

Financial Inclusion through P2P Lending

Key Takeaways

Peer-to-Peer (P2P) lending enabled by information technology is a powerful tool that has already scaled up rapidly in many countries, especially China. In India it has shown early promise and is expected to become a significant contributor to financial inclusion. This policy brief looks at the benefits and risks that go with P2P lending and outlines the requisite regulatory approach in this evolving space in India.

- P2P lending has a high potential for covering the financial inclusion gap, by meeting the credit needs of customer segments unserved by traditional banks.
- International experience shows that unhindered, this sector can scale up rapidly. However, expansion without any regulation has its risks, with fly-by-night operators, Ponzi schemes etc. hurting low income consumers and creating financial instability.
- The RBI has to balance the need for growth of the sector with customer protection and financial stability. For this, regulation needs to be light-touch and yet proactive, with real time monitoring being critical to appropriate and efficient response. For instance, the RBI should examine whether the current borrowing cap of Rs. ten lakhs, which has been put in to mitigate systemic risk, can be raised to accommodate legitimate working capital needs of micro and small enterprises.
- It is extremely crucial that the RBI work with industry on a regular basis to ascertain the characteristics of borrowing, the extent of and reasons behind default and the experience of customers vis-à-vis grievance redressal.
- Apart from passing the long overdue data protection legislation, the government should also consider measures to address the vexing problem of consent e.g. limiting use of data for legitimate purposes, establishing a fiduciary relationship between providers and consumers and appointing learned intermediaries for consumers.

Introduction: P2P lending and financial inclusion

Financial technology or fintech plays an important role in furthering financial inclusion. The key advantage being its ability to provide a simple and cost-effective means of accessing services of payments, savings, borrowings, investments and protection through insurance and pension. Moreover, with the rising use of mobile phones and access to raw digital data, fintech companies have found space to reduce existing frictions that prevented banks from servicing the needs of low-income households and micro or small businesses. Emerging financial technologies therefore are expected to play an important role in covering the gaps left in the banking segment.

Conventional banking models are unable to sustainably provide credit services to lower income segments and micro businesses for many reasons. The financial lives of the poor are characterized by irregular low value incomes and transactions, few and undocumented assets and high demand to borrow for consumption purposes. Further, beyond the mandated target of priority sector lending, banks are typically averse to greater funding a segment they consider high-risk—micro and small businesses. Such enterprises are intrinsically more vulnerable to economic downturns, and the inherently long receivables realization cycles make for greater cash flow uncertainties. Traditional credit appraisal methods used by banks break down in the absence of key information and documentation such as financial and legal status, tax returns, account books etc.

However, over the past few years, there has been a trend of greater digitisation not only in small businesses in India (Omidyar Network,

2018), but also amongst the poor. This has been facilitated by the ubiquitous mobile phone, increased digital government payouts, the introduction of the Goods and Services Tax, increased digital payment options and greater penetration of bank accounts. Since electronic transactions have the great advantage of being recorded and logged in real time and are also easily shared, alternative credit appraisal models including those that are automated or assisted, can be developed.

Fintech lending has many business models (DLAI, January 2019):

- Point of Sale transactions-based lending where credit is extended using data of electronic transactions at POS and against future receivables at POS;
- Fintech partnership with banks for lending for specific needs like travel, food etc.;
- Invoice discounting exchange where unpaid invoices can be discounted by MSMEs to a network of financiers, wealth managers and retail investors;
- Online marketplace that connects to financial institutions, provide additional value by digitizing the entire supply chain for borrowers;
- Bank-led digital model where digital platforms are used to sell loans and acquire credit card customers;
- Captive model where companies that exist in entirely different businesses are entering the lending space in order to lend to their captive customer base either directly by setting up NBFCs or by partnering with financial institutions;
- P2P model that connects individual borrowers to individual lenders

In this policy brief we focus on the last model, i.e. Peer-to-Peer (P2P) lending. As noted by the RBI Working Group on Fintech and Digital Banking (RBI, 2017), P2P lending originally involved direct matching of individual lenders and borrowers on a one-to-one basis through an electronic platform. However, it has since evolved into a form of marketplace lending where individual investors lend into a pool that borrowers can access. This evolution, arguably, has further strengthened its potential in addressing a large proportion of the unmet need in the financial inclusion space.

