Challenges and opportunities in peer to peer lending

Vijosh Kumar S.V.*

Peer-to-peer-lending or in its neo progressive term known as social or crowd lending is a form of lending having its origin from the early human civilization era and is still in existence without losing its importance and glory, having turned over many times, and at the latest moulded to get managed at the tip of our fingers and still bouncing ahead with today's modern world economic needs. But, there exists a thinner line of separation that differentiates between peer-to-peer lending and crowd funding. In crowd funding investments are made into equity capital but, in peer-to-peer lending the investors are mere creditors. Peer-to-peer funding is regulated by central banks and crowd lending is regulated by capital market regulators.

Peer-to-peer lending is the mother of today's well stabilized banking system having a parallel wing of its own primitive structural existence. Meanwhile intermediaries were evolved at the time of churning of time to regularise and reduce the risk in peer-to-peer lending which later transformed into banks. As the name suggest, in peer-to-peer lending there is no intermediate agencies for selection of loanee, but all the rights and risks are reserved and restricted to the loaner alone. The growth of peer-to-peer lending is boosted because of its easiness to avail loan without much hurdles and the high returns from it. The scope of peer-to-peer lending is spread from the very small hand loans given between individuals to commercial papers issued between corporates. This restricts the balancing and controlling of peer-to-peer lending under a single statutory and regulatory authority.

In a micro economic level the major parties involved are lender and a lendee as per the choice of the lender, but in a macro economic prospect the other parties involved are peer-to-peer lending online platforms, regulatory, statutory and legal authorities. Many countries like Japan and Israel have posed restrictions over peer-to-peer lending and investments in those areas. Even in countries where peer-to-peer lending is regulated, there is no monetary protection provided to investors in case of default. Still, we see a great growth in peer-to-peer lending business because of high development of online digital platforms and the easiness of doing business. Also the speedy upward growth of the economy adds to the growth of this economy. The peer-to-peer lending keeps an upward pace until an economic recession and shows more than hundred percentage year on year growth. The returns in peer-to-peer lending is comparatively two to three times than the investments made on share market or fixed deposit.

In India, peer-to-peer lending is regulated by Reserve Bank of India. As per the RBI master circular numbered RBI/DNBR/2017-18/257 Master direction DNBR (PD) 090/03.10124/2017-18 dated 4th October 2017 clearly explains that a company holding a certificate of registration as NBFC-P2P and a minimum capital of Rupees Twenty Lakh only will be allowed to enter into peer-to-peer lending platforms in India which operates on commission basis for matching up of lenders and lendee. The platforms charge an origination fee to the borrower and operation fee to the lender. The platforms should also be technically viable as per

*Branch Manager, Oriental Bank of Commerce.

the standard norms laid down by RBI. Peer-to-peer lending virtual platforms are still in its infant state in developing and under developed countries. But, the physical structure are widely spread and deep rooted in the society which makes it mandatory to analyse the opportunities and challenges of peer-to-peer lending.

Opportunities of lender/investor in peer-to-peer lending

- **Higher rate of return**

Peer-to-peer investor or lender is the most benefited party among all the parties involved in peer-to-peer lending system. Lender will have higher rate of return compared to savings deposit, investment in equity and other capital market investments. The interest rate may shoot up to 30% and more depending upon the category of the borrower.

- **Selection of the borrower**

Lender alone is reserved with the rights of selection of a loanee. Lender can have a detailed viability study before lending which reduces the risk factor. Lender can reject any loanee applicant. The loanee does not hold any legal rights to avail loan from peer-to-peer lender. But, in banking system the borrower will have rights to avail loans.

- **High valued security**

In most of the cases the value of the security is the major driving factor than the viability of the project. The lenders will focus only on the realizable value of the security which will be always higher than the loan amount. The lender will be attaching the securities towards the issued loan.

- **Evasion of statutory obligations**

The money lenders evade statutory obligations like tax on interest income by managing the investment portfolio without accounting into the banking system. More than ninety percent of the peer-to-peer transactions are unrecorded which creates a wider scope of evasion of tax and accumulation of higher income.

- **Right to cease the contract and changes in sanction terms**

On practical terms the lender can modify the sanction terms at any point of the tenure of the loan. For securing the assets the loanee also will be forced to accept the changes in the sanction terms and pay according to the lenders choice. Here, the lender is having an advantage over the borrower.

