February 18, 2023

Peer To Peer Lending in India

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FOREWORD[1]

As technology continues to change the way we book flights, book a taxi, or search for a hotel room, fintech continues to make massive transformation in the way flow of money and settlements of transactions happen. One of the ways fintech continues to make significant impact on the world of finance is to enable fintech-based lending. Known by various names as fintech credit, marketplace lending, crowdfunding of loans, P2P lending, etc., there is no doubt that these forms of lending transactions are the most remarkable development of the decade.

It may be sensible to distinguish the amplitude of each of the terms – the term fintech credit is quite broad, including in its ambit all forms of credit originated making use of fintech – including online lending. Marketplace lending include lending where lenders and borrowers are connected making use of online platforms, but on the supply side, there are wholesale lenders as well as "peers". Strictly speaking, the term P2P lending should include only such lending where there are peers on both the sides – that is, lending by persons who are not professional lenders, connected with borrowers mostly including individuals and small businesses. However, these terms are mostly intermixed. In this report, we have used the term P2P lending as implying marketplace lending.

The growth of marketplace lending over the recent years has been phenomenal. While in more mature markets such as the USA, there have been periods of slow growth or negative

[1] As appearing in the previous instalment of the Report (2019-20)

growth in personal lending, at the same time, the growth in SME-focused lending or student loans has made good for the reduced volumes.

As the marketplace lending industry gains its size, it obviously became the target for regulatory attention. In fact, the latter might have been far higher than the growth itself. There have been arguments that the growth of P2P lending will weaken financial stability, since regulators will find it difficult to monitor a largely dispersed base of lenders or lending platforms. There are issues of frauds, causing wide-spread losses. Additionally, the platforms, with little skin in the game but with impressive data of high returns and low defaults in the past, may attract lenders thereby reducing underwriting standards, promoting lax lending, and so on. Prof Jan Kregel of the Levy Economics Institute warned regulators thus: "The new payments systems have the ability to evade or distort regulation on financial institutions, and P2P lending systems replace due diligence of banks with algorithms. The regulation of this system is thus critical. P2P lending is the modern day equivalent of Securities Affiliates, which were at the centre of fraud in the run-up to the Great Depression. These systems eliminate normal due diligence, and they pose a huge threat to stability in the system."[2] Thus, unsurprisingly, regulation of P2P lending has been the regulatory theme. Chinese regulators had come up with multi-agency regulations, imposing several regulatory norms. The USA continues with its approach dating back to 2008 holding that the tradable loan notes issued by P2P platforms are securities, and thus, come under the regulations of the SEC, whereas, if the platform is simply originating loans for the banks, the platform acts as a conduit to originate for the respective banks. Several of the US consumer lending laws also apply to P2P lending platforms. The UK also regulates P2P lending through its Financial Conduct Authority (FCA).

In India, the RBI has notified[3] P2P lending platforms to be NBFCs, using its powers conferred by sec. 45I (f) of the RBI Act.

In India, the P2P business seems to be riding piggyback on the growth of consumer lending, which is currently seeming interesting for both banks, non-banking financial companies, as also informal lenders. The rates of return on P2P lending are substantially higher than those offered by traditional investment opportunities. To the extent this is the reason for attracting capital on the platforms, the same may be short-lived. Eventually, P2P lending has to thrive on building direct connectivity between the end-provider of money and the end-user of money, i.e., the economics of disintermediation. of course, such economics also need to take into account the structural risk that come with such disintermediation as has been highlighted by the RBI in its 25th Financial Stability Report[4].