Global experience in P2P lending

China has been the leader in the world, with a veritable explosion in this space. While P2P lending did perform a useful and significant role in funding underserved segments like SMEs and low-income households in China, there were considerable risks that materialised, hitting further gains from this innovation (BIS, October 2018). Left unregulated by the People's Bank of China, inappropriate market practices and fraud, including Ponzi schemes, were rife. It was only from 2015 that the Chinese authorities began responding with new rules that prohibited practices such as P2P lenders raising funds for themselves, disallowed guaranteeing of investments, mandated the depositing of client funds etc. More measures were taken in 2017 like banning new student loans and tightening of the regulation for cash loans. As a result of the clean-up that continues even today, new P2P lending peaked in 2017 in China and has been falling since (BIS Quarterly Review September 2018).

In Kenya, the experiences from surveys on digital credit, pushed mainly through mobile phones, have lessons for India. For instance, difficulty in repayment mainly due to poor business performance or losing the source of income, short repayment period, high charges to clear their names from negative credit list etc. (Wright, 2018; MicroSave, 2018). The Kenyan experience also has shown up higher interest rates than expected, multiple borrowings by customers, unclear disclosure of interest rates, terms and conditions, and a trend to push loans through SMS messaging (CGAP, 2016). While the Indian P2P lending industry may not throw up the same issues, it is extremely crucial that the RBI works with the industry on a regular basis to ascertain the characteristics of borrowing, the extent and reasons behind default and the experience of customers vis-à-vis grievance redressal. In fact, understanding the reasons behind default becomes key to ensuring that the entire ecosystem functions effectively.

Without regular assessment, the risk of exclusion can arise. Credit delivered digitally through P2P mode works best for customers with smart phones, ability to buy data packages and living in urban and peri-urban areas which have good connectivity. Low-value rural communities typically get left out. Again, data must be collected on a regular basis to find out whether the target segments of financial inclusion are being benefited, or whether they are being left unserved again.

The global experience so far reveals that left to themselves, P2P lending does have the potential to serve low-income customers and small businesses and can scale up rapidly. However, at the same time, their activities must be closely monitored by the regulator to ensure that the customer is protected and the digital divide does not deepen. Maintaining a balance between encouraging growth in this new industry and protecting stability and the consumer calls for a light touch and vigilant regulatory regime.

As this industry evolves in India, the regulatory approach adopted by the RBI is detailed in the next section, followed by the challenges that remain to be addressed.

Regulatory approach in India

The P2P sector is new in India, and just as it began taking off, the experiences from other countries alerted the RBI to introduce protective regulation. A consultation paper on Peer to Peer lending (P2P) (RBI, 2016) noted that there were five separate regulatory regimes across the world in place at that time: a) Exempt market/Unregulated through lack of definition in China, Ecuador, Egypt, South Korea, Tunisia; b) Regulation as an Intermediary in Australia, Argentina, Canada (Ontario), New Zealand, United Kingdom; c) regulation as banks in Germany, Italy; d) a US Model with two levels of regulation, Federal and State; and e) Prohibited under legislation in Israel, Japan. Clearly, the evolving model had evoked different responses from regulators across the globe, each tailored to their specific economies.

The RBI chose to go with regulating P2P lenders as Non-banking Financial Companies (NBFCs) observing that in its nascent stage, the industry had the potential to disrupt the financial sector and “throw surprises.” The capacity of P2P lending activity to lower operational costs and soften interest rates by providing competition to banks was understood. However, the RBI also recognised that allowing the sector to go unregulated could lead to unhealthy practices by firms, which could disrupt the financial system and impact customers adversely. Thus, in October 2017, the RBI issued guidelines for “Non-Banking Financial Company- Peer to Peer Lending Platform (NBFC-P2P), which defined the NBFC-P2P, and set up prudential and operational guidelines. With this, the sector got greater legal accountability through registration and licensing.