- **Short term investment**

Eighty percent of the loans are having less than one year maturity period. This indicates that the funds are deployed for short term duration with higher rate of return. This creates a scope for redeploying the funds.

- **Smaller chunks of investment**

Investors are having an option to make the investment in smaller multiples of accepted minimum deposit. This allows the investor to make multiple investment of the money in different borrowers. The risk is minimized by diversifying the investment portfolio and by making the investments in smaller sum of money. Investors having a diversified investment portfolio are having lesser change of getting loss on averaging the benefits received.

Challenges of lender in peer-to-peer investments

- **Higher risk compared to other investments**

As the saying goes it is better to be a borrower than to be a lender is true when viewed under risk angle. Even though the returns are high in peer-to-peer lending, recovery of the due amount can't be guaranteed. Recovery of amount in peer-to-peer banking is four times tiresome than the normal recovery risk taken by banks.

- **Lack of statutory/regulatory and legal protections**

Though RBI has taken some initiatives to bring all the peer-to-peer platforms under a regulatory system, mechanism to protect the lenders is still under in its infant stage. Legal protection for recovery of dues is time and energy consuming. Countries in which peer-

to-peer lending is restricted do not have any recovery mechanism to assist the lenders.

- **Technical assessment of loans**

Only one percent of the investors are technically trained to appraise a loan. All other investors access their investment portfolio just by checking the value of the securities available with them. Wrong appraisals may lead to mortality of the assets and turning them to NPA.

- **Locking up of funds**

If the repayment of the due amount is not on the due date, the investor will be under liquidity problem. Banks diversify its funds to reduce the liquidity problem. But, small peer-to-peer investors can't make a diversified choice of lenders. Also, banks have a regulatory authority as a last lender of resort at times to resolve the liquidity problem.

- **Returns depends upon economy**

More than eighty five percent of the investments are unproductive loans. These loans were majorly for consumer durables and other expenditures. Income is not generated in all these investments and will be turning to NPA at very early stages of economic recession. When the economy is upward income will be churning around, but it can't bear even a small jerk and get spilled out everywhere.

- **Verification of lendee in online platforms**

The lender is restricted to have a physical verification of the lendee as he will be in some other places of the country. This restricts the lender to have a clear picture of the borrower, but need to believe what the borrower presents. Additional expenses will be occurred for the lender for detailed verification.

- **Investments are in smaller chunks**

The investors investing in smaller chunk of money in different borrowers for reducing the risk find it difficult to recover the amount from individual borrowers as the sum of money will be considerably lesser. The investors better write off than expending recovery expenses.

Opportunities of the borrower in peer-to-peer lending

- **Easy access to credit facility**

The borrower is getting funds within a short turnaround time. If applied through banks, either a proposal will get stuck up in hefty paper works or in sanction of deviations. But in peer-to-peer lending, the decision and amount will be disbursed in a speedy manner at a lesser cost of expenditure than the banks. The reduction in turn around time promotes productivity of the borrower which always happens in peer-to-peer lending.

- **Interest free/low rate of interest**

In developed countries the interest rates on peer-to-peer lending is lesser compared to banks. This is because there are no operational expenditures. But, the case is different in India. In India peer-to-peer borrowings are charged more because of unavailability of lendable funds outside the banking system. In closed groups where the numbers of participants are restricted the rate of interest is lesser than bank interest. In India societies and trusts with non-profit motive also promote peer-to-peer lending and provides funds for free of cost.

- **Investment portfolio not judged**

Banks check the end use of funds and all the borrowings should be for a productive purpose. But, in peer-to-peer lending the borrower is financed even for paying back of old debts and to make investments in consumer goods and non-income generating assets. Borrower is responsible for the end use of funds.

- **Importance for security than project viability**

A party intending to invest an amount of Rupees Five Lakh only without having proper license from metrology department to extract water, but having a collateral security of an amount of Rupees Ten Lakh

only will find it easier to get loans from peer-to-peer lenders than from a recognized bank. The bankers look into the viability of the project than the value of security but lenders look vice-versa.

- **Detailed assessment waived**

The need for the detailed assessment of the viability of the project is waived under peer-to-peer borrowing arrangements. This helps the party to surpass the major overhauls of the project and make arrangement for the borrowing. In a banking system most of the times the de-merits are put for special sanction from the competent authority and charged more interest rate.