In this Report, we have tried to capture the development of the P2P lending business in India and the world. We have done primary research talking to several P2P lenders in business in

[2] http://fessud.eu/financial-stability-risk-peer-peer-lending-new-payment-systems/

[3] NBFC-P2P Master Directions notified by the RBI - https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11137

[4] https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=1203

India, and therefore, the Report is not merely a collation of work already done, but extends the understanding of the business in India with work of primary significance. We hope readers will find this work useful. --**Vinod Kothari**

ABSTRACT

P2P lending is in a nascent stage in India. With the country boasting a wide mobile phone connections of around 1.14 billion in October 2022 (as compared to approximately 1.16 billion, a slight dip of ~2% year-on-year)[5] along with an increased focus on financial inclusion, P2P lending has brought about the possibility of a major disruption in the way people avail credit, and the role of banks and financial institutions in this.

With the RBI coming out with the P2P Master Directions in October 2017[6], the industry has a formally recognized legal framework, and no longer needs to operate in a regulatory grey area. There is now a definite set of guidelines and regulations that govern this industry. This report discusses these guidelines at length.

The report also discusses various models of P2P lending and draws on and discusses good and bad experiences worldwide, including from the USA, UK and China. It then goes on to compare the regulatory regime in India with that in these countries.

We also carried out a market survey among Indian P2P players concerning their business practices. The results are contained herein. P2Ps also offer an array of ancillary services such as credit assessment, profile verification and loan monitoring to name a few. We discuss these from a regulatory angle. Lastly, worldwide, P2P platforms have sought to counter investor hostility by maintaining a skin-in-the-game. These mechanisms are also discussed.

While so far P2Ps are complementary rather than competitive in nature to banks, it would be in the interest of both to join hands instead of competing with each other which would allow them to offer services to various classes of borrowers in conjunction rather than fight to win market share.

[5] As per Telecom Subscription Data available on the TRAI portal - https://trai.gov.in/release-publication/reports/telecom-subscriptions-reports

[6] Reviewed by RBI *vide* notification no. DOR.NBFC(PD) CC. No. 106/ 03.10.124/2019-120, dated 23.12.2019.

Introduction

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. Both the entities followed by several others boast of connecting millions of lenders and borrowers through the platform and of successful lending records over the years.

The idea spread widely to Asian countries as well over the years and the idea was often cited as an alternate or complementary role of banking. The concept of P2Ps has been extended to several kinds of business model, but doing lending using the proponents of P2P is what is causing a real disruption in the financial space.

This brings us to the most pertinent question as to what is P2P or P2P lending.

What is P2P and How does P2P lending work?

More commonly referred to as "loan-based crowdfunding", Peer-to-Peer lending is:

1. Interaction between two parties without the need for an intermediary who virtually meet and interact on a common network;
2. For loans/ financial assistance of unsecured nature.
3. P2P from a financial perspective, is facilitation of lending money to unrelated individuals, or "peers" without going through banks or other traditional financial institutions;
4. Lending takes place online on peer-to-peer lending platforms;
5. Operationally less cumbersome;
6. Easy registration and less cumbersome evaluation and documentation process along with faster loan processing time.

The following figure represents the transaction flow in a typical P2P transaction:

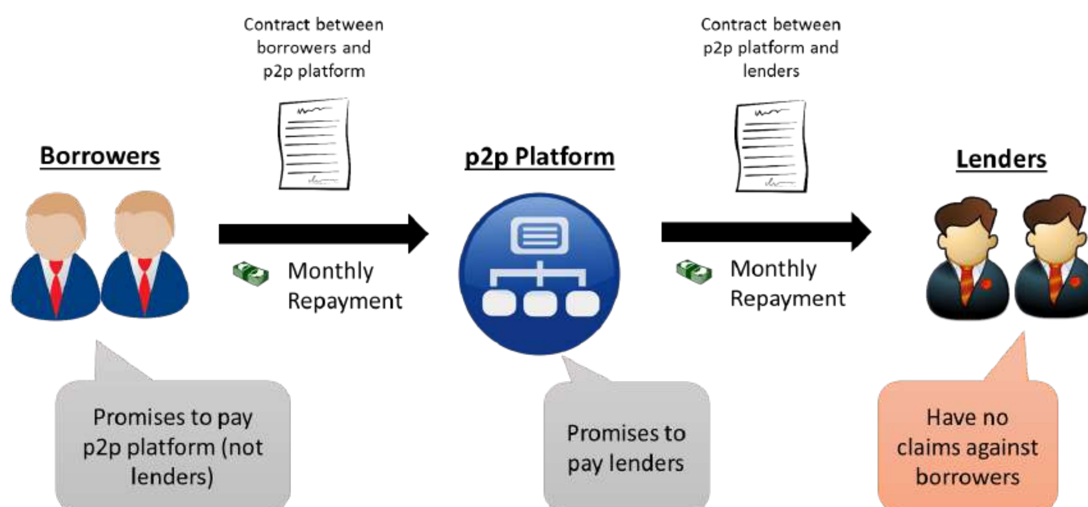

FIGURE 1: P2P LENDING PROCESS

The prospective borrower registers on the platform by submitting his/ her credentials and makes an application for a loan. The platform would process the data, do a preliminary credit evaluation and generate a report summary for the investor's perusal and the investor relying on the platform's credit evaluation report or with additional assessment of the borrower make the decision of lending.

The borrower pays a loan origination fee to the platform and the lender pays a fee for loan sourcing and processing to the platform, depending upon the terms of the platform. The interest rates are in some cases decided by the platform or could be decided mutually by the parties. Importantly, the routing of the money aswell as individual loan contracts is directly transacted between the borrower and the lender, and the same is only monitored through the platform.

FROM P2P TO MARKETPLACE LENDING:

On the P2P platform, as the name implies, the lenders are "peers", and the borrowers are "peers". The idea seems to be a large, open-ended group of self-help lenders, lending on a mutual platform. Mutual lending groups have existed through centuries – cooperative credit societies have existed in India, and different other forms of mutual savings institutions have existed, world-over, in different ways. However, the P2P platforms break the limitations of mutuality, and extend the lenders and borrowers both to a completely open-ended democratic mass.

This is how P2P platforms began – with non-financial entities on both sides of the spectrum. In the USA, Lending Club and Prosper, the two leading platforms, will issue participation notes for the loans, funded by warehousing lines of credit, which will then get transferred to retail investors. However, this was soon seen as resulting into creation of a

"security", and hence, attracting SEC regulations. In addition, with plenty of financial intermediaries' money being available for retail lending, institutional investors would soon start gaining preponderance as investors on the platforms. Hence, the word P2P platforms soon gave way to "marketplace lenders". That is, regulated lending entities will see the platform as a marketplace for loans.

P2Ps growing edge over banks?

As per the Global Findex Database 2021, issued by the World Bank[7], globally, about 1.7 billion adults remain unbanked—without an account at a financial institution or through a mobile money provider. The Federal Deposit Insurance Corporation estimated that, in 2018 approximately 6.5 % of US households were unbanked and 16% were underbanked.[8] Of such unbanked population, nearly half live in just seven developing economies *including* India. Tapping this void, the P2P Lending industry saw it as an opportunity to satisfy the high demand of borrowers, through matching them to yield-hungry investors.

P2Ps have caused a disruption in the financial intermediation space. It has established that borrowing can go beyond traditional and conventional means, beyond banks and financial institutions and so lending could not be restricted to these financial institutions. The direct access of the haves and the have-nots is what makes the proposition so lucrative and is thus growing in demand on both sides. Just as was the case for unconventional businesses, where banks and financial institutions could not offer funds and it led to angel investors and venture funds coming to aid, something similar happened in the P2P space as well, as they operate in a parallel realm of financial facilitation.

