Peer-to-peer lending opens capital access to start ups, but at a risk

Peer-to-peer lending is an emerging form of finance enabled by the Internet, matching investors with borrowers to get around rigid bank requirements faced by small and medium-sized enterprises—SMEs—and start-ups.

Borrowers apply to a peer-to-peer—P2P—platform of investors. The platform assesses the borrower's credit risk and gives a credit score based on the platform's own credit rating model. Investors then split up their money and lend it to borrowers, usually depending on the maturity of the loan and the risk entailed.

David Storey, an analyst at the Asian Development Bank Institute, told a round-table forum at the Tokyo-based think tank that P2P lending was like a loan-based crowd funding as opposed to equity-based crowd funding or broad-based crowd funding, such as Kickstarter, referring to popular Internet sites used by individuals to raise donations from friends and strangers to help pay for, say a medical emergency, a death in the family, or to start a small business in a community.

P2P lending works on a similar though higher level, says Storey, who looked at SMEs and what is happening in the United States, the United Kingdom, the People's Republic of China, and Japan, to work out what emerging economies might learn from them.

He says there is a funding gap for SME financing, because banks mostly only want to lend to low-risk enterprises, and when they do lend to SMEs it's at higher interest rates because of insufficient credit information, adding an average 1.5 per cent on top of the usual, according to data from the Organisation for Economic Co-operation and Development.

While it doesn't make sense for banks to lend to high-risk SMEs, peer-to-peer investors are looking for higher risk and so it's more efficient to match them with these high-risk small and medium-sized businesses. Another factor is regulatory arbitrage: peer-to-peer lenders have lighter regulation than banks do. Their costs are lower and their operational structure is leaner, which allows them to offer lower interest rates.

The People's Republic of China has the biggest market for peer-to-peer lending, with 100 billion dollars of new lending in 2015. The US has about 35 billion dollars. Storey says that as P2P lending grows, different problems will emerge under different governments. Development and growth depends a lot on the sectors attracting P2P lending, so it's important that money is not wasted on get rich quick schemes.

Maintaining financial stability is important to both borrowers and lenders, and though risk and higher interest rates are what attracts the investor, better regulation is needed to protect borrowers and lenders, he says.

Firstly, it should provide a safe and effective investment channel for broad segments of society. It should allow borrowers to access affordable and reliable capital on their terms. The lending should differentiate between borrowers based on risk of default, otherwise you have moral-hazard problems. They should also provide information to investors so investors can understand the risk they're taking on. Unviable platforms should be allowed to exit the market without causing losses to investors or causing problems for borrowers. The lending should be robust to cyclical downturns so that you don't have platform failures or other problems and that should be competitive

markets so that it's not dominated by one or two platforms. Which is often get to run for these platform based businesses which tends to favor economies of scale, and lastly it should be socially useful and serve the real economy and the needs of businesses.

In the US, the investing side is regulated by the Securities and Exchange Commission, the SEC. The platform is required to issue a security to the investor, and the investor becomes a creditor of the platform. On the borrowing side a loan is issued on behalf of the platform. The borrower is then the debtor to the P2P platform and this is regulated separately by the Consumer Financial Protection Bureau and the Federal Trade Commission.

The manner of regulation has had a few consequences to the market in the US. Firstly, the application for