- **Total borrowings are bifurcated to smaller chunks**

The total amount of borrowings are bifurcated in smaller chunks and distributed to numerous lenders with different sanction terms, interest rate, moratorium and tenure. It is difficult to recover smaller sum of money from the borrower than to recover a huge amount. This cushion is utilized by the borrower at the times of reverse spin of the economy.

Challenges of borrower in peer-to-peer lending

- **Liquidity mismanagement**

Majority of the P2P investments are of short term tenure. This creates a liquidity problem when the borrowers invest in long term assets with this short term borrowings. For matching this liquidity problem, the borrower is forced to mobilize more and more funds from the market which pushes into more debts.

- **Higher rate of interest**

In developing and under developing markets the rate of interest of peer-to-peer investments will always be higher than bank loan interests. Higher rate of interest will reduce the output of the borrower. The rate of interest may even be calculated in overnight basis varying from 15 percentage pa to 24% per annum which in most case is higher than the average accepted net profit margin of any business in India.

- **Management of large number of investors**

As investors majorly tend to invest in small chunks of money for diversifying the risk factor, the borrower finds it difficult to get the required amount of funds on time and manage the larger group of investors. The borrower is forced to collect the amount in partial basis and park the amount ideal until the required amount is collected fully, but pay interest for the ideal amount.

- **Huge repayment default penalty**

On default the borrower is charged a huge amount of penalty which again creates fund mismanagement and liquidity problems to the borrower and eventually winding up of the project with heavy debts.

- **Need of high value security**

Borrower is to arrange for higher value security for peer-to-peer lending which is a difficult task for startup companies and new business players. This again creates obligations by sharing equity and profit only for the purpose of security. Because of this, only big players are allowed to enter into the game.

- **Excessive pressure for output**

Excessive credit facility from peer-to-peer lenders and liquidity problems make the borrower to move to risk edges without having a hedging option. This high risk high profit will always have more chance of going bankrupt. Banks always finance the units with realistic figures and even analysis with worst situations for giving a secondary support to the borrower.

- **High expenditure**

Borrower pays a token for the arranger /online platform as matching fees. Fund management parties are also paid to deal with the liquidity problems. Ideal funds are also costly. The entire expenditure may sometimes give a push back to the economy.

Opportunities of peer-to-peer lending platforms/ arrangers

- **Arrangers earn commission based income**

The income for arrangers/ platforms is from both the lenders and borrowers. Additional income for rating and credit appraisal is also charged for knowing the borrowers profile in detail. The arrangers also collect due amounts for the lenders on payment of a small fees.

- **Do not lend directly**

Arrangers do not lend or borrow, but only arrange for matching of lenders and borrowers. The selection of borrower depends upon the lender. This do not create any obligation to the arranger.

- **Business ends after match making**

Match making of the borrower and lenders are done and after that the obligation of the arrangers cease. Thereafter, the arrangers do not have any obligations and rights.

- **KYC verification through banks**

The platforms do not require special KYC (Know Your Customers) verification platforms for verifying the details as all the platforms are linked with the bank accounts. AML and KYC risks are hedged with the mainstream bank accounts.

- **Mobilization of Foreign currency**

The platforms will be having access towards the foreign currency at lower interest rates. This helps them to make further investments in subsidiaries and ancillary companies. The liquidity problem is solved to the companies and always has surplus funds which again the companies may park for overnight market.

Challenges faced by peer-to-peer platforms

- **Heavy capital investments**

Reserve Bank of India has restricted the licenses to the companies having net owned funds above Rupees Twenty millions only. This has restricted many smaller players to enter into the game.

- **Development of digital platforms**

The arrangers need to develop the digital platforms with higher security options. This is expenditure for the digital players. All the apps and digital platforms should be secure enough like banks platforms.

- **Competition is higher**

The platforms have competition from banks, share market, equity market and mutual funds. This competition forces the players to make significantly higher rate of interest for the lenders which are par with the risk afforded by the lenders.

- **Scrutiny of borrower**

The platforms should analyse the borrowers like bankers to give more security for the lenders so that lenders will be investing a higher amount. This requires rating and appraisal of the borrower with available data. But for appraisal the platforms will run short of time and resources.

