Journal of Exclusive Management Science - October 2020 - Vol 9 Issue 10 - ISSN 2320 - 866X

FINANCIAL LENDING IS CHANGING -

AN OVERVIEW OF PEER TO PEER LENDING IN INDIA

Praveen Kaur
Lecturer. Department of Commerce (Evening), Shri Shikshayatan College Kolkata 700001.

Abstract: Previously technology was used to enhance the services of the traditional financial sector but in the present scenario it is posing a threat to the existence of the traditional financial sector by trying to replace it with its modern, fast growing, technologically driven financial companies operating online. These fintech companies use technology to provide the various financial services by operating on an online platform. Peer to Peer Lending refers to the practice of providing an online platform to match the needs of borrowers of funds with those of the lenders. Peer to Peer lending belongs to the broader 'Crowdfunding' model.
Key Words: Fintech, Peer to Peer Lending, Crowdfunding, intermediary.

1.Introduction Financial Technology or as it is popularly called 'Fintech' is the application of technology in the process of providing various financial services. These financial services include fund raising, lending, transfer, payment, investing etc. The relation between finance and technology is not something new. The invention of credit cards, debit cards, ATM machines, online stock trading, use of computers by the banks for storing data and performing various operations, advent of e- commerce were all application of technology in the financial sector. Previously technology was used to enhance the services of the traditional financial sector but in the present scenario it is posing a threat to the existence of the traditional financial sector by trying to replace it with its modern, fast growing, technologically driven financial companies operating online. These companies can be both startups and established financial companies trying to incorporate technology in their operations to compete in the changing scenario. Mostly it involves the startup companies only. These fintech companies use technology to provide the various financial services by operating on an online platform. The use of internet for all of their operations is the most vital feature of these companies. One of the areas of Fintech that is rapidly growing is Peer to Peer Lending.

Peer to Peer Lending refers to the practice of providing an online platform to match the needs of borrowers of funds with those of the lenders. It completely rejects the concept of a traditional brick and mortar bank and thereby reduces its overheads by removing any kind of intermediary between the lenders and the borrowers. It is a favorable situation for both the borrowers and the lenders. The lenders get a higher rate of interest by lending rather than just saving and the borrowers on the other hand have to pay a lower rate of interest as opposed to borrowing from a traditional bank. The various types of loans given under this arrangement include student loan, medical loan, house renovation loan, foreign trip loan, business expansion loan, etc. Peer to Peer lending belongs to the broader 'Crowdfunding' model. Crowdfunding is basically financing a project/ idea/ venture on an online platform by raising small amount of funds from a large number of investors who have an interest in project/ idea/ venture. This interest could be the economic benefits or any kind of rewards associated with the success of the project or a simply a connection with the underlying message or purpose of the project. This project/ idea/ venture can be an idea for a startup business, a new product launch, making of a movie, or simply a loan for some kind of personal or professional motive.

This is a purely online platform where the seekers of funds have to raise the required amount of funds for their projects within a stipulated period of time by grabbing the interest of the investors. This can be achieved by either uploading videos, photographs relating to the project or engaging in continuous campaigns to popularize the idea on some social media platforms to attract the investors. A crowdfunding company is one that acts as an intermediary by bringing the borrowers and investors together.

2. Literature Review

Direct evidence in the area of peer to peer lending platforms in India is scarce. But there is evidence relating to peer to peer lending platforms in foreign countries. A survey of the existing literature is made in the following paragraphs in this regard.

