P2P Lending

Prevalent Models & Challenges

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Introduction to P2P Lending

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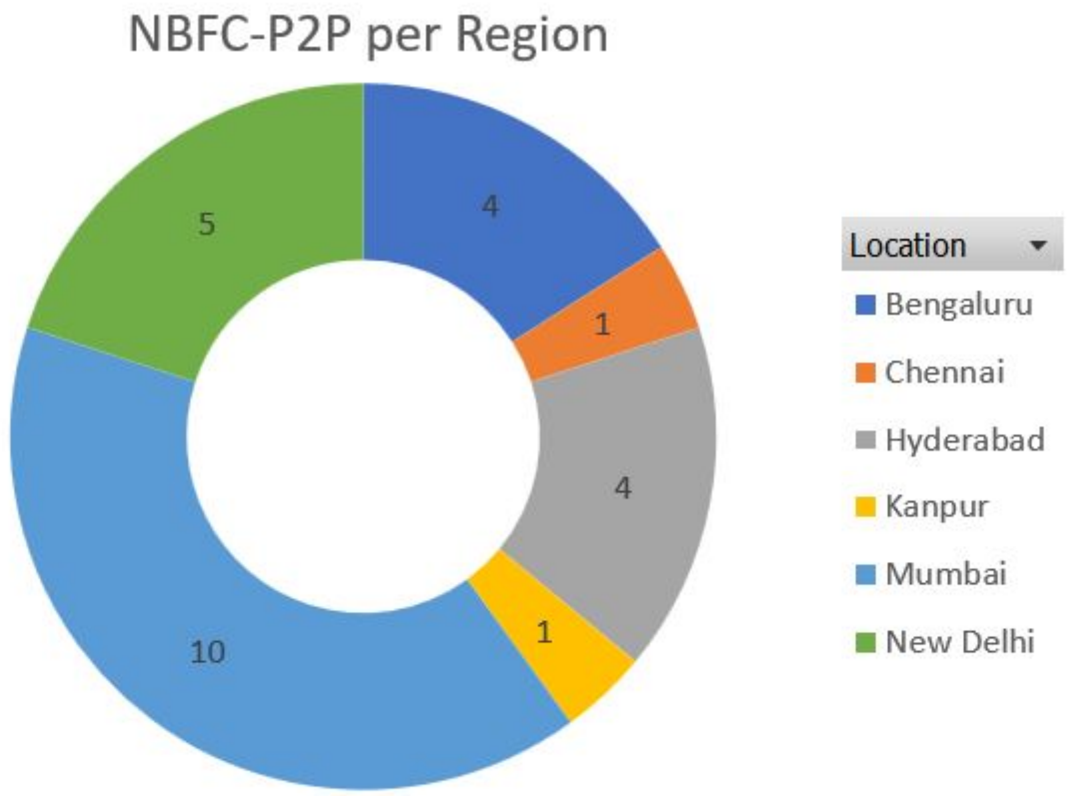
Brief History

- Peer-to-peer lending or P2P lending was launched by a U.K based firm called – "Zopa" in 2005
- Followed by "Prosper" in 2006 in the U.S
  - The idea boasted of connecting millions of lenders and borrowers through the platform.
- The idea spread to Asian Countries as well. "WeLab" in Hong Kong
- Australia following suit with "SocietyOne" in 2012
- The suit was followed in India as well and a need to regulate was felt in lieu of which RBI came out with Master Directions in 2017
- As on March 31, 2023, a total of 25 NBFC-P2P were registered in India



NBFC P2P registered across various Indian states (Source: RBI)