One theory about P2Ps is that they will disrupt the existing organisational and institutional structure of banking[9]. The edge that P2Ps enjoy over banks is evident, with low administrative costs, P2Ps can operate in a low margin space, work with customers who are turned down by banks and use technology for rapid customer service. However, the model also suffers from some disadvantages which arise out of the fact that the invention is fairly new for apprehensions on genuineness of business, sustenance of the business model to invest money in, legality of the business, transparency in

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[7] https://www.worldbank.org/en/publication/globalfindex

[8] https://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-beyond-covid-19-new-opportunities-for-fintech-companies.pdf

[9] The Business Models and Economics of Peer-to-Peer Lending by Alistair Milne, see link here https://www.ceps.eu/system/files/ECRI%20RR17%20P2P%20Lending.pdf

business transactions and acceptability to technology. These disadvantages seem to be only relevant till P2Ps have some seasoning and should get eased out with time. There are examples of disruptions quoted in The business Models and economics of peer-to-peer lending which include recorded music distribution, telephony or in air travel reservations, Airbnb (in consumer to consumer segment) etc. Currently P2Ps are seen as playing a complementary role to banks and financial institutions.

Crowdfunding is also a kind of P2P model, where several individuals invest for a common cause. In India, this is mostly used for creating a social impact (Ketto.org being an example, in this case).

On the business side, from a financial institutions' perspective, we understand that there is lack of outreach or unwillingness to cater to the financially excluded, as conventional means of financial facilitation do not recognise them. This limitation does not make them unsuitable candidates for lending. P2Ps not only confirm this theory but also are built on it.

On the other side, those with funds available for investment and looking for alternative means of investing also find the proposition much worthy of consideration, as the segment offers higher returns. While there is no authentic data available on the returns earned, business models adopted by P2Ps in India, but in a dialogue with ET, Faircent reported that P2P lenders would earn a gross return of 18-26%[10].

A NASSCOM- KMPG report suggests that the P2Ps lending industry will grow into a $4-$5 billion industry by 2023[11] given its attractiveness. An interesting comparative has been made for investors on why P2Ps are worthy of consideration as an investment option[12]:

Benchmarking						
Investment	**FD**	**Gold**	**MF**	**Real Estate**	**P2P**	**Rental Income**
RoR	6%	-12.50%	16%	5%	18%	7%
Taxable	Yes	Yes	Yes	Yes	Yes	Yes
Tax	30%	30%	0%	20%	30%	30%

10 http://economictimes.indiatimes.com/small-biz/money/over-90-lenders-in-p2p-lending-earn-gross-returns-of-18-26-per-annum-faircent-report/articleshow/58789339.cms

11 https://inc42.com/buzz/p2p-lending-fintech-loans/

12 https://p2plendingsite.wordpress.com/2017/06/30/12-benchmarking-p2p-alternative-vs-mainstream-returns/

Net RoR	4.20%	-8.75%	16.00%	4.00%	12.60%	4.90%
Downside	0%	10%	10%	0%	15%	0%
Invested	Rs. 1,00,000.00	Rs. 1,00,000.00	Rs. 1,00,000.00	Rs. 1,00,000.00	Rs. 1,00,000.00	Rs. 1,00,000.00
Risk Adj. Return	4.20%	-7.88%	14.40%	4.00%	10.71%	4.90%
Notes	YTD-returns	YTD-returns	YTD-returns (my avg. MF returns)	Annualised 5 year-to-date Return	Annualised 2 year return	Annualised 2 year return

Source: See footnote

One of the risks of lending on P2Ps is that they have a higher probability of to lower the returns in comparison to the mutual funds. In a later segment, we have analysed some of the aspects of P2P lending which also bring out these facets. A counter to this is that the risk is spread among several investors, if the P2P allows for several lenders to lend against a single loan. This in turn leads to spreading out of risks as against a bank offering a loan to a similar customer.

