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Prospects Of Non Conventional Souces Of Credit- A Case Study On Peer To Peer Lending In India

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Abstract: *The mainstream financial system imploded after the collapse of the financial system in 2008 which left millions of borrowers an extraordinary debt burden and individuals and small businesses cut off from fresh sources of credit. The volatility in the stock markets and low rates in most categories of bonds popularized the term disintermediation and prompted more investors to turn to non conventional sources of funding. Revolutionizing credit was considered as a need of the hour. In this growing global market getting in touch with potential investors and borrowers is challenging and this is where these non conventional lending platforms come in with their technology enabling them to operate more efficiently and at cost advantage than the traditional banking system. Markets like the USA and the UK have adopted the concept of peer-to-peer lending and numerous financial organizations are successfully operating in that space. In India the concept is new, but lending market is huge and there is great potential for the concept of peer-to-peer loans to be a success. Several online portals have sprung up in India to facilitate such lending, some even getting private funding from investors, but it is still at a nascent stage compared with countries such as the US and China. It is now time to wait for regulations to come in from RBI and SEBI to actually evaluate the effectiveness of this platform. According to SEBI, India, so far does not face a significant exposure to crowd funding but given that this mode of fund raising is growing at a scorching pace, it is important that regulators keep an open eye and a vigilant attitude. RBI is actively studying P2P arrangements with an eye on risks that may emanate out of such innovations.*

Key words: *crowd funding, Non conventional sources of finance, Peer to peer lending, credit scores*

I. Background Of The Study

The global financial crisis, investor appetite for alternative sources of yield, big data and improved analytics, faster response times, quicker loan approval times and faster funding are few factors that paved the way for innovations in credit platform. Crowd funding being a non conventional credit platform refers to a spectrum of activities and the underlying idea is: that funding that one would have to borrow is gathered from a group of individuals. Technology expands access to credit (Einav, Jenkins, and Levin 2013). The growth of internet has allowed this to be applicable for a much larger and diverse crowd. Debt based form of crowd funding is peer to peer lending, social investing, direct consumer lending or market place lending. It is the household credit implementation of crowd funding. The number of P2P lending companies in the online space has been increasing significantly. So far this year, close to 20 new online P2P lending companies has been launched, according to data compiled by Tracxn, a data analytics company. As of now, there are over 30 online P2P lending start-ups in India. This is much lower than in China, where the number of registered P2P companies is reported to have crossed 2,000.

WHAT IS PEER-TO-PEER LENDING?

A method of debt financing that enables individuals to borrow and lend money - without the use of an official financial institution as an intermediary. Peer-to-peer lending removes the middleman from the process, but it also involves more time, effort and risk than the general brick-and-mortar lending scenarios. The advantage to the lenders is that the loans generate income in the form of interest, which can often exceed the amount interest that can be earned by traditional means (such as from saving accounts and CDs). Plus P2P loans give borrowers' access to financing that they may not have otherwise gotten approval for by standard financial intermediaries.

GLOBAL SCENARIO

So far, marketplace lenders have focused on unsecured consumer credit, with roughly 80% of loans used to consolidate debt, and small business loans—with an estimated $100 billion in unmet demand solely in the US. According to Morgan Stanley Research estimates , marketplace lending has increased over the years,

