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Impact of P2P Lending on Formal Financial System: An Exploratory Analysis

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Abstract:
The swift mobilization of funds is required for the development of an economy. The aim of this research is to study the impact of crowd funding on formal financial system and explore the pragmatic approach of P2P lending (Crowd funding). As financial system is becoming complex during last decade with regard to small size advances to fulfil the financial needs of individuals for short term. The concept of P2P lending has merged one of the important sources of fund requirement for next generation customers. P2P platform is giving tough competition to micro & small finance institutions along with various scheduled commercial banks.

***Keywords**: P2P lending, formal financial system, Trust, micro finance.*

INTRODUCTION

P2P lending or in other words known as crowd funding is building up attention towards new era of lending by eliminating the middlemen (Formal Financial System) by connecting investor and borrower directly (Kiisel, 2013). The high-risk high profit approach of P2P lending is topic of discussion. The whole picture of Crowd funding or social funding revolves around unsecured loans. The interest rate depends on the creditworthiness of the borrower low creditworthiness means high rate of interest

There has been a lot of fuss about several alternative asset classes that have been claimed to give higher returns than mainstream investment (Lee &Lee,2012). Crowd lending if not the largest is one of the largest asset class across the globe. Alternative investments is anything that is not: cash, bond or stock. Fixed deposits and similar products are classified as cash products. So, if you go beyond the cash, bond and stock, what you have are alternative investments. Futures and options, commodities, arts and collectables, real estate, and more importantly p2p lending are alternative investments. Alternative assets carry very unique risk as the nature of each asset is unique and niche. For example, real and commercial estate is not highly liquid and carry lot of legal complication in buy-sell activity. Commodities like Gold are negatively linked to the S&P. A conflict in Middle East can cause oil shortage and cause the prices of oil go up. So except for residential and commercial real estate and gold, the average person or the millennial do not invest heavily in alternative asset class. But then gold is more of a hedging instrument rather than an investment for the middle class. Also, the alternative asset class is costlier. Middle class family head can’t say I’ll buy a1000 litters of oil and sell it at a higher price when there is shortage. Another affordable alternative asset that has emerged is the p2p lending. A small ticket size of 10,000 one can start lending and build a portfolio over time and generate a return up to 18%. Risks associated with p2p lending and one has to be prepared for a drawdown. As many as genuine borrowers but there is also wilful defaulter. The returns offered are attractive and so have a chance to benchmark it against other possible investments. One thing that is mention about p2p lending is that unless you do turn around your EMI and into new loans each month, your returns would

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be lower than 18% but under no pressure one should invest if the borrower is not right. The lending returns attract taxes and we have to also adjust for risk by understanding the drawdown. So below mentioned table shows the benchmarking for various returns on the investment of make by the money lenders to the various SME's which are operating in the Indian market:

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%
Net RoR	4.20%	-8.75%	16.00%	4.00%	12.60%	4.90%
Downside	0%	10%	10%	0%	15%	0%
Invested	₹1,00,000.00	₹1,00,000.00	₹1,00,000.00	₹1,00,000.00	₹1,00,000.00	₹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)	Annualized 5 Year-to-Date Return	Annualized 2 year return	Annualized 2 year return

Source: Essay on P2P, June 2017

Purpose and significance of the research

[I] To comprehend the structure of P2P lending in India

Crowd funding are fundamentally based on e-commerce financial service providers, registered under companies act 2013. They act as match maker between investor and borrower, both lender and borrower have to register themselves on the required website(Feng, Fan,et.al.2015). Some platforms use reverse auction through which borrower have the option to choose the suitable lender.

Fintech is the buzz word for SME's investors today; as was e-commerce a few years ago. The objective was simple, Angels wanted growth to sell to venture capitalists, VCs wanted to growth to offload via IPO/PE. Iterate [read as repeat] and make money. Sometimes one start-up was acquired by another for better valuation; that also worked. Exaggerated financials/growth metrics/hyped product value is the norm. All this comes with scaling and burning VC money. A recent article by Forbes also pointed to the fact that Indian SME's are likely to be unsuccessful due to lack of innovation as they merely try to copy the western SME's with some minor alterations. This is why p2p scaling is opening new portals. A p2p platform what is geographically concentrated and has strong recollection process and network to reach to potential borrowers are better equipped to scale in future(Lin&Prabhala NR,et.al.2013). But it is highly unregulated which makes it really risky and can impact the economy negatively due rise in unsecured loans, which directly ameliorate the informal sector lending (Chen&Han,2012). To avoid this situation RBI plays a crucial role by regulating it without delay

Regulatory framework of P2P lending (Crowd funding)

Harnessing the flow of digital era is very Substantial, proper channelizing of resources through motivating the investors to invest in productive area to minimize the losses is what required. (Berger &Gleisner 2009)

1. The **debt recovery procedures [laws] in India** are quite lengthy, sometimes weak and certainly time and money consuming. The money lending law for local lenders does not even mention anything about recovery. Challenging someone in court to payback can take months even with all the necessary evidence. P2P platforms wash their hands

from recovery because the "triparty" agreement between lender, borrower and platforms has wording that implies recovery is non-binding on the platform thus implying the lender is left hanging dry if the loan sour. So much for giving value proposition to lenders. As of now, many P2P Lending players have stopped lending to borrowers from tier II cities., reduced their ticket size, and waiting for very specific type of borrowers to invest in, even if it means sitting of pile of unallocated cash. A trend reflects some platforms is that as long as new lenders are attracted and borrowers get funded, they can keep up the expansion. All these pointing to serious ethical issues if such platforms are at all concerned if lenders are losing their hard-earned money. Lender confidence is quite fragile. P2P lending unlike other start-ups is carries far more risk, especially reputational risk that can damage financial projections for p2p lending to SME's Sector. Crowd funding is legal in India but it is highly unregulated.