To prevent money-laundering, cash transactions are prohibited. Further, all transfers are mandated to take place between bank accounts and two escrow accounts have to be maintained, one for collections from borrowers and one for funds received from lenders, pending disbursement. These requirements make for a more stable system, protecting the customers (both lenders and borrowers) from fraud.

Other quantitative limits include the requirement of a minimum net-owned fund of Rs.2 crores; caps on quantum of lending and borrowing to ensure diversification of risk - a lender cannot invest more than Rs.10 lakh across all P2P platforms, a borrower cannot borrow more than Rs.10 lakh across P2P platforms and a lender cannot lend more than Rs.50,000 to a single borrower. While these caps may seem rather low and can slow the growth of the industry, it is evident that the regulator is seeking to direct such innovation towards only the smaller borrowers and lenders. On the other hand, these guidelines may also be overly restrictive. For instance, the Digital Lenders Association of India has requested a higher cap of Rs.1 crore if the loan is for working capital and fixing the lender cap at 25% of net worth of the lender, to tap into high-net worth individuals who may have the risk appetite to be in this segment.

The experiences in China and Kenya reveal that customer protection is a significant cause of concern. This needs to be addressed at an early stage itself, so that as the space evolves and matures, so does the ability of the regulator to monitor and enforce good practices. An efficient monitoring mechanism that maintains security and privacy while identifying potential risks will take both time and resources.

Starting early therefore is critical.

The NBFC-P2P guidelines cover setting up a Fair Practice Code and Customer Grievance Redressal mechanism, leaving the specific details to the firm's board to frame. The guidelines call for transparency and disclosure requirements that include sharing certain details between the borrower and the lender and disclosure online of the credit assessment methodology, usage/protection of data, grievance redressal mechanism, portfolio performance including share of non-performing assets on a monthly basis and segregation by age and broad business model. Large NBFC-P2Ps with asset sizes of more than a billion rupees would come under the Ombudsman Scheme for Non-Banking Financial Companies, 2018 put into place since February 2018. Thus a basic framework has been put in place, with the freedom given to the company to put in specific policies, and recourse to the consumer to go to the Ombudsman for redressal if needed.

The regulations have only recently come into place, and will undoubtedly be tweaked as we go along. The RBI is expected to be compiling data every quarter on the number of complaints received and disposed of by both lenders and borrowers. This process has already begun (VC Circle, 2019), and as the trends become clear over time, the RBI can make appropriate responses.

However, the RBI must go beyond just framing the guidelines and expecting the consumer protection model to work effectively in practice. In the next section, we discuss how the RBI must ensure that the firms are complying with the guidelines in the right spirit, and not treating this as a mere compliance issue.

Resolving the issue of Trust and Consent

Building and maintaining the trust of the customer lies at the crux of the digital financial services model. Low-income customers are managing their financial lives using cash transactions through their informal and trusted networks. It is for the regulators and the industry to work together to gain the confidence of these customers, ensure that their needs are met and that they stay within the formal financial system. There are two angles to this – one, the use of credible personal data that allows digital credit appraisal models to be automated and data sharing onwards to third parties; and two, transparency during the actual loan process such that the customer knows exactly what s/he is in for. Even as India awaits a data protection legislation and protocols for data sharing and privacy, it is critical that the RBI put in place a system for effective monitoring and supervision.

Presently, the guidelines related to transparency and disclosure (listed in the previous section), and consent to data sharing follow standard legal language.

- *There is a mandate that the NBFC-P2P shares credit data with Credit Information Companies, with “necessary consents in the agreement with the participants for providing the required credit information”.*
- *The firm has also been asked to “obtain explicit affirmation from the lender stating that he/ she has understood the risks associated with the proposed transaction and that there is no guarantee of return and that there exists a likelihood of loss of entire principal in case of default by a borrower. The platform shall not provide any assurance for the recovery of loans.”*
- *However, the RBI has distanced itself in the eyes of the customer with this legally worded caveat: “Further, the*

platform shall display a caveat that “Reserve Bank of India does not accept any responsibility for the correctness of any of the statements or representations made or opinions expressed by the NBFC-P2P, and does not provide any assurance for repayment of the loans lent on it”.