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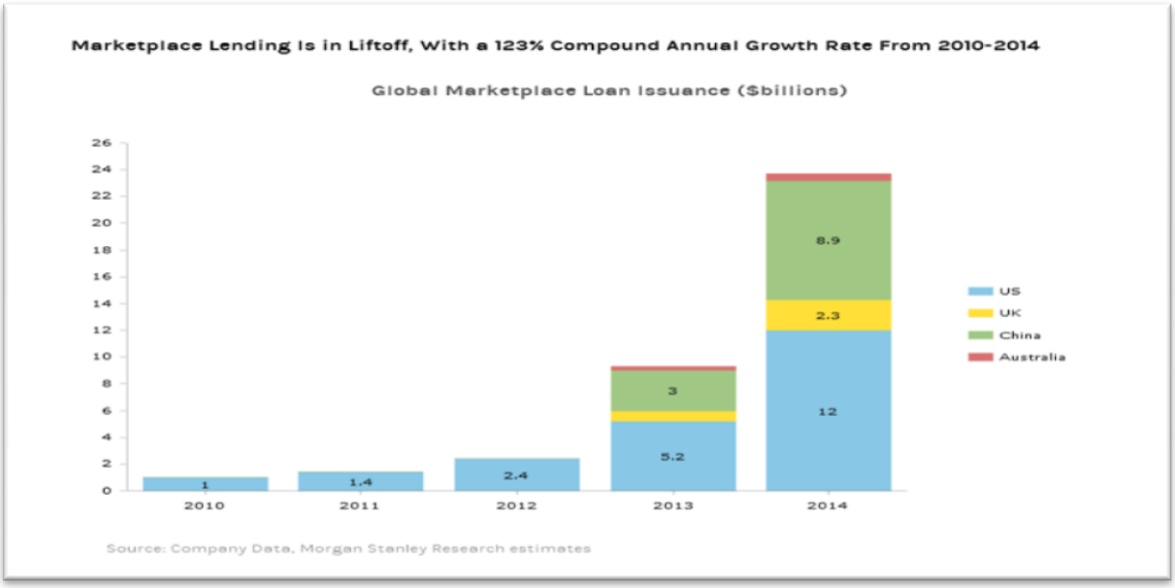
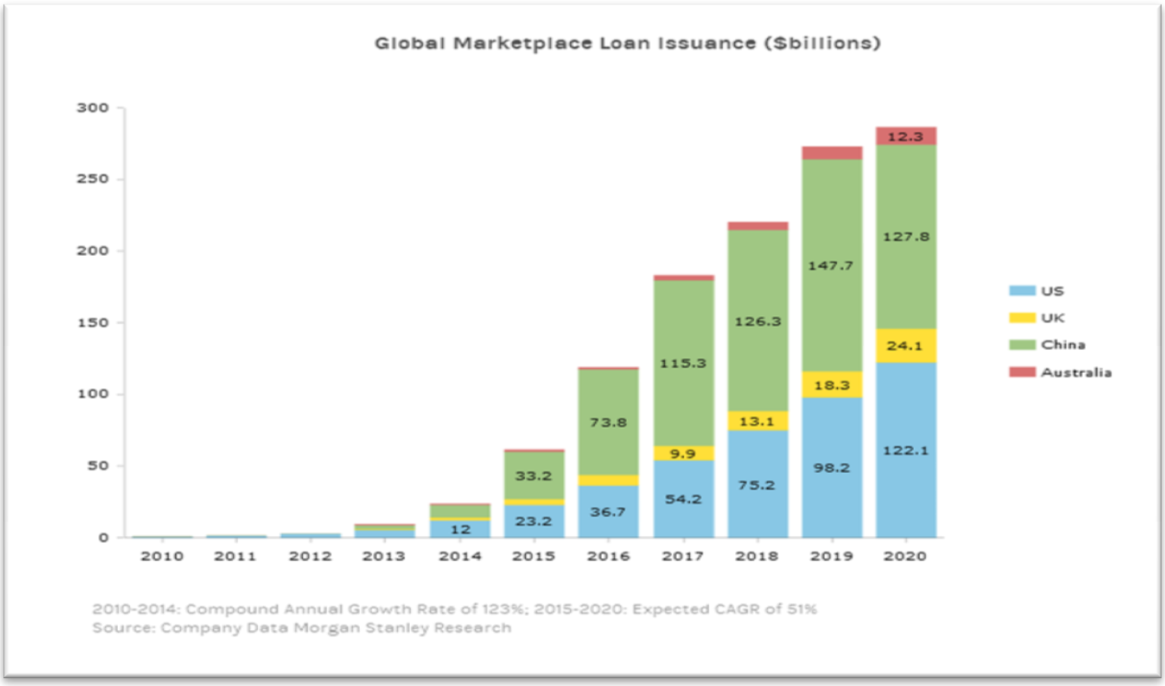
2014 being the leading year in terms of both CAGR as well as loan issuances. China and USA are the most prominent players in terms of loan issuances. P2P operates in china, the USA, Australia and the UK. In china it operates with more than 1500 lending platforms and operating both online and offline.





Peer-to-peer lending platforms today with a promise of disintermediation are sustained by a wide array of intermediaries, including banks, secondary markets facilitated by note trading platforms, third party investing tools that analyze loan data and automate the investing process, wealth advisory firms that help large investors manage portfolios of loans, and marketplace platforms that match lenders and borrowers within a larger pool of peer-to-peer loan originators.

