

## Comprehending the 'Peer to Peer Lending Concept

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# Full-Length Paper

## Introduction

Peer-to-peer lending is a form of crowd-funding used to raise loans for people who need to borrow, from people who want to invest. It enables individuals to borrow and lend money without any financial institution as an intermediary, and extends credit to borrowers who are unable to get it through traditional financial institutions. The main idea is savers getting higher interest by lending out their money instead of saving it, and borrowers getting funds at comparatively low interest rates. It typically uses an online platform where the borrowers and lenders register themselves. Due diligence is carried out before allowing the parties to participate in any lending or borrowing activity.

In other words, Peer-to-peer lending (P2P) is 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.

## Indian Scenario

Peer to peer lending (P2P) platforms would be considered as non-banking financial companies (NBFCs) and will come under the regulatory lenses of Reserve Bank of India. It is to be noted that till April 2016, there were approximately 30 start-up P2P lending corporate houses in India. According to Reserve Bank of India, though the concept of P2P lending is nascent in India and not significant in value yet, the potential benefits that P2P lending promises to various stakeholders (to the borrowers, lenders, agencies etc.) and its associated risks to the financial system are too important to be ignored.

Global cumulative lending through P2P platforms at the end of Q4 of 2015, had reached 4.4 billion GBP (approximately Rs 38,300 crore) from 2.2 million GBP (about Rs 19 crore) in 2012. At present, it is partially or fully regulated in Australia, Argentina, Canada (Ontario), New Zealand, United Kingdom, France, Germany, Italy and USA while it is

banned in Israel and Japan. China has the largest P2P market in the world, with hundreds of platforms offering diverse services, but the sector is not regulated currently.

P2P lending platforms are largely tech companies registered under the Companies Act. Once the borrowers and lenders register themselves on the website, due diligence is carried out by the platform and those found acceptable are allowed to participate in lending/borrowing activity. The companies often follow a reverse auction model in which the lenders bid for a borrower's loan proposal and the borrower has the freedom to either accept or reject the offer.

### **The Bright and Grey areas of P2P Lending- The Global Angle**

- 1) Access to higher returns: P2P can potentially give access to significantly higher returns than you could get through a high-street savings account.
  
- 2) Risk diversification: P2P platforms allow to spread the capital across multiple loans<sup>1</sup>. This enables in better management of exposure to risk. For example if £5000 spread over 100 loans and one of those loans defaulted the potential loss is INR £50. Whereas if one spread the same £5,000 over just 10 loans and one defaulted then the potential loss is £500.
  
- 3) Choice: Under P2P platform, one can decide to whom the money is to be lent. For instance, the lender can decide the basis of selection of borrower, i.e. the money will be lent to the borrower who is having an asset like property to offer as collateral.
  
- 4) Personal Savings Allowance: Any interest earned through peer-to-peer lending is now included in your 'Personal Savings Allowance'. This currently stands at £1,000 interest for individuals paying basic-rate tax and £500 for higher rate payers.
  
- 5) Access to money at short notice: Many P2P lenders allow liquidation of funds before the loan ends if required, as long as they can sell that loan position on. One will of course need to check this with the individual platform. For example, on average, Bond Mason clients have been able to fully liquidate their positions in full within 24-48 hours.

## Grey Areas

- 1) Money at risk: Probably the most important risk one need to understand is that, unlike mainstream banks, the money is not covered by the Financial Services Compensation Scheme (FSCS) – which currently compensates you up to £85,000. Therefore, if one decide to deploy the capital through a P2P platform, choosing one's platform carefully is essential. One needs to ensure that they are clear and upfront about the risks involved and any plans they have in place in the event something goes wrong.
- 2) Interest is not tax free: With the exception of Personal Savings Allowance, any interest earned will be taxed and one will be required to declare any interest earned on the annual tax return.
- 3) One's cash may not be lent immediately: Whilst one may be waiting for the cash to be lent it won't be earning any interest. However, majority of P2P platforms will be as eager as the person who desires to get his or her cash deployed. In fact, even if someone's money is slower to get lent out, the overall impact on return is likely to be minimum in the long term.
- 4) Time constraints: There can be a thing as too much choice. Because of the wide range loan choices (some of which are complicated) and considerations, managing a diverse portfolio can be time consuming.

## **Way Forward**

India's big digital push has got everyone excited, especially in the fintech sector. As big data, algorithms and intuitive technology combine, a million dollar question that emerges is What will it do for India's ambitious, yet to be achieved financial inclusion targets?. The answer is Peer-to-Peer Lending. The sector has clocked an impressive growth over the course of past two years and more so in the past few months. However, what is noteworthy is that P2P as a product does have the ability to make a real difference in the financial inclusion space.

Over the course of the past few years, with businesses, services and products going digital, being online has taken over our discourse. According to "Accenture's Digital Disruption: The Growth Multiplier" report, digital tech could power \$2 trillion of global

economic output by 2020. The survey states that the US is leading the race with digital revenue making up a third (33%) of output. In terms of industry sector, Financial Services is the largest contributor in terms of their digital contribution.

P2P lending and borrowing ticks all the boxes in terms of being simple, rates that appeal to both borrowers and lenders and is available to individuals often neglected by banks. As a result, it is finding traction regardless of social strata, age or education.

A quick look at Faircent's Research & Analysis Report April 2017, reveals that youngsters are quick to adapt to this digital disruption and make the most of it. Our lenders are young with 51% belonging to the age bracket of 30-39 years. About 36 % of the lenders are over 40 and 13 % are below the age of 30.

## **Bibliography**

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