Article

Peer to Peer Lending- the new age thing

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Peer to Peer Lending – technology revamped

In India, the traditional sources of funding are well established. Banks and financial institutions in India have been largely responsible for making available credit in the economy. This apart, where conventional sources of funding have not been available the needs of the financially excluded have been catered to through community-based financing, chit funds, co-operative societies advancing loans to its members and so on. The sourcing of funds at the granular level to bring about financial inclusion has been sporadic and disorganized and hence at small scale. All these sources of funding, conventional or otherwise, over the years have had a limitation of physical interface.

With the advent of technology, the world seems to be shrinking and so have the dynamics of communication, transactions and contractual understandings changing. The need for physical interface is reducing constantly. The upside of the technological advent is the outreach for any person has increased manifold; I could reach out to anyone anywhere in the world at any given point of time, also reach out to several people across world simultaneously, at the same time. This upside has led to innovation in the lending business as well, whereas virtual interface/ marketplace can be created for buyers and sellers.

The emergence of technology aided innovations such as Peer to Peer Lending (P2P) models. Such web portals act as a conduit or a virtual platform to be more specific, to bring together the lenders and the borrowers virtually. The web portals do not undertake credit underwriting or financing business – it just provides lists the borrowers and the lenders, making lending opportunity available from one to many.

The basic functions that the web portal carries out are that of a service provider and on a broader perspective include the following:

a. Provide a platform for lenders and borrowers to meet;

b. Basic information about borrowers and lenders;

c. Providing ancillary services for the financial transaction and carrying out operational activities ancillary to financial arrangement.

d. The platform can provide services pertaining to loans for facilitating the lending transactions but does not subsume the role of the borrower or the lender in any of the transactions.

While there are no regulations specific guiding the peer to peer lending model, there are some nagging questions which one needs to address while determining the question of setting up a P2P lending platform.

Legal Aspects:

Following questions addresses the basic queries that may come into the mind of new entrants into this sector:

1. **Should the Company running this platform require a NBFC registration with RBI or with state money lending law?**

   NBFCs are regulated by the RBI Act, 1934 and various directions issued by the RBI on this behalf. Section 45I (f) of the RBI Act, 1934 defines NBFCs as 'a financial institution which is a company.' Section 45I (c) defines financial institution as:

   'Financial institution' is defined to be those institutions which are engaged in financial activities.

   Since the principal business of the company/ platform is to connect the lender and the borrower, the company itself is not engaging in the activity of financing/ funding it is merely providing for a platform for the lenders and borrowers to meet and is charging servicing fees for rendering such a platform. Hence, the activity carried out by the platform under the present business model would not qualify to be carrying out financial activity and hence not an NBFC requiring registration with the RBI.

   With regard to applicability of the money lending law or registration of the company under the Money Lender's Act, most states have their own Act. Money Lender includes any such person or firm carrying the business of money lending.

   Again, by the same logic, since the business model of the company is to merely provide a platform for facilitating lending activity, the platform itself cannot be said to be providing loans or advances, rather is a service provider charging a nominal fees in facilitating the financing business. Hence registration under money lending laws may not be required.

2. **Will the cash account maintained for the lenders/ investors by the platform qualify as public deposits under RBI's "Acceptance of Public Deposit" directives?**

   The amount held by the P2P lending platform will be for and on behalf of the lenders. The platform will only act as a facilitating agent for the multiple transactions taking place on its platform, neither does it on-lend nor does it aggregate or allocate the funds of the lenders. It is merely acting as a conduit and an interface for facilitating the virtual meeting.

   Going by that analogy, any amount held in trust for and on behalf of another person shall not qualify to be deposit as per the Companies (Acceptance of Deposits) Rules, 2014.

3. **Claw-back rights of the creditors of the company running the platform on the cash accounts of the investors in the event of bankruptcy of the company?**

   The Company/ platform is holding money in trust for lenders in the cash account created for the lenders under the conditions mentioned in the business model. The Company/ platform would neither be lending out on behalf of the lenders from this cash account, nor operating this account, at will, for the benefit of the lenders. Therefore, the amount in the lenders' cash account held with the platform cannot be taken as a part of the bankruptcy estate of the platform. Hence there cannot be a claw back by the creditors of the company/ platform on the cash accounts created for the lenders which is held in trust by the platform for the lenders.

4. **As multiple investors would come together to fund a single loan, will it constitute as "Collective Investment Scheme" as per SEBI CIS Regulations?**

   Under Section 11AA sub-section (2) of the Securities Exchange Board of India Act, 1934 one of the conditions is that there should be **pooling of money** for any scheme or arrangement with the purpose of making profits or earning income from the investment and the investment is managed on behalf of the investors. Such platform merely acts as an interface for the lenders and borrowers to meet. However there is NO pooling in of money which is lent out to borrowers. A single borrower may have multiple lenders but that does not tantamount to pooling of money. Each lender would be lending out to a single borrower. Each lender is maintaining his/ her separate account and is managing the portfolio by making an informed decision. Hence such platforms would not attract CIS regulations of SEBI.

5. **Will the platform be responsible for deducting tax on the income earned by the lenders through this platform?**

   Platform/ company is only acting as an interface for meeting of the lender and the borrower. The borrower while making payment to the lender for the installments and payment to the platform for services rendered would be liable to deduct tax under section 194A or such other section as may be relevant under the Income Tax Act, 1961.

   The platform may be charging fees for the services provided by it to the lenders and the borrowers and the same may be subject to taxes as well.

6. **In the event of default of any loan, can the lenders have a recourse to the platform?**

In the event of default, the platform/ company **may** use its resources to recover the money from the borrower to the extent of hiring a recovery agent as well, however the company/ platform shall not assume any liability of repayment of the loan to the lender.

To elaborate further, the company/ platform is not party to any of the loans and does not oblige itself to recovery of money from the borrowers as that would tantamount to assuming liability as a guarantor in the transactions undertaken between the borrower and the lender.

The idea of a P2P platform is not to intermediate in a loan but is to facilitate the loans. Hence while the platform/ company may assist in recovery of the money from the borrower, the liability of non-recovery would be on the lender himself. This can be stated very clearly in the agreements that you enter with the lender to make the understanding clear. Also please bear in mind that RBI has strict guidelines for engagement of recovery agents.

P2P lending too futuristic in India?

Globally P2P models are a phenomenon and are as easily accepted as the conventional model of lending. Some offsprings of P2P model, such as crowd funding also are becoming popular in India in the philanthropy sector. Considering the novelty of the idea, there are several issues to tackle while intending to set up a P2P platform which one may not find legal provisions to currently, however, with the popularity of the concept, the laws and regulations will evolve as well.

Since technological intervention is more and more becoming a part of life, the redundancy of physical interaction will be growing in the lending and financial services business as well. Growth of P2P lending models in India is not too futuristic; it probably is the next thing arriving in the country.