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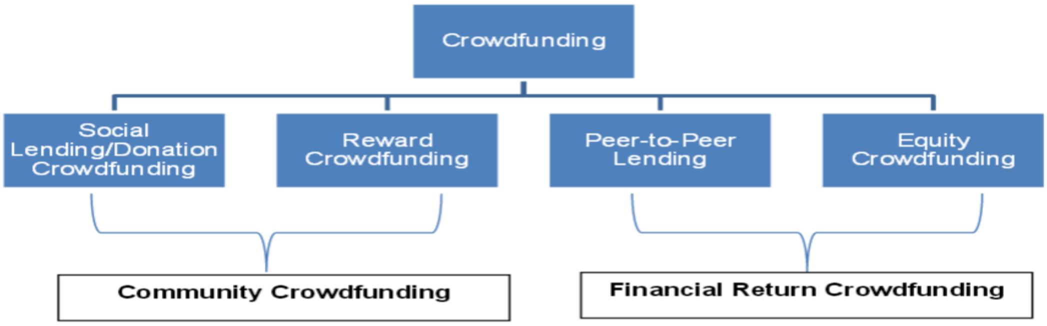
II. The Ecosystem Of Peer-To-Peer/Marketplace Lending Today



Source: IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast , 2014

Like crowd funding and microfinance, the emergence of peer-to-peer lending has its origin in what is sometimes called "collaborative finance." Fueled by the "growth of mass collaboration via the Internet," its advocates argue that collaborative finance is characterized by "transparency, openness, and sharing" horizontally among peers. P2P is indeed a disintermediation of consumer finance using a social marketplace. The disintermediation facet is that, investors wanting diversified exposure to a fixed income asset class of consumer loans need not go through asset-backed security (ABS) markets, removing layers of intermediation and opening the asset class to smaller investors. According to Morgan Stanley report it is a fast-growing financial model, with global variations, that is predicted could upend the traditional banking industry. Right now, however, it is attracting institutional investors, as well as big banks eager to learn how to become more agile. In 2014, around 65% of over $3 billion in loans on Lending Club and Prosper (US P2P platforms) were funded by institutional investors who purchased whole loans. Among large investors include banks, hedge funds, business development companies, and others.

P2P platforms are able to market themselves as modest community operations with an advantage of reduced costs for lending and borrowing. Zopa, a British P2P platform, offers 4.9% to lenders (most bank accounts pay nothing) and typically charges 5.6% on a personal loan (which is competitive with the rates most banks charge). The intermediaries such as lending club in USA, Faircent and i-lend in India are platforms that use a credit score-based model for evaluating investment options. P2P lending provides funding that might not be available elsewhere and rates are lower than for alternatives. With the retail business model seeming to be firmly entrenched, P2P lenders are now allowing institutional investors, private equity firms and even traditional banks to lend through them. Indications are that investors can earn much better returns by buying the safest loans from some of the P2P platforms and now there are discussions about developing secondary markets for such loans and their securitized products.

In P2P arrangement the individuals, fund small portions of loans and receive their principal plus interest when the borrower repays the loan. Borrowers choose P2P lending for three primary reasons: (a) Lower interest rates (b) Quicker disbursal times (c) Greater access to credit.

P2P lending companies, apart from finding potential lenders and borrowers, also provide support services like verification of identity and financial details of the borrowers, credit models for pricing of loans and customer service to borrowers. Screening of loan applications is done by following credit score used by formal lending institutions and also rely on additional self-reported information that traditionally are not reported to credit bureaus . They use variables such as a borrower's income, debt-to-income ratio, number of inquiries on the credit bureau, and loan payment performance on prior loans, among others. This doesn't mean that there is no risk of default. When lending money there is always a risk of default but it is how mitigation of risk happens. The loan grade is determined based on the lending platform's historical loan performance and payment history, which is used to predict how a particular loan is likely to perform. The loan grade sets a range of possible interest rates. For example, a loan on Lending Club with a letter grade A (highest score) on the Model Rank, has an average 7.64% interest rate, whereas loans with grades F and G (lowest score) have an average 22.53% interest rate. This is what makes lending through P2P a good investment decision. P2P ensures that the loan is monitored during its tenure and also helps investors to recover a default by engaging the services of a collection agency. Peer-to-peer lending started out as a relatively simple system for facilitating loans between individuals online, but has since grown into a complex ecosystem of technologies, institutions, and auxiliary startups. Today, globally the peer-to-peer lending landscape can be represented broadly as in Annexure 1.