- **Merging of peer-to-peer lending and crowd funding**

The peer-to-peer lending and crowd funding are basically different as the peer-to-peer lending is always a loan and crowd funding is an equity contribution. But because of the combined growth of this there exists only a thinner line of separation between crowd funding and peer-to-peer lending.

Micro economic analysis of peer-to-peer lending is limited to lender and borrower. Statutory, legal and macroeconomic prospects should also be analysed to get a clear picture of the peer-to-peer lending system to modulate a macro economy.

Opportunities of peer-to-peer lending in a Macro economy

- **Higher Gross domestic production**

The GDP of the country moves upward as the flow of lending is liberalized. This bridges the need of the bank to work for the progression of the economy and also to achieve the economic goals of the country.

- **Reduced rate of interest**

On movement of time the rate of interest will be coming drastically down to less than banking rates. As more lenders are allowed to enter into the market the rate of interest will be notably stabilized in a low profile.

- **Promotion of high investments by bank**

Once, the peer-to-peer lending investors are on real numbers the banks can be promoted to make bigger investments that are required for national development. Banks will be having heavy funds with them which can be invested in bulk.

- **High momentum on economy**

Higher momentum of economy is expected to churn out as there will be heavy inflows and outflows of amount which creates heavy momentum to the economy making the country for tremendous changes within short period of time.

- **Creation of employment and income generation**

As the economy keeps on pacing upward there will be a heavy employment and income generation opportunities in peer-to-peer lending which again adds to the economic development.

- **Liberalization of stringent credit assessment methods**

Because of vigorous lending and borrowing between members of peer-to-peer lending, the banks are compelled to modify and liberalize the existing credit assessment patterns. On liberalization again the economy will be moving upward. Current pattern of assessment shall be made to have tremendous changes to accommodate the completion from peer-to-peer lenders.

- **Cheaper funds from abroad**

The country will be seeing fund flows from developed countries in peer-to-peer lending as the returns are high in nature. This creates a foreign exchange surplus of the country reducing the fiscal deficit of the country.

Challenges of peer-to-peer lending in a macro economy

- **Unstable economy**

The dynamicity of the economy will be fired high keeping the economy unstable and uncontrollable. Instability will flip flop the economy. As a result, net output will be changing and falling down.

- **Emergence of parallel banking**

In cash rich economy, if the investors are promoted to lend freely there will be a rise of parallel banking which will get merged within the system making it difficult to balance the economy and support the infrastructural and developmental activities in the nation.

- **Unbalanced economy**

As the lenders charge higher interest rate accordingly the distribution of income will be creating disparities in the economy cutting short the living standards of the country. Higher population will be pushed towards poverty.

- **Unethical lending**

Many people lending to many other people without an intermediary will be creating many unethical lending deals and then create variable per capita income generation. This unethical practice also destroys the stability of the country.

- **Accumulation of black money**

Lending without intermediary creates a dangerous scope for accumulation of black money. This black money accumulation will be a greatest hurdle for the economic growth. This also fuels price rise and hoarding which again are antisocial elements.

- **High inflation**

Country will be facing high inflation as the value of the money gets reduced because of higher interest rates which are boosted by the peer-to-peer lenders. Controlling of inflation also can't be done as the inflation depends on the stability of the economy.

- **Funding of terrorism and antisocial activities**

When there is no big eye to protect our system of borrowing and lending, there can be change of terrorism funding and shell company promotions. This antisocial elements may threat the social harmony of the country making it miserable clubbed with inflationary pressures.

- **Reduction in per capita income**

More amount of per capita income will be utilized for debt payments which reduce the actual per capita income and thereby creating discrimination among the people. The per capita income utilization portion will be divided for debt repayment and write off of debts.

- **Failure of banks**

If peer-to-peer lending is taking full-fledged actions in economy the existing banking system will be failing to perform well. And then they should be modified to peer-to-peer lending platforms which matches lender with the borrowers.

Opportunities for regulatory/statutory and legal authorities

- **Great opportunities for growth**

The authorities are having more and more opportunity to grow as all these are in infantry state along with peer-to-peer platforms. Because of this the regulatory and statutory need to expand with the platforms.

- **Supportive legal formations for recovery**

The laws are getting amended such that the recoveries of the funds are made easier than the existing forms. New recovery and bankruptcy laws motivate people to make bulk investments in peer-to-peer lending.