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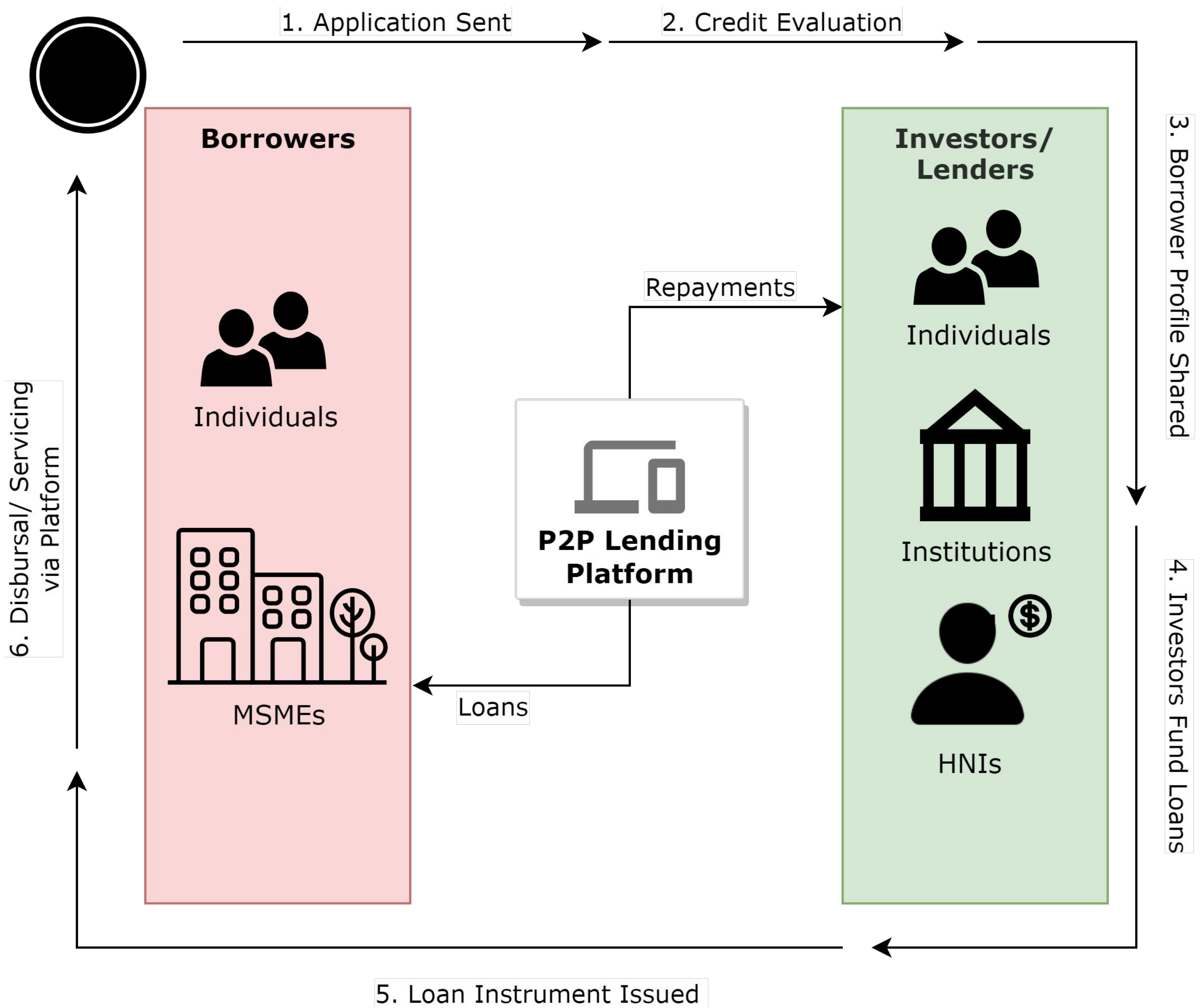
How P2P Lending Works?



- The prospective borrower registers on the platform by submitting credentials and makes an application.
- The platform process the data, does a preliminary credit evaluation and generate a report summary for the investor's perusal.
- The investor, relying on the platform's credit evaluation or additional assessment, makes the funding decision.
- The borrower pays a loan origination fee to the platform and the lender pays a fee for loan sourcing and processing to the platform.
- Loan instrument is executed and the disbursal and servicing, generally, occur vide the Platform

Note *- The interest rates are in some cases decided by the platform or could be decided mutually by the parties.*

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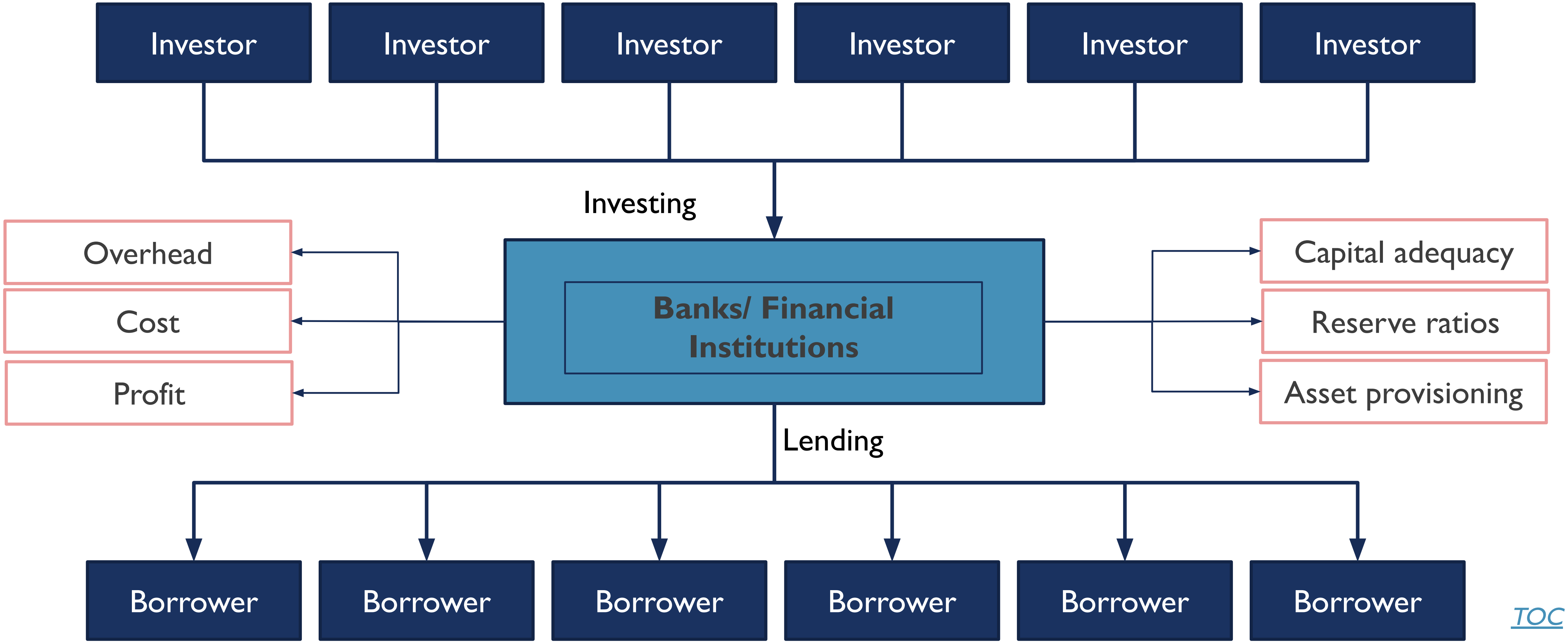
Bank Finance Vs. P2P Lending (1/2)



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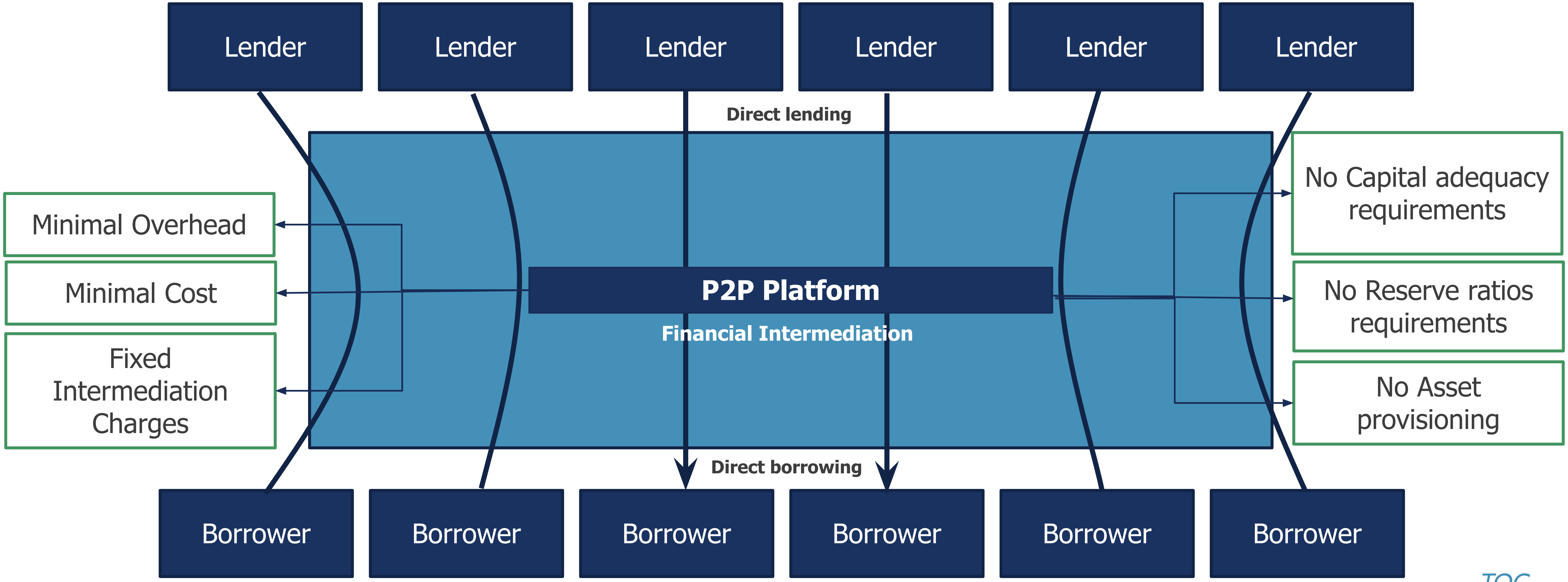
Bank Finance Vs. P2P Lending (2/2)



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Why P2P Platforms?

