded in 2016, decided to shut down its operations in 2019. Although Loan Meet raised an undisclosed amount from Chinese and Indian investors, it was unable to raise subsequent funds. Puddle, a US P2P start-up founded in 2012, announced its shutdown in 2018 as its founders realised that their business was unsustainable.

Regulations

Until few years back, P2Ps were not subject to any regulatory authorities, which meant that some platforms were free to follow their own policies. Several P2P practices were found undesirable and that creates mistrust among investors and borrowers. Most of the P2P participants wanted government to introduce some regulations over P2P platforms and take steps to minimise default rates. A regulatory body could protect parties against risk and maintain a fair yet competitive market to encourage lending to small businesses.

Every borrower and investor who is registered with P2P platform should be verified using several criteria, including social, personal, and financial and the sources from where the investment is coming from.

The regulation of P2P platforms has evolved significantly word wide over the last few years. It has had beneficial effects on the P2P industry. For instance, in China, taking lessons from the past, regulation has become increasingly strict since 2015 and the People's Bank of China (PBOC) has issued guidelines. Because of the new strict rules the number of P2P platforms has decreased by one-third since 2015 (Economist 2017). However, many platforms have welcomed these rules, which they believe will help



P2P become a more profitable and reliable sector. The role of P2P platforms in the US and China is reflected to the role of information intermediary, and therefore the platforms in these countries rely on banks to originate the loans.

Till October 2017, P2P companies were not regulated in India. Learning from failure of unregulated P2P lending firms in China, Reserve Bank Of India (RBI) invited suggestions from all the P2P platforms for regulations to be introduced in order to streamline the sector. On the basis of suggestions, RBI launched regulations and made it compulsory for all the P2P platforms to register themselves as Non Banking Financial Companies. As per the guidelines issued by RBI, the lending and borrowing amount is to be maintained under a cap on the platforms. Similarly, a borrower cannot borrow more than 10 lakhs across all P2P platforms. Also, at any given point of time, an investor cannot lend more than ₹ 50,000 to the same borrower across all P2P platforms. Maturity period has been restricted to

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36 months. Funds transfers between lenders and borrowers will take place through escrow account mechanism. To register as a P2P with RBI, the applicant should have minimum net owned funds of Rupees 20 Million. This will ensure that platforms have enough "Economic skin" in the game. Although P2P firms did feel the sting of conservativeness from the regulators, but keeping in mind the 2008 crisis, it is felt that precaution is justified.

As on 31st August 2019, 19 P2P firms have registered with the RBI. According to report by global accounting firm, over the next four years, the estimated worth of the P2P market in India would be around $ 4-5 Billion.

Different countries have taken a different approach towards regulations and as a result, the characteristics of the markets that have emerged also vary. At present, it is partially or fully regulated in many countries such as USA, UK, Japan, China and India.

A survey of the US lending platforms founded that 37% of investors believed regulations to be excessive, while only 63% wanted more regulations (CCAF 2017). To some extent, in US, the relative lack of funding to SMEs from P2P is a result of the regulations in that country. Stringent regulation have discouraged new participants to enter the market and providing a healthy competition to established platforms.

In the UK, maintaining provision funds by P2P has become a common policy in the lending industry. However, when platforms guarantee returns on investments either way, it takes away the lender's incentive to differentiate between different risks categories. Still, the P2P in the UK has successfully met the funding requirements of SMEs.

China's lending platforms, in contrast to those in the US, believes that the existing regulations are insufficient. In a survey of China's P2P business lending platforms in March 2016, 68% called for increased regulations (Cambridge Centre for Alternative Finance 2016).

Sometimes P2P is subject to two different regulations, which creates conflict. In Japan, a P2P platform, Minnano Credit, collected 4,500 Million yen from investors to fund SMEs. However, these funds were actually extended to a single SME unit associated with Minnano credit. This fact was hidden from the investors by exploiting ambiguities in the disclosure regulation.

In the absence of regulations, P2P platforms across different countries have been known to carry out unethical practices. In some countries such as China, P2P platforms have engaged in fraudulent practices.

Thus regulations, if implemented in the right spirit, will enhance the creditworthiness of both lenders and borrowers at P2P platforms. The sources for funds are the investors, and the investors will offer more funds if they trust the platform. The regulations help the P2P platforms to maintain that trust among investors and ensure a regular supply of funds. Along with the regulations, trust could further be strengthened by having a good number of experienced members on the team having expertise in banking or finance to effectively run the platform. Tax exemption on interest will also contribute towards expanding the P2P lending business models.

Conclusion

Overall, P2P has proved to be a successful alternate business model. With strict credit policies by the appropriate authorities and other initiatives, it is estimated that the model will see a remarkable annual growth rate (CAGR) during 2019-2025, and would be worth Billions by 2025. Further, simplification of the processes and incorporation of advanced technologies, such as blockchain and smart contracts will enhance transparency in the system can lead to an even steeper growth of the market. ■