These guidelines strive to cover the whole gamut of the regulatory framework. Looking closely at these six areas
The RBI could consider framing guidelines on the clear display of the representative annual percentage rates and risk and reward benefit analysis, to be explained on the website. The guidelines should also explain the regulator's position on borrowers using multiple platforms for loans against the same purpose or use.

[III] Balanced growth of P2P Lending

2. The paper has proposed a balanced approach to help P2P lenders flourish as well as safeguard them from the risks inherent in the model P2P lending in India. The concept, which started with only individuals as participants, has extended its reach to include micro, small and medium-sized businesses, proprietors, retailers and the like. P2P lending is now moving away from the online mode of lending to establishing offline channels by entering into partnerships with leading banks, making them fund custodians. Morgan Stanley in his research stated that P2P lending is estimated to see a rise to $290 billion globally by 2020, growing at an expected compounded annual growth rate of 51%.

[IV]Risk element associated with regard to repayment of credit

This research aims to analysis the credit risk involvement while giving credit to the SME of the country. Rapid scaling of p2p loans is very dangerous especially in India where the borrower market is very opaque and if someone deliberately decides to default it would be a nightmare of lenders to recover(Greiner&Wang,2010). Almost all the platforms lack comprehensive and streamlined way to deal with defaults and update lenders.

[V] Problem of Undeveloped platform

It has generally been the case that unless lenders themselves don't tell the platforms that lender hasn't got the EMI, the platform doesn't take notice. The borrower can under false pretence borrow money they can go into hiding and become untraceable. Many a borrower who works for a multinational consulting group in a metro city. Now, as soon as he got the money, he switched jobs, moved to another city, disabled contact number and disappeared in thin air. The platform couldn't even get in touch him once after that. The collection agency also failed to locate him. This is not an unusual case, almost all the major lenders had at least 5-6 such cases. The even more disturbing fact is that platforms themselves do not know what

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to do about it. After sometime, they just stop replying to mails by lenders and thus discouraging lenders to lend more. Rapid scaling thus, possesses a challenge of getting highly quality borrowers thus dilution in underwriting process. Lending Club suffered from this crisis, there is nothing to stop that happening in India. RBI policy is still awaited despite RBI in it's initial assessment calling p2p "possess risk to the financial system" so that SME's are not able to get benefit from the concept of p2p lending.

Cyber Crime through P2P lending

Due to unregulated market lots of platform under the umbrella of lucrative interest rates perpetrates fraud. Which is creating a negative publicity against it, the volatile nature of P2P lending is somehow creating a question of accountability on the service providers and creating challenges (Duarte & Siegel et al., 2012). Proper surveillance is the key to augment trust among the stakeholders.

Methodology:

The research is descriptive in nature. The analysis is based on secondary data of crowd funding and SME's in India.

Limitations:

P2P is new concept in India, this study has considered only the credit / lending component.

The concept of p2p Lending to SME's is at the inception stage where the total focus is on the regulators of this market.

Contribution:

Peer-to-Peer (P2P) lending often serves as a long-term solution for the capital requirements of such small companies. P2P lending in India generally operates online, wherein marketplace like Fair cent introduce SME borrowers directly to a wide range of investors and lenders. For instance, the financial experts at Fair cent screen SMEs for quality and provide their information to a vast pool of lending resources (currently, more than 6000 registered lenders have pledged more than Rs. 11 crores to fund 26000 registered borrowers with demand totalling to Rs. 7.7 crores approx. on the platform). Once the documentation and other nuances of borrowing are confirmed, the lenders registered with Fair cent release funds to SMEs in the form of personal loans or business loans across a widely spaced risk basket – typically, low risk (12-14%) to high risk (26-30%) loans.

Today, easy business loans are being offered to SMEs via technology-backed peer-to-peer lending platforms to help them generate more capital and better growth opportunities. P2P personal loans and business loans are way easier and faster!

- In general, these loans have flexible timelines (at Fair cent, the loan tenure stretches from 6 months to 36 months) for the repayment of forecasted loan amounts.

- Loan approvals are also on the basis of current/ future cash flows and not based only on the historic financial statements of borrowers.

- The in-house technology platforms and modern underwriting approach of P2P lending agencies ensure that money flows into the accounts of credit worthy borrowers in just a couple of days.

Even though the concept of crowd funding or social lending is at genesis stage in India, it's a matter of time before it will start competing with its counterparts in more mature economies. This alternative method of financing is here to stay. It is fast becoming the answer to the many challenges of easy access to credit in the Indian economy – especially for SMEs and micro-businesses.

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