P2P LENDING: THE INDIA SCENARIO

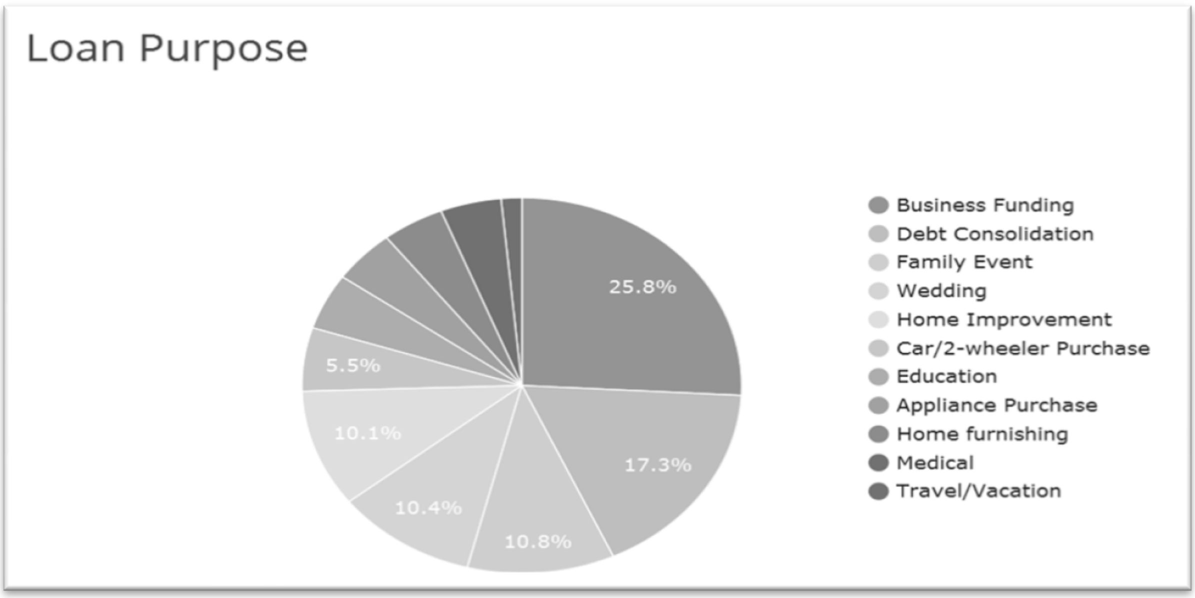
Last decade witnessed the advent of peer-to-peer lending in the Western market and it soon gained traction. Today, some of the top P2P lending companies operate out of USA and Europe. The concept of P2P lending in India is relatively new and is yet to create a strong foothold. Over the last few years, multiple companies have come to offer peer-to-peer lending services in India and are witnessing a fairly good response.

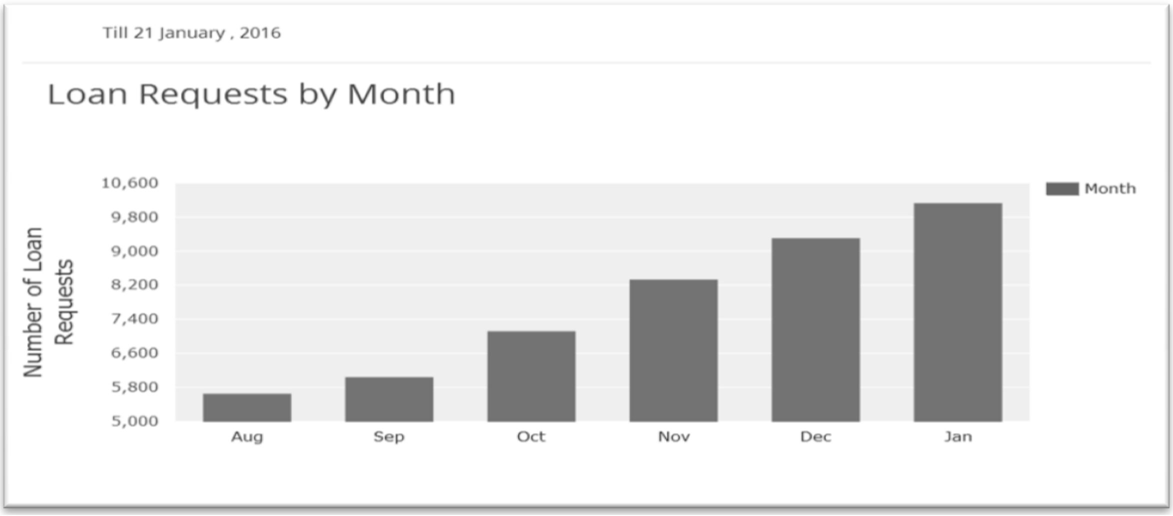
THE KEY TO SUCCESS

The Indian market is huge and immensely potential for P2P lending platforms. There is a need now to educate and spread awareness about this to consumers in Indian who are now in the framework of formal credit. A financial market as regulated and dominated by legacy like India would require P2P lending companies focus strongly on their customers. With high bank rates, strict loan margins, formalities and documentation conventional sources of credit is slowing becoming unpopular among borrowers. It is in these scenarios that peer-to-peer lending can help borrowers avail quick loans. As most of the P2P lending platform enables direct interaction between borrowers and lenders, loan settlement becomes an easy process. With the power to negotiate for the best interest rates, the borrowers are ensured of loans at good rates and fast as well. On the other hand, investors with an outlook to invest can explore multiple investment options with peer-to-peer lending. With the ability to select multiple creditworthy borrowers, investors are now assured of fixed monthly returns.