Advantages for Borrowers

- **Easy Application**
  - Application can be made online by putting in a few pieces of personal information
- **Speed of Funding**
  - Loans can be raised in matter of weeks, whereas the banks and other institutions takes over a months time to sanction a loan
- **Funding for all kinds of loans**
  - P2P loans can be raised for any amount, even amount which are small/ large enough for banks to reject them

Advantages for Lenders

- **Spreading Risk**
  - A single P2P loan may be funded by a number of lenders, leading to distribution of risk among the borrowers
- **Higher Earnings**
  - The lenders uses their own discretion to finance a loan request, so he/she decides on the interest component of the loan
- **Choice of Borrowers**
  - Lenders have the full knowledge of the parties to whom their fund goes, unlike banks where the bank lend out the funds and the individual depositors have no knowledge where there funds are invested by the bank

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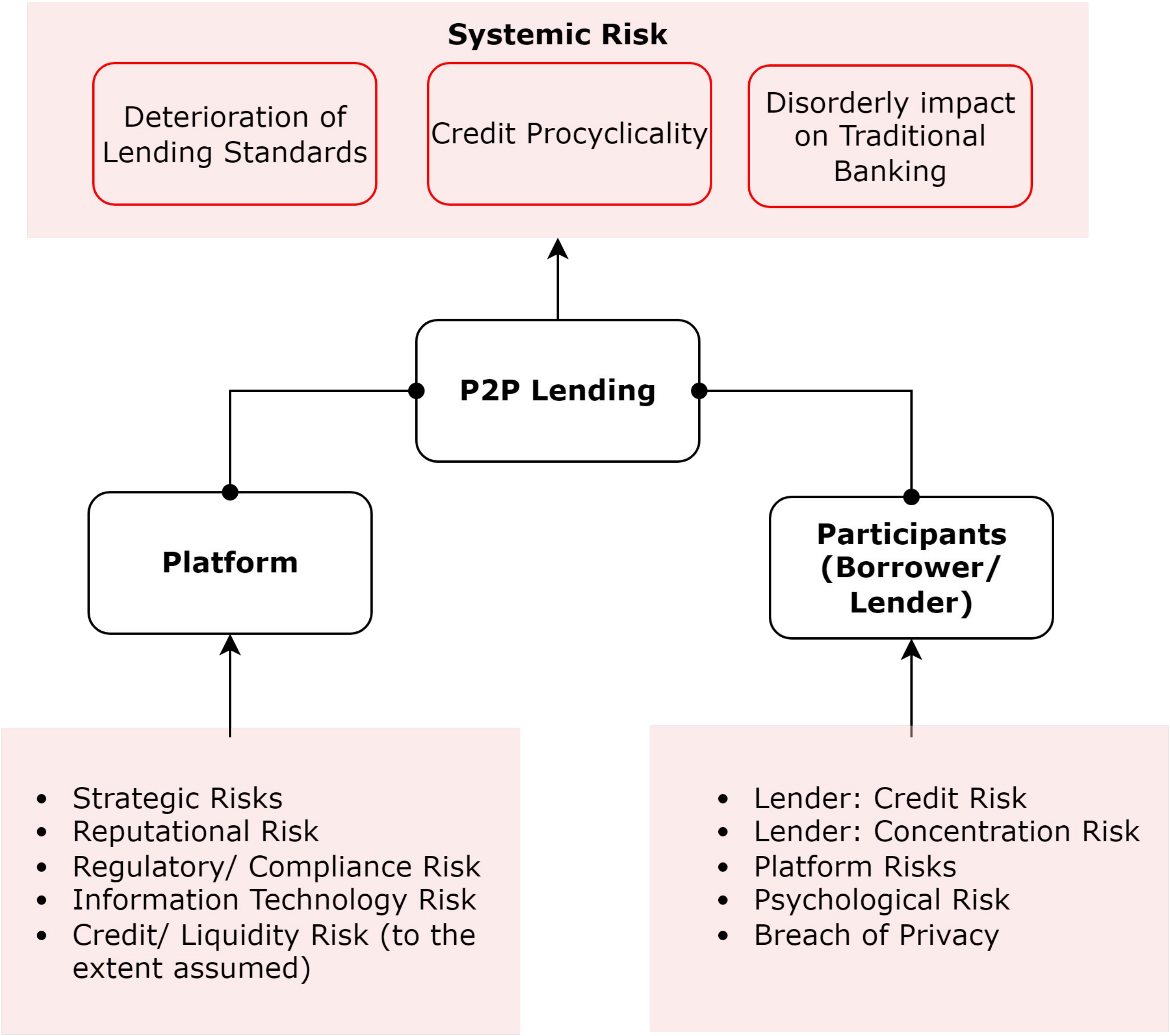
Identified Risks



- **Systemic Risk:** In India, P2P Lending Platforms are categorised as Base-layer entities (under SBR framework). Hence, from the point of view of India, one can conclude that the regulator currently perceives systemic risks stemming from such Platforms to be trivial.

Industry/ Sector-specific Risks affecting P2P Lending:

- Formal P2P lending platforms are of recent vintage. Limited precedents to learn from or rely upon for doing business.
- The larger the number of borrowers and lenders ('Participants') on platform, the larger is the success of the platform. Hence the success of the platform is dependent on number of borrowers and lenders using the platform and fees are often subsidised to lure Users .
- Simplicity of the product offering, and **proper functioning and availability** of the platform are also risks that the Participants/ platform needs to tackle.

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P2P Lending Models

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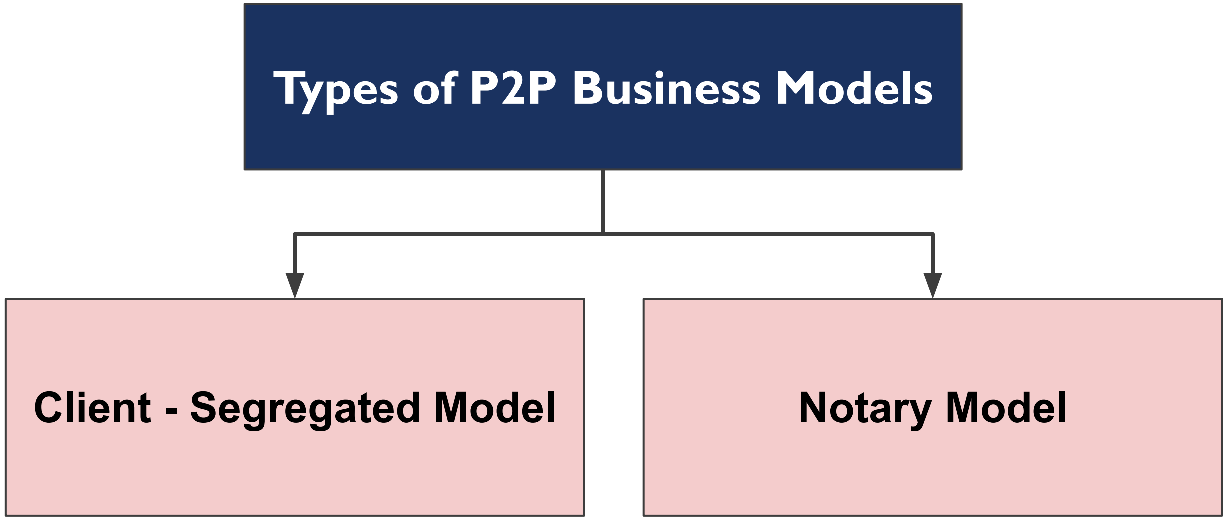
P2P Business Models



- The overarching idea of P2P lending platforms is to provide an online market that allows lenders to deal directly with borrowers
- P2P Lending vs Marketplace Lending
- Primary Models are - Client - Segregated (Traditional) and Notary Models

- Other prevalent models -
  - "Guaranteed return model" - the platform operator guarantees the creditors' principal and/or interest on loans
  - "Balance sheet model" - Balance sheet lending platforms originate and retain loans on their own balance sheet
  - "Invoice trading" platforms - offering recourse factoring usually to startups/ small business
- Such models, however, generally attract registration mandates and large P2P platforms, especially in the US, have secured full service banking licenses to continue operations.
- In India, Recent RBI Guidelines restrict entities that can participate in such models

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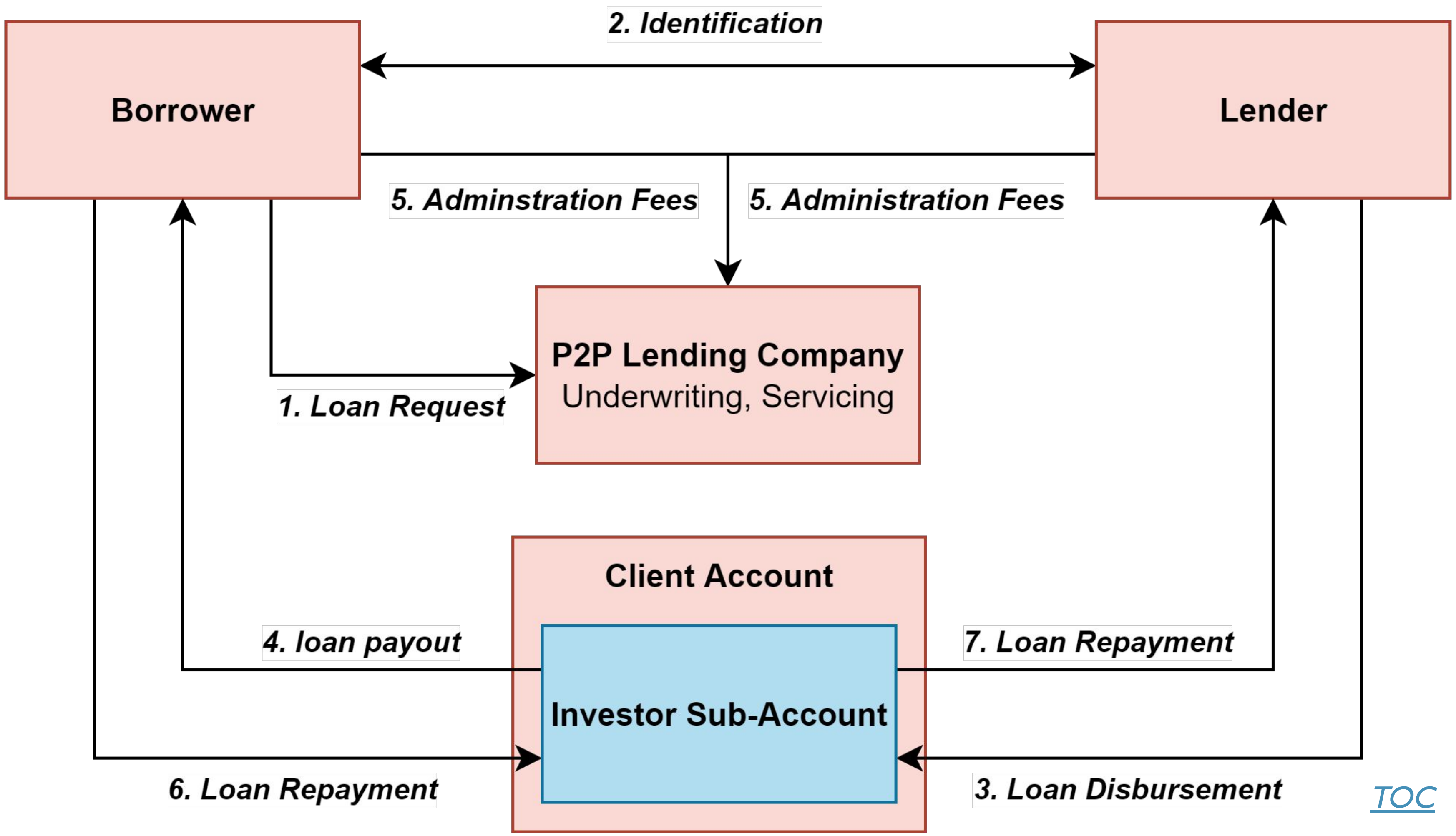
Client - Segregated Account Model

This is the simplest form of P2P model, where the lenders directly interact with the borrowers and they themselves fix their counterparties.



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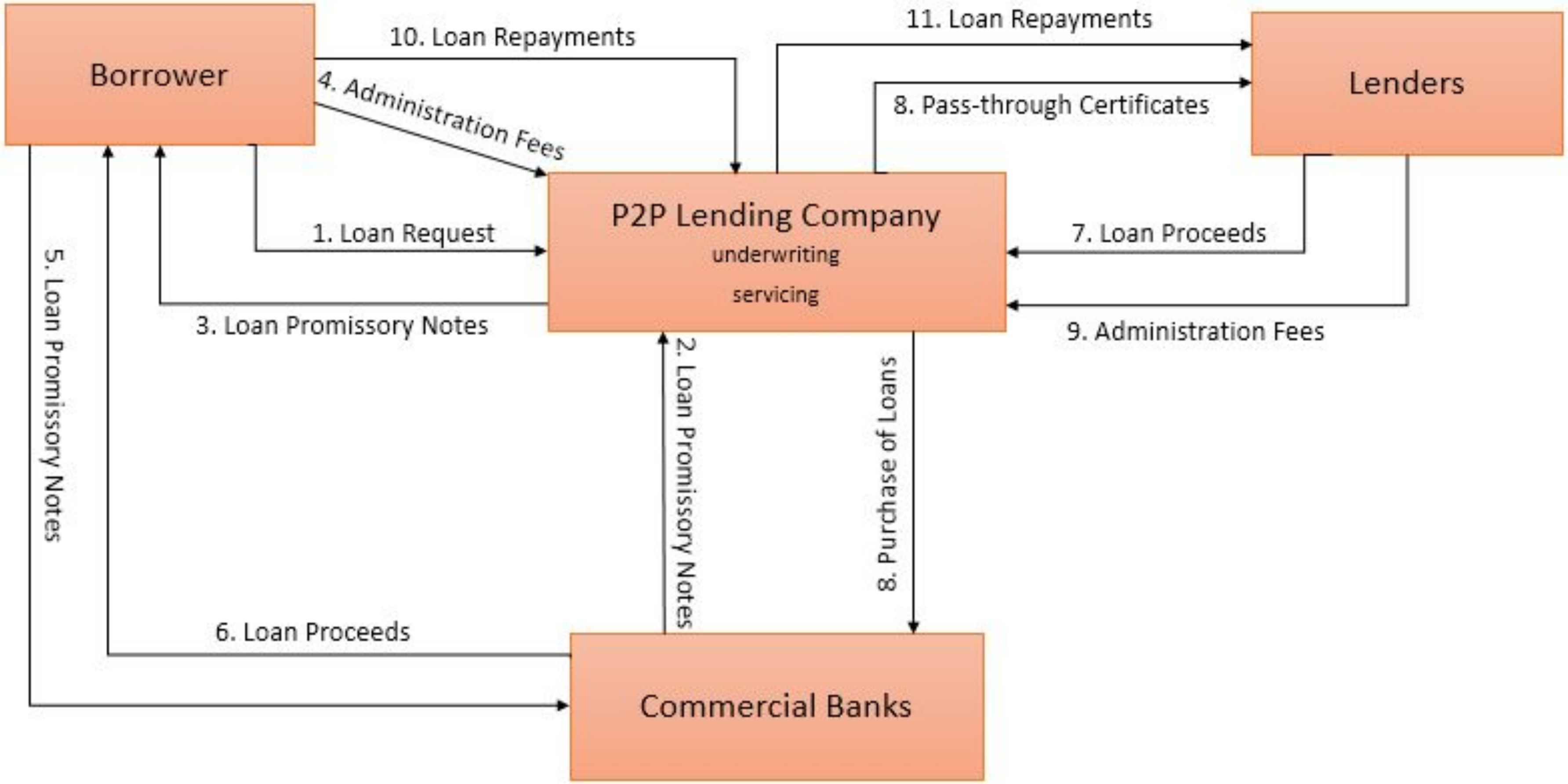
Notary Model

This is a significantly more complex form of P2P business, which involves a commercial bank apart from the lender and the borrower



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P2P Lending in India - Practices & Issues

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Market Scenario

- As technology continues to change fintech continues to make massive transformation. P2P lending has found its way into the financial mainstream in India
- Faircent was the first P2P platform registered in India. During the COVID - 19 pandemic it is reported to have disbursed upwards of Rs.1100 crores to more than 8 lac small businesses and individuals
- The industry's legal framework is provided by the RBI via its P2P Master Directions of 2017.
- The Regulator has imposed stringent conditions on the companies undertaking the business of peer-to-peer lending platform.
- One such condition that has weeded out small players is the requirement of having net owned funds of Rs. 2 crores. Further, there are caps on the exposure of the lender and aggregate loans taken by the borrower.
- P2P lending providers have shrunk. Currently there are only 25 P2P platforms registered with RBI as per the data released by RBI on March 31, 2023

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Functions

The P2P Lending Platform in India, perform the following functions -

- Act as an intermediary between the Lender and Borrower (i.e. the platform participants)
- Store and process data relating to its activities and participants
- Undertake due diligence of participants
- Undertake credit assessment and risk profiling of borrowers and share such assessment with the lenders
- Undertake of documentation of loan agreement and other such documents
- Render services for servicing/ recovery of loans originated on such platform
- Credit Reporting to CICs for loans disbursed via the Platform

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Revenue Model

- The platform earns by way of fees/ charges on the participants (lenders and borrowers)

From Lenders

- Fixed charges:
  - Platform registration fee (usually waived)
  - Documentation/ processing fee per loan or plan invested in
- Transaction value linked charges:
  - Servicing fee as a percentage of loan disbursed/ investment amount,
  - Recovery charges as a percentage of amount recovered
- Contingent charges:
  - Withdrawal charges over a specified limit
- Return linked charges (usually linked to servicing):
  - Step-up rates linked to APR/ actual ROI
  - Sweeping returns over a specified threshold rate

From Borrowers

- Fixed amount charges
  - Platform registration fees (usually waived)
  - Loan request registration/ loan service charge
- Transaction value linked charges
  - Loan tie-up (% of loan amount disbursed via the platform)
- Contingent charges
  - Prepayment charge
  - Payment delay charges

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NBFC-P2P Regulations (1/2)

Key Requirements:

- Registration requirement - Only NBFCs registered as NBFC-P2P can carry on business of P2P
- NOF requirement of ₹2 crores, Max. leverage ratio of 2
- Restriction on activity - May only act as intermediary. May provide services involving credit assessment and risk profiling of the borrowers
- Platform (website) disclosure requirement (e.g. credit assessment methodology, data privacy, grievance redressal mechanism, portfolio performance incl. share of NPA)
- Must meet specified prudential requirements to be eligible for declaration of dividend
- Transparency requirement -
  - Borrower details to lenders
  - Lender details to borrower
- Reporting to CICs
- Reporting to the RBI (quarterly statements on disbursements, closure, outstanding)
- Fund transfers through escrows under the control of a trust. Trust should be bank promoted.
- Robust information technology framework/ BCP, requirement of IS Audit
- Governance - Prior approval for change in ownership or control (shareholding > 26%), takeover or acquisition

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NBFC-P2P Regulations (2/2)

Prudential Norms:

- Concentration limits: The Directions provide for several concentration limits:
  - Maximum that a single lender can lend across all P2P platforms – Rs. 50 lakhs
  - Lender investing more than Rs. 10 lakhs shall produce a certificate to P2P platforms from a practising CA certifying minimum net-worth of Rs. 50 lakhs
  - Maximum that a single borrower can borrow across all P2P platforms – Rs. 10 lakhs
  - Maximum that a single lender can lend to a single borrower across all P2P platforms – Rs. 50,000
- Loan type & tenure: Unsecured loans with tenure not exceeding 36 months.

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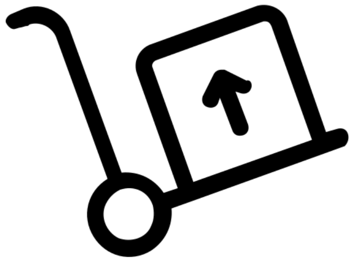
Innovative Practices (1/2)

Secondary Market & Offloading of Loans

- P2P lending platform advertise themselves as platform where refinancing may be obtained.
- Allowing borrowers stuck with high interest cost to refinance such loans with more competitive rates.
- Platforms also provide a secondary market Lenders can opt to list their existing loans for sale, as well as buy loans that have been listed on the platform provided marketplace
- Algorithmic matching mechanism may be provided (similar to exchange OMM)



Issue: Opacity of such platforms, especially, related to lender identity it may also be used by institutional lenders to offload their existing loan commitments to retail participants registered on such platform.

Platform as participant

- Platforms themselves go beyond the role of mere intermediaries and assume credit risk on their balance
- Providing a part of the funding or by using other off-balance sheet method such as guarantees.
- Such guarantees may be in the form of partial principal protection or by assuring a rate of return against a fee or in return for sweeping any residual return.

Issue: While such practices creates a 'skin in the game' for the platform provider it also leads to spreading of substantial credit risks beyond regulated entities that are guided by regulatory capital and other prudential requirements.

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Innovative Practices (2/2)

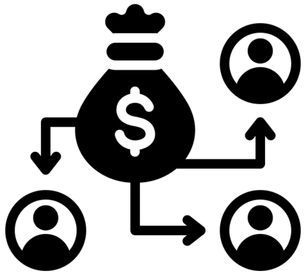
Partner Tie Ups

- P2P Lending Platform are naturally incentivised to provide a large and diversified loan portfolios
- Tie ups are developed purpose of sourcing of loans.

Issue: Product bundling - such partnerships come with corresponding commitments to find lending partners or provide associated financial services like insurance or servicing contracts.

Aggregation and Fractionalisation

- Single investment commitment by a lender may be spread across multiple borrowers/ loans, a
- Single loan may be funded by multiple lenders. The quantum of the funding requirement may be an organic motivator for such fractionalisation
- Such slicing, dicing and admixing provide a diversified portfolio of loans to invest in. Creation of a corpus/ fund as well as creation of bite-sized lots for allowing retail participation in the nature of collective investment schemes.



Issue: With commercial and institutional loans also being registered on the P2P platform, the platform also assumes the complexion of a retail bond/ securities trading platform.

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