Benefits of P2P Lending

P2P lending has, over a few years, brought about turnaround changes in the economy as a whole and the way the masses look at their financial needs. It has aided the financial market in the following manner:

- **Financial inclusion**- The platforms enhance the availability of various alternative funding and investment options. Greater diversity in the sources of credit can also lower the risks that the economy faces when a few banks dominate credit provision
- **Lower cost of credit**- With availability of numerous options for funding, the demand and supply factors get operational. Thus, while demand being the same and the variety of sources widening, the cost is bound to lower down.
- **Diversification of sources of credit in the economy**.
- **Cushion against idiosyncratic risks of banking system**- "In other words, platforms might be a "spare tyre" for lending in the economy, much in the way some forms of market-based finance are for certain lending segments. While it is plausible that the funding environment could be unfavourable for FinTech credit platforms if there were concerns over the regulated banking system, in this case FinTech credit platforms might still provide another avenue through which credit could flow to other parts of the economy if bank lending were impaired"
- **Resilience of lending in the economy to pure liquidity shocks**.

Further, certain benefits exclusive to the lenders and borrowers are depicted in the following table:

Benefits to borrowers	Benefits to lenders
Spreading Risk: A single P2P loan may be funded by a number of lenders, leading to distribution of risk among the borrowers.	**Easy Application:** Application can be made on-line by putting in a few pieces of personal information.
Higher Earnings: The lender uses his/her own discretion to finance a loan request, so he/she decides on the interest component of the loan.	**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.
Choice of borrowers: Lenders have the full knowledge of the parties to which his/her fund goes, unlike banks where the bank lend out the funds and the individual depositors have no knowledge where their funds are invested by the bank.	**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**.**

Types of P2P Models

CLIENT-SEGREGATED ACCOUNT MODEL

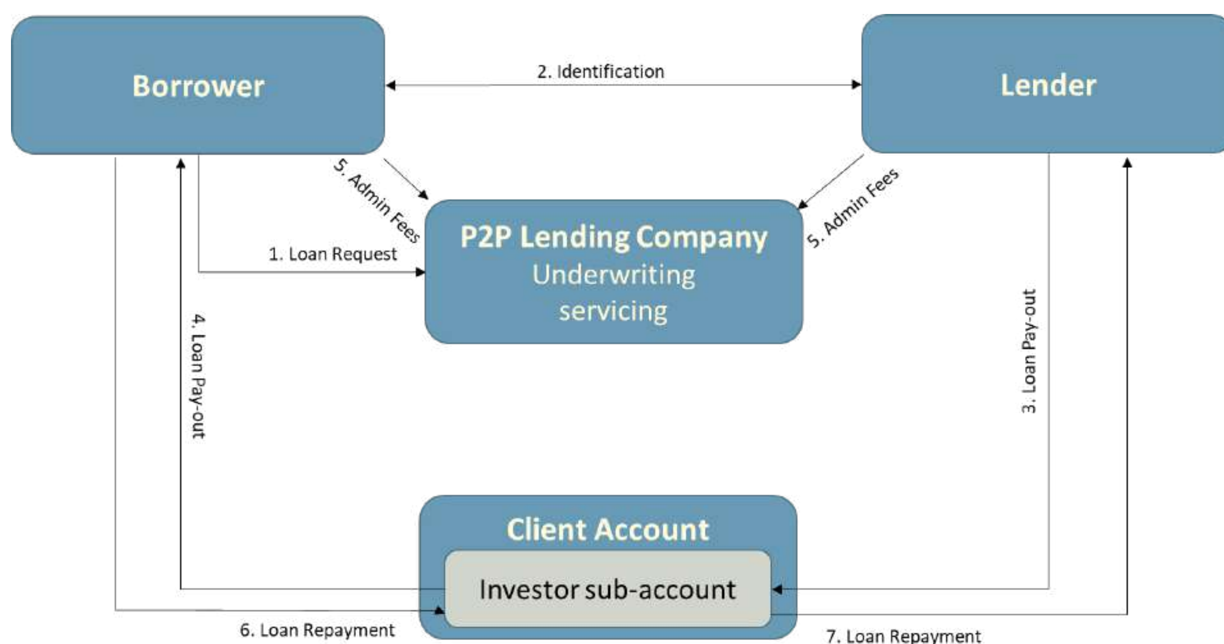

Figure 2: Client-Segregated Account Model- Graphical Representation

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

The process of client-segregated accounts model is briefed below:

1. The borrower first puts in a loan request on the P2P site
2. The loan request is then listed on the P2P website for the lenders to identify and act on the loan request
3. After successful identification and assessment of credit worthiness and various other factors related to the borrower, the lenders then release the funds in favour of the borrowers, which are deposited into a specific account called the Investor Sub-Account maintained with the P2P, there is a separate investor sub-account for each and every client (lender and borrower).Release of funds in favor of the borrower, is acceptance of the borrower's request for the loan
4. These funds are then transferred into the Investor Sub-Account of the borrower for him to put to use
5. On the remittance of the funds between the lender and borrower, the P2P usually deducts its loan origination charges/ administration fee, fees charged for using the platform, by whatever nomenclature it may be called, from both of the clients
6. At time of repayment, the borrower repays the amount by depositing the same into its Investor Sub-Account from where it travels into the lender's accounts
7. From the borrowers' Investor Sub-Account it travels into the lenders' accounts.

   While these accounts are operated by the lenders and borrowers themselves usually, the information pertaining to flow of funds is routed through the P2P portal.

This form of P2P model is very transparent as both the parties have complete knowledge of flow of funds. Here the lenders do not face any risk of losing their money in the event of bankruptcy of the P2P company as there is a direct agreement between the lender and the borrower, neither does the P2P faces any risk of claims from the lenders in case of default of the borrowers, as the lenders use discretion for making lending decisions.

The name "segregated" implies that the amount put in by the lenders is put into a segregated account, maintained by the marketplace lender, from where the funding to the borrowers happens.

NOTARY MODEL

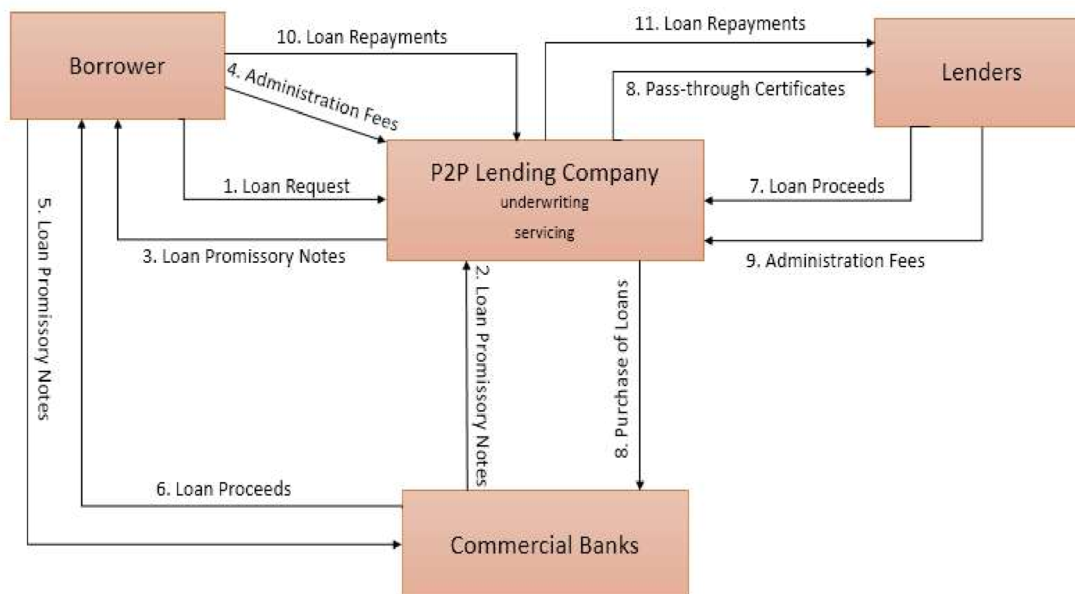

FIGURE 3: NOTARY MODEL-GRAPHICAL REPRESENTATION

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

The process of the notary model is briefed below:

1. The borrower first put in their loan request on the P2P site
2. The P2P then forwards the loan request to a commercial bank associated with the P2P, the bank then sanctions the loan and issues a note promising to pay the debt to the P2P
3. The P2P then forwards the note to the borrower
4. The P2P then charges its fees from the borrower
5. The borrower submits the promise note to the issuing bank
6. The bank in return pays the promised loan amount to the borrower
7. Meanwhile the P2P lists the loan request on its website, for the lenders to view them and advance funds to finance the loan request
8. Once there are sufficient funds with the P2P from the lenders, the P2P immediately buys the loan receivables from the lending bank and issues certificates representing debt converted into tradable units to lenders in proportion to the funding extended by the lenders to the loan
9. At this time, the P2P charges its administration fees from the lenders
10. At time of repayment of the loans, the borrowers pays the lenders through the P2P.

Essentially the loan origination is through a bank which acts as a vehicle to convert the loan into tradable units which are then subscribed by the lenders on the P2P platform.

This form of P2P model is advantageous to the borrowers as they do not need to wait for a lender to identify him/her and advance them loans, instead the P2P helps the borrowers by facilitating the banks to originate the loans and later converting the loan into a P2P loan. This is the model that was being used by the platforms such as Lending Club and Zopa.

Other Structures

Other structures have also emerged where the platform also has a ‘skin-in-the-game’ such as the ‘Guarantee Model’. P2P marketplaces have also Fintech companies indulging in lending on their own balance sheet and assume the nature of a ‘Balance Sheet Lender’. Such models, however, generally attract registration mandates and large P2P platforms, especially in the US, have secured full service banking licenses to continue operations.

Global Overview

Performance of P2P Lending Globally

The P2P model of lending remains the most widely adopted model of lending, as the lending volume in 2019 , excluding China, totalled to $33.6 billion constituting 37% of total global volume. In 2020 as well, the lending volume constituted 31% of the market share and quantified to a volume of $34.7 billion[13] (refer to the section on Impact of the pandemic in P2P lending). The global peer-to-peer (P2P) lending market is saw volume of $80.19 billion in 2021 and is expected to grow to $106.09 billion in 2022, albeit at a lower CAGR with the Russo-Ukranian war disrupting global economic recovery from the COVID-19 pandemic.[14]

The first ever P2P was Zopa. A U.K. born company established in 2005 that introduced this idea of raising funds from any common person around the world that had idle money lying with him. United States, seeing the rise of such a business model, introduced Prosper and LendingClub in 2006, two of the heavyweights in today's scenario as well. China too cloned this structure, with the P2P story mushrooming in the year 2007.

As on 30th September, 2022, loan origination through P2P in UK amounted to £5.7 billion in 2018. The cumulative loan origination volumes grew at a CAGR of 175% between the first quarter of 2005, when Zopa Ltd. launched the industry into existence, and the first quarter of 2019.

Further, AltFi reports[15] annual lending of £6.17 billion in UK in the year 2019. However, the annual volume for lending in the UK in 2020 declined to GBP 4.02 billion (£4.78 billion)[16].

Further, statistics show that, the global P2P Lending Market is valued at USD 67.93 Billion in 2019 and expected to reach USD 558.91 Billion by 2027 with a CAGR of 29.7% over the forecast period.[17]

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[13] https://www.jbs.cam.ac.uk/wp-content/uploads/2021/06/ccaf-2021-06-report-2nd-global-alternative-finance-benchmarking-study-report.pdf

[14] https://www.globenewswire.com/news-release/2022/12/01/2565843/0/en/Peer-to-Peer-P2P-Lending-Global-Market-Report-2022-Ukraine-Russia-War-Impact.html

[15] https://www.altfi.com/state-of-the-market

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