- *“NBFC-P2P shall ensure that any information relating to the participants received by it is not disclosed to any third party without the consent of the participants.”*

While the RBI has covered itself and the NBFC-P2Ps in legally appropriate guidelines, the concern is that in reality, very few people actually read the terms and conditions, before consenting to them. Even after the terms are read, it is not clear how many are understood. A recent survey of 2,000 users of mobile phone services in the USA (Deloitte, 2017) showed that 91% willingly accept legal terms and conditions without reading them before installing apps/signing on to online services etc. The problem is that most of the language of terms and conditions is legal and too complex for the lay person. For India as well, we can expect almost all low-income, poorly educated customers, who are being pulled into a new system, to consent without checking the terms adequately. This can lead to the problems such as those experienced in Kenya, of greater defaults as customers are faced with fees that they did not anticipate but have “consented” to.

Gayatri Murthy and David Medine (CGAP, 7 January 2019) have put forth three approaches that policy makers can use to correct for the problem of consent.

1. Limiting data use for legitimate purposes: Providers should be allowed to collect, create, use and share only such data as may be necessary for or compatible with disclosed uses. Any data that is not in use should not be retained in an identifiable form. Most importantly, this approach cannot be over-ridden by obtaining individual consent.
2. Establishing a fiduciary relationship between providers and consumers: This approach has been included in India's draft data protection legislation imposing a duty on the provider to act in the best interests of their clients, and in the case of a conflict, must put their clients' interests above their own.
3. Appointing learned intermediaries to help consumers: This approach mooted by Rahul Matthan notes that compliance under the fiduciary relationship needs “learned intermediaries” to audit for and remedy improper data use (Matthan, 2017).

Way Forward

To conclude, P2P lending can play a large role in meeting the financial needs of the poor and small businesses, who have been left underserved by banks. With the rising usage of mobile phones and access to digital data, non-banks have found space to intermediate between lenders and borrowers, by using automated credit appraisal models. Though there are clear benefits for inclusion, the regulators have to manage the inherent risks in the model, particularly when it comes to customer protection. Light touch regulation that keeps the interests of the consumer at the forefront is key to a fair, efficient ecosystem.

In India, the RBI has chosen to treat P2P lenders as NBFCs and issued guidelines in 2017, that mandated licensing and registration. The industry is young and evolving. While there were more than 30 P2P platforms in India in 2016, only half have succeeded in obtaining the RBI licence so far. In 2018, overall P2P lending rose from Rs 5-6 crore in

January to Rs 20-25 crore in December – note that these are unofficial figures sourced from P2P lending firm i2ifunding, as the RBI has yet to release data (Money Control, 2019). Over the past year, P2P lending has spread into Tier 2 and 3 cities. For instance, Faircent reports a tripling of disbursements in Tier 3 cities, and near doubling in Tier 2 cities. With GST, there has been greater interest in SME lending as well (ETOnline, 2018).

At this stage it is extremely crucial that the RBI balance growth and stability through its regulations. For instance, caps that have been set on borrowing and lending to diversify risk can hamper the ability of NBFC-P2Ps to attract more high net worth lenders and satisfy the MSME need for working capital.

It is important that the RBI initiate independent customer surveys that will identify the reasons behind borrowing, the extent of and reasons behind default, the experience with the grievance redressal mechanism and other emerging issues faced by customers. In particular, there must be greater discussion amongst all stakeholders on building and maintaining trust in digital financial services.

Going forward, low-income households and small businesses must be encouraged to use digital transactions and deepen their digital footprints. However, it is crucial for the RBI to ensure that a trusted, convenient and efficient digital ecosystem develops through close monitoring and rapid yet not overly intrusive corrective action.

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