Freedman and Jin (2008) identified that the lenders face difficulty in selection because they observe the categories of credit grades rather than the actual credit scores. Also higher interest rate can imply a lower rate of return because higher interest attracts lower quality borrowers. **Klafft (2009)** focused on the factors that affect the loan funding and also the interest rates applied. Verified bank account information has an impact on the success of the funding. Personal information like photographs, online peer groups also influence the funding. **Iyer et al (2010)** analyzed whether the lenders are able to analyze the borrower information to assess their credit worthiness correctly. The lenders mainly focus on the aggregate credit category of the borrowers. The lenders do so by not only studying the standard banking information but also the non standard information obtained from photographs and other personal descriptions of the borrowers. **Herzenstein et al (2011)** said that the number of identity claims of the borrowers and their contents have an impact on their funding. As the number of identity claims increases the chances of the loan funding increases but these borrowers have a high chance of defaulting thus the loan performance is affected. The identity content also plays a vital role. **Lin et al (2012)** found that online friendships have an impact on online borrowing. Friendships increase credit rating of the borrowers thus increasing the chance of getting a successful loan, lower interest rates and also lower chances of default. **Duarte et al (2012)** concluded that the appearance of the borrowers has an impact on their funding. The borrowers who appear trust worthy have higher chances of their loans getting funded and moreover they have better credit scores. **Michels (2012)** found out that the disclosure of information plays a role in reducing market inefficiencies.

Studies mainly based on the factors influencing the lending on such platforms have been conducted. Not many studies have been conducted highlighting the workings of peer to peer lending sector. Also not many studies are available involving the scenario in India. In the light of the above survey the present study intends to fulfill the said research gap.

3. Objectives

In view of the research gap identified above the primary objective of this study is to give an overview of the Peer to Peer lending sector in India. More specifically the study intends to:

i. To give a clear idea regarding how a Peer to Peer Lending Company works. It aims to show in details the borrowing and lending mechanism under this kind of arrangement.
ii. To highlight some important guidelines relating to these companies as issued by the RBI in its master directions.
iii. To identify the growth prospects and the challenges that might be faced by this sector.

4. Research Method

The methodology used for the study is secondary. It is a purely descriptive paper that aims to give an in-depth understanding of the emerging concept of Peer to Peer Lending. The information given in this paper has been obtained from various sources like internet, newspapers, journals etc.

5. Analysis and Findings

5.1 How does it work?

- The participants (both investors and borrowers) can select any company out of the large number of companies operating as per their requirements after doing a comparative analysis of the various companies.
- Next, the participants have to register themselves as lenders or as borrowers (depending on their motive) with the company selected. This is done by furnishing the various details and uploading supporting documents as required from company to company. Most companies require the participants to pay an initial registration fee which is very nominal in amount.
- The company then exercises due diligence to study the creditworthiness of the participants especially of the borrowers, to assess the credit risk involved. It results in a credit rating of the borrowers. The credit risk and hence the rating is based on a number of factors- employment status, monthly income, credit card history, years of employment, type and locality of residence etc.
- Based on the credit rating each borrower is assigned an interest rate for their respective loan. A profile of the borrower indicating the amount of loan, period, interest rate, purpose is uploaded on the website of the company.
- The registered investors can then select the option (borrower) in which they want to invest depending on their requirements and their risk appetite. They can either invest the entire amount in a single project or can invest in a number of projects to diversify the risk and hence the returns. If a loan gets funded by a number of investors then all the investors should be paid the same rate of interest to avoid any kind of speculation.
- After matching the borrowers and the investors and a verification of the both, a loan agreement is created and signed by both the parties.
- The investor then transfers the fund to a nodal escrow account from where they are disbursed to the borrower.
- The borrower should repay the amount along with the interest in the manner decided and within the stipulated time period. On default a penalty will be charged on the borrower.
- The investor can either withdraw the amount or reinvest it again in some other project.

5.2 A brief summary highlighting the major guidelines is as follows:

The Reserve Bank of India issued a notification No DNBR. 045/CGM (CDS) - 2017 on August 24th, 2017 which contains directions for compliance by every peer to peer lending company. The RBI recognized these companies as a new category of NBFCs, thus giving this sector a formal recognition by bringing it under its regulatory control. These directions are known as Non Banking Financial Company- Peer to Peer Lending Platform (Reserve Bank) directions, 2017.