- **Regulatory aspects become stronger**

RBI, SEBI and all other legal departments come together to frame an integrated law suit for the purpose of recovery of the funds and preventing Anti Money Laundering. As the regulatory boards are having sufficient experience and have an existing strong supportive system, it will be easier for them to form new laws and regulations.

Challenges for regulatory, statutory and legal authorities in peer to peer lending

- **Anti-Money Laundering**

The regulatory aspect finds it very much difficult to operate the system without Anti Money Laundering and preventing funding for terrorism. This aspect shall be thoroughly checked to prevent funding of anti-social events and programmes.

- **Controlling of inflation**

One of the major duties of Reserve Bank of India is to regulate inflation. If the peer-to-peer lending comes into active, the economy will be more dynamic and creates more inflation in the system.

- **Prevention of black money**

The Reserve Bank of India will find it difficult to manage the black money menace. Also peer-to-peer lending will promote the growth of black money. For this all the amount transacted should be accounted.

- **Fixing of Interest cap**

RBI will be forced to fix an interest cap to the borrowings to prevent unethical growth of lending business. For fixing of the cap, the central bank should be verifying different aspects of the economy. This cap can even restrict the growth potential of the lending business.

- **Protection of the lender**

It will be a hidden duty of the central bank to create some easy recover procedure for recovery of the loan amount. This requires a strong legal support. Protection of interest income and principal should be done framing a well-defined system.

- **Lack of experience in peer-to-peer lending**

It will be difficult to the bank as the new lending system is in its infantry state and requires more practical issues to be resolved. This creates more pressure of framing a well settled constitution for the peer-to-peer lending business.

- **Regulation of foreign funds**

Funds will be flowing in if allowed to invest in peer-to-peer business by the government. This interrupted flow of money will create problems with the foreign reserves creating instability and loss of balance of the current position of the economy.

- **Controlling economic instability**

The liberalized lender lendee relationship will create a heavy momentum in the economy which should be clearly assessed and managed else, it will turn into a disaster. This is a role where government intervened integrated frame skeleton should be developed. This process majorly works on assumptions where the results are not practically visualized but guessed into a point and arrived into a structure.

Other Opportunities in peer-to-peer lending

- **Growth of credit appraisal factories**

As a subsidiary of the peer-to-peer lending many subsidiary companies will be coming up for appraisal, rating and recovery of the loans issued by peer-to-peer lending. This creates momentum of the economy.

- **FII's and FDI's invest in India**

The Foreign Institutional Investors start investing in India. This helps the nation to have a higher ranking and position in world ranks.

- **Rating of the country improves**

On liberalization of peer-to-peer lending systems, the world rating of the country improves as there is tremendous churning of economy. This gives a statistical position for the country among the world class countries.

Other challenges in peer-to-peer lending

- **Restricting the expansion of banking system**

Banking system in India in its stabilized condition will be ignored once the liberalized peer to peer lending spins out. This will be creating an economic jump which sometimes can't be afforded by a developing economy.

- **Price rise and hoarding**

The commodities will be costlier than they are. This is because all the income is earned to pay EMI's. This creates an inflationary situation in the country.

- **Sudden break to the economy**

Jumping from one economic system to another economic system brings a sudden break to the economy and sometimes it may take a longer time than expected to recover from the jerk.

Conclusion

Peer-to-peer lending in India is still in its very basic form. Because of this reason we are unable to judge the system with just inferences made. Practical hurdles and opportunities of this lending system may even be vaster and wider than the inferences made. As a trial and error method, this is the reason why RBI has kept a minimum networth cap of Rupees Twenty million only for investment in peer-to-peer lending platforms. Once this trial and error is rolled out, we will be provided with sufficient backup data to frame a detailed preamble for the lending business. Only after the first trial roll out that we could conclude whether to promote the peer-to-peer lending or push the economy to stick on to the traditional earmarked banking system. Every investor should be protected and every borrower should be benefited out of this new system. Sometimes there may be insurance companies coming up with insurance schemes to protect the investors or else sometimes these investments may be restricted like crypto currencies to safe guard the interest of the economy. Any of this happening will sprout a motion in the economy. The nation should also be ready with a backup plan for controlling either the forward churning or back ward spinning of the economy.

References

The major references for this thesis were taken from RBI website, Wikipedia, investopedia and IIBF sites.