Peer to Peer (P2P) Lending in India: A positive disruption to traditional financing, albeit cautious approach required

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Contact:

Revati Kasture
Senior Director
revati.kasture@careratings.com
91-11- 6754 3407

Mitul Budhbhatti
Associate Director
mitul.budhbhatti@careratings.com
91-11- 6754 3547

Ravi Kumar
Associate Director
ravi.kumar@careratings.com
91-11- 6754 3421

Jay Parekh
Deputy Manager
jay.parekh@careratings.com
91-11- 6754 3544

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
91-11- 6754 3515

Summary:

The NBFC sector in India has grown significantly during the last few years and has become an important segment in the financial sector contributing to almost 10 per cent of the total assets of the financial sector[(1)]. The RBI has recently introduced guidelines for NBFC P2P (The P2P lending involves matching of borrowers and investors via an online platform managed by P2P operator) which defines scope of activities of a P2P platform and prudential norms with respect to maximum leverage ratio, aggregate and individual borrowing and lending limits of a participant and maximum loan tenure. The guidelines also talk about other important aspects like fund transfer mechanism, participant grievance redressal mechanism and various transparency and disclosure requirements to be undertaken by a P2P platform. Apart from this, sharing of data to the credit information companies is also an important norm prescribed by RBI as it will help the P2P model to maintain asset quality. With P2P lenders coming under RBI purview, there will be better transparency in the system and higher confidence amongst participating lenders and borrowers. Thus the recent regulatory framework for P2P lending by RBI is positive for the sector.

In the global space, P2P lending has been growing year on year in terms of both volume and number of players. Globally, USA, UK and China markets have been dominant in terms of P2P lending. In India, the industry is at very nascent stage and has limited operating history. The ability of the P2P operator to assess borrowers based on their credit models in terms of accuracy and consistency on a large scale is yet to be demonstrated. In addition to this, there is also a need for third party assessment of these credit models on an ongoing basis to provide a fair and transparent view to the lenders. P2P operators also have to demonstrate their viability in terms of their ability to bring in volumes and sustain their business model on a continuous basis. Further, it is seen from the global experience that P2P lending in spite of its existence for more than ten years globally, has been struggling with issues such as frauds, higher delinquencies and financial sustainability of P2P operators.

CARE Ratings expects that P2P lending will continue to grow given its current nascent stage; however, the industry faces numerous challenges of scaling up substantially. Hence, a cautious approach has to be adopted by the various market participants including NBFC P2P, investors and borrowers to create a sustainable model in the long term.

Currently the P2P model is focussed on retail investors as there is lending cap from RBI (Rs.10 lakhs aggregate exposure to all borrowers), wherein the risk appetite is lower than that of High Networth Individuals (HNIs) and institutional investors. This may inhibit the growth in the sector as retail participation may not grow as envisaged due to their lower risk appetite and other funding avenues available for investment with reasonable returns.

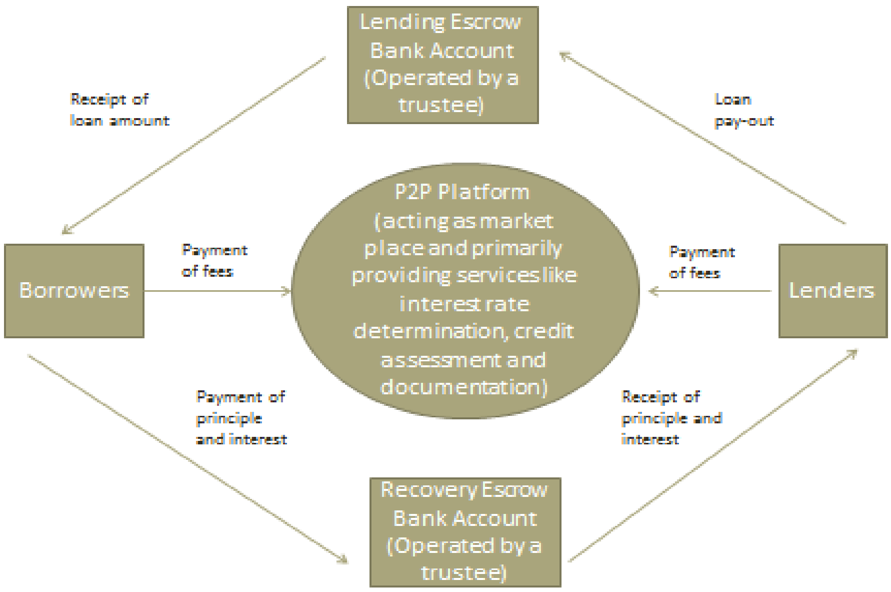
[(1)]Based on RBI Report

Background

The overall size of the NBFC sector in India has grown significantly during the last few years with increasing share of NBFC total assets to bank total assets (approximately around 15 per cent of the total banking assets). Innovative and constantly changing dynamics of the NBFC sector has led to changing landscape of the regulatory framework resulting in NBFCs attracting higher support and regulatory scrutiny. RBI has recently introduced guidelines pertaining to a new category of NBFCs for Peer to Peer lending i.e. NBFC P2P.

The P2P Model

One of the recent innovative concepts within NBFC space in India is peer to peer lending carried out through an intermediary referred as 'peer to peer lending platform' whose primary role is to match lenders with borrowers via an online platform (P2P operator).



The loans under P2P model are unsecured and interest rate is decided by the platform based on the assessment of borrower's profile. The platform typically targets consumers in the personal loan category and small business loan category. The platform earns its revenue via fee income received from lenders and borrowers for providing the market place, credit assessment of borrower, loan facilitation and documentation.

P2P Lending: A Global Perspective

Globally, P2P lending has been growing year on year in terms of both volume and number of players. In the global space, USA, UK and China markets have been dominant in this segment. However, the fast growth in the P2P segment globally has been accompanied by problems in the sector witnessing issues ranging from frauds, defaults and platform closures.

P2P lending in UK is regulated by the Financial Conduct Authority (FCA) and in US it is regulated by the Securities and Exchange Commission (SEC) and applicable state regulations. China has recently moved to regulate P2P industry wherein the China Banking Regulatory Commission has published guidelines for managing online lending platforms.

P2P Lending in UK: In UK, the P2P market has seen active retail investor participation. The outstanding loan book in the UK industry is approximately around £2.9 billion (~Rs.25,000 crore) as on Q3-2017 as compared to £0.75 billion (~Rs.6,500 crore) as on Q4-2014[2]. Based on the outstanding loan book as on Q3-2017, the key players in the segment are Funding Circle, Zopa, FolktoFolk, Ratesetter and ThinCats capturing majority of the market.

P2P Lending in USA: P2P industry in USA is around $20 billion (~Rs.1.3 trillion) in 2016 up from $18 billion in 2015[3]. P2P lending in the USA has seen active participation of institutional investors (approximately 70 per cent of the total investor volumes) lending to borrowers through the platforms. In the USA, three dominant players capture majority of the market which include Lending Club, Prosper and Sofi.

P2P Lending in China: Globally, China has the largest market size of P2P lending which started in 2006. As of January 2017, there were total 2388 P2P platforms in China[4] with trading volume in 2015 touching $67 billion (~Rs.4.4 trillion) which is ten times that of UK and four times bigger than USA. However unlike USA and UK, the China P2P market is dominated by large number of small and medium size firms.

P2P Lending in India: Globally P2P lending has been in existence for more than ten years; however, it has been evolving in India in the last couple of years. Given the recent RBI guidelines, companies will now need to obtain NBFC–P2P license and will come under the purview of the regulator. There are more than 50 P2P online platforms operating in India. I-Lend, LenDenClub, Faircent, Lendbox, i2iFunding, Monexo, India Money Mart, Rupaiya Exchange are some of the leading P2P platforms operating in India. Currently, some of the leading P2P platforms claim to disburse loans amounting to ~Rs.1 to 2 crore a month. Outstanding loans under P2P model is estimated to have reached ~Rs.50-60 crore.

Some of the platforms also provide additional services like recovery and legal assistance (in case of default) to lender by charging addition fees. Apart from collecting and authenticating personal, professional and financial details of borrowers, many of the platforms use big data enabled algorithms to arrive at credit scores of the borrowers that incorporate not only standard credit bureau reports but also data from various social media platforms.

[2] As per the data from Peer to Peer Finance Association based on data contributed by its members
[3] 2017 The Americas Alternative Finance Industry Report- Hitting Stride
[4] Online P2P lending and regulatory responses in China: Opportunities and Challenges by Robin Hui Huang

RBI Guidelines for NBFC – P2P

The RBI has issued guidelines (October 2017) to companies operating as peer to peer lending platform and have classified them as NBFC-P2P. This is the twelfth category of NBFC introduced by RBI with the last one being for microfinance companies (i.e. NBFC-MFI).

RBI defines 'the business of a peer to peer lending platform' as the business of providing under a contract, the service of loan facilitation, via online medium or otherwise, to the participants who have entered into an arrangement with that platform to lend on it or to avail of loan facilitation services provided by it.

The following table summarises the dos and don'ts under the RBI guidelines for NBFC-P2P:

Do's	Don'ts
✓ Provide online platform to participants involved in P2P lending	× Raise deposits
✓ Due Diligence of participants	× Lend on its own
✓ Credit risk assessment and risk profiling of borrowers	× Provide credit enhancement or credit guarantee
✓ Documentation of loan agreements	× Hold funds for lending or receive funds from borrowers
✓ Assistance in disbursements and repayments of loan amount	× Cross sell products
✓ Services for recovery of loans	× Cash transactions
✓ Submission of data to credit information companies	

The other prudential guidelines include maximum leverage ratio that can be maintained (2 times), minimum net owned funds (Rs.2 crore), cap on aggregate exposure of lender to all borrowers (Rs.10 lakh), borrowers across all P2P (Rs.10 lakh), exposure of single lender to borrower (Rs.50,000) and maturity of loans (not exceed 36 months). Apart from these norms, RBI has also prescribed fund transfer between participants to be done through escrow arrangements operated by the Trustee appointed by the bank maintaining the escrow accounts.

The guidelines also put lots of emphasis on the transparency and disclosure requirements to the lenders, borrowers and in the public domain. This includes overview of credit assessment/score methodology and factors considered, protection of data, grievance redressal mechanism, portfolio performance on non-performing assets on monthly assets and segregation by age.

Although, RBI has defined scope of activities that a platform can and can't undertake, there is need for more clarity specific to operational guidelines for the scope of activities. The current lending cap prescribed by the RBI is likely to restrict scale up of P2P lending as HNIs and institutional segment will not be able to participate in this segment who have higher risk appetite towards such products.

Further, although the guidelines talk about maximum leverage ratio, it doesn't talk about link between capital and amount of lending activities managed by an operator.

In the event of wind up or closure of the platform, RBI has specified P2P lenders to have an alternate arrangement in place to ensure that loan agreements on the platform to be managed and administered by other third party servicer. However, implementation of such structure is yet to be seen.

Growth Prospects for the sector in India

- Increasing digital penetration and growing awareness of digital transactions
- An alternate asset class for retail investors
- High unmet financial demand from individuals who face difficulty in obtaining finance from traditional banking and NBFC system
- With the sector coming under the purview of RBI, there will be better transparency in the system and higher confidence amongst participants

Key Challenges for the Sector in India

- Likely higher default risks on account of unsecured lending and risky borrower profile
- Ability of the P2P operator to assess borrowers based on their credit models on a larger scale is yet to be demonstrated
- Direct credit risk on the investors on account of lack of guarantee or liquidity support from the platform
- Sustainability of P2P operator with respect to financial, operational, liquidity and reputation risks
- High competition from traditional chit fund model, microfinance entities, small finance banks and NBFCs engaged in low ticket size retail segment

CORPORATE OFFICE:
CARE Ratings Limited (Formerly known as Credit Analysis & Research Ltd)
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway,
Sion (East), Mumbai - 400 022; CIN: L67190MH1993PLC071691
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457
E-mail: care@careratings.com I Website: www.careratings.com