Table 1

Summary of the Major Guidelines

1.**Registration**	Only a non banking company can undertake the business of peer to peer lending. It shall have to obtain a certificate of registration from RBI after fulfilling certain conditions as laid down by the bank. It should have a net owned fund of not less than rupees twenty million or such higher amount as specified by RBI.
2.**Scope**	An NBFC-P2P shall act only as an intermediary providing an online platform to the participants. Neither it is allowed to raise deposits nor lend on its own. International flow of funds is not allowed. Only unsecured loans are permitted on these platforms.
3.**Prudential Norms**	The aggregate exposure of a lender to all borrowers at any point of time across all P2Ps shall not exceed rupees 10 lakhs. The aggregate loan taken by a borrower at any point of time across all P2Ps shall not exceed rupees 10 lakhs. The exposure of a single lender to the same borrower across all P2Ps shall not exceed rupees 50 thousand. The maturity period of the loan should not exceed 36 months.
4.**Reporting Requirements**	The RBI may require the NBFC-P2Ps to submit returns from time to time as it deems fit. The following quarterly statements shall have to be submitted to the regional office within 15 days after the said quarter. A statement showing the number and amount in respect of loans outstanding, closed and disbursed during the quarter. Statement showing amount of funds held in escrow accounts.

	Number of complaints outstanding at the beginning and at the end of the quarter. Leverage ratio clearly showing the items in the numerator and denominator.
5.**Other Norms**	Fund Transfer Mechanism: All the fund transfer between participants shall take place through escrow accounts operated by a trustee. Data: An NBFC-P2P shall have to become a member of all the credit information companies and shall have to submit updated data to them on a regular basis. Interest Rate: The interest rate should be in annualized percentage rate format.

Source: author's compilation

5.3 The growth prospects and the challenges that might be faced by this sector are:

Growth Prospects	Challenges
It's a quick and easy process. It requires less documentation. The borrowers are charged a less rate of interest due to the removal of intermediaries. No collateral is required as loans are unsecured. The investors can invest a small amount of money too. The investors can diversify the risks by investing in a number of projects. The investors have the choice of deciding in which project they want to invest. Early recover of loans as the maturity period of a loan cannot exceed 36 months.	Risk is involved in this type of lending as the loans are given without any collateral. Lesser penetration of internet and technological ignorance is a major challenge faced by this sector. Usually loans of a small amount are given under such arrangement. For a large amount of loan people still have to depend on the traditional banking system. Credit information especially of the borrowers is shared on this platform. Although strict data security measures are undertaken, the fear of misuse of data still remains in the minds of people.

6. Conclusion and Recommendation

This fintech industry is fast growing. Due to large internet connection penetration, positive attitude towards startups, growing technological development, fierce competition in the financial sector, large portion of unmet financial demand and the recognition provided by RBI this industry is soon to take an important position in the Indian economy, making India a global fintech hub.

In the present scenario it is difficult to imagine a financial market without the operation of a bank. These companies require more awareness among the people. More marketing programs should be undertaken by these companies to increase their exposure as the idea is still unknown and at a nascent stage in our country.

References

- Duarte, J., Siegel, S., & Young, L. (2012). Trust and Credit: The Role of Appearance in Peer-to-Peer Lending. *The Review of Financial Studies*, 25:8, 2455–2484.
- Freedman, S., & Jin, G. Z., (2008). Do Social Networks Solve Information Problems for Peer-to-Peer Lending? Evidence from Prosper.com. 10.2139/ssrn.1304138, NET Institute, Working Papers.
- Herzenstein, M., Sonenshein, S., & Dholakia, U. M., (2011). Tell Me a Good Story and I May Lend You Money. *Journal of Marketing Research,* 48, 138-149.
- Iyer, R., Khwaja, A. I., Luttmer, E. F.P., & Shue, (2010). Screening in New Credit Markets: Can Individual Lenders Infer Borrower Creditworthiness in Peer-to-Peer Lending? AFA 2011 Denver Meetings Paper.
- Klafft, M., (2009). Peer to Peer Lending: Auctioning Microcredits over the Internet.
- Lin, M., Prabhala, N. R., & Viswanathan, S. (2012). Judging Borrowers by the Company They Keep. *Management Science,* 59:1, 17-35.
- Michels, J., (2012). Do Unverifiable Disclosures Matter? Evidence from Peer-to-Peer Lending. *The Accounting Review,* 87:4, 1385-1413.

URLs Visited

- www.rbi.org.in
- en.wikipedia.org
- www.livemint.com
- www.i2ifunding.com
- www.faircent.com
- www.careratings.com
- www.pwc.in
- www.quora.com