III. Data Analysis With Specific Reference To Faircent.Com(P2p Platform)

According to Faircent one of the leading P2P platforms in India, the concept is one of the most innovative financial products of recent times. The data collected from the loan issuances details under Faircent gives us a clear view of the status of P2P in India. Using a snapshot of loan data, we can characterize borrowing and lending trends. Loans are availed for various purposes business as well as domestic. The main reasons being funding the business, debt consolidation and for personal purposes. There is an increase in the number of loan requests at the same time. The increase in the loan requests suggest us the gaining popularity of the platform by lenders and borrowers. The ROI on the loan transaction is dependent on the risk buckets. High risk profile borrower will be charged a high rate of interest and a low risk profile borrower is charged with an average rate of interest.





Source: Faircent.com

Loan Requests by Tenure

Month	Aug	Sep	Oct	Nov	Dec	Jan	TOTAL
6 Month	43	45	72	75	46	63	344
12 Month	36	61	129	146	145	99	616
18 Month	33	39	89	98	72	69	400
24 Month	40	77	181	223	194	142	857
36 Month	63	166	616	667	516	451	2479
TOTAL	215	388	1087	1209	973	824	4696

Source: Faircent.com

The Road Ahead

According to P2P reports introducing a new idea in a market like India is worth it and would definitely take some time to gain visible grounds in this market. However the real test would be the intensity of acceptability amongst the people. Having said so, India is already home to such players like Faircent and i-lend and i-lend being the premier among them, has been the forerunner in introducing the concept of P2P lending in India. Through a simple online platform, i-lend enables borrowers and lenders to interact one-on-one and discuss loan amount and interest rates before finalizing the agreement. This is a huge opportunity for both the borrowers and lenders, as it gives them complete freedom to negotiate fairly. This definitely indicates towards the probable future of peer-to-peer lending in India. It will definitely play a major role in shaping the financial future of the country.

IV. Conclusion

Various non conventional forms of lending emerged out of which peer to peer lending or marketplace lending is one which started as a relatively simple system for facilitating loans between individuals online. P2P Lending has gained a solid traction in the Western market and it would be a matter of time before it sets a solid foot in India as well. However, the highly regulated market in India would make things time consuming. Having said so, P2P lending would definitely provide a mechanism enabling lenders and borrowers mutually strike a beneficial deal. Peer to peer loans are the easiest to avail with justified interest rates. P2P lending also enables investors earn a profitable margin by investing in credit worthy borrowers. Today these loans are purchased by large investors like banks, hedge funds and wealth management firms. The entry of these investors has motivated a growth of startups and other actors dedicated to advising investors, performing loan data analysis, and automating the investment process. P2P platforms in India are prone to attract only higher risk borrowers. This combined with the fact that individual lenders have limited risk-assessment tools available to them results in sub-optimal risk adjusted returns for lenders. Need of the hour is regulating the alternative consumer lending, greater monitoring of data accuracy in underwriting, scrutiny on compliance with laws

Some questions still Unanswered:

- In the peer-to-peer lending model, companies draw profit from servicing and late payment fees rather than from repayment of principal and interest on the loan. In such a model, where do incentives for accountability towards consumers lie?
- What standards should exist for judging fairness in this industry? How will underwriting standards change as institutional investors increasingly purchase a larger proportion of available loans? Will peer-to-peer lending companies be able to draw in sufficient volume of borrowers, and will there be consequences to new tactics (such as marketing) for attracting borrowers?
- Is P2P too futuristic in India? While intending to set up a P2P platform, one may not find legal provisions for this at present. However, with the popularity of the concept, the laws and regulations will have to evolve.
- Is India is ready for crowd funding or is it premature to introduce such risky investment channel? With the segment gaining popularity the central bank may also have to look at the quasi-fiscal element. The question is if the segment continues with the momentum and popularity, would the central bank not want any oversight or have some degree of control so that its fiscal and monetary stance is maintained? Many interventions to infuse or mop up liquidity have an inherent fiscal element to them and a day may not be far when P2P is no exception. Executives are worried about the risks of a “Bitcoin-style bust” that could rattle confidence in the nascent industry.

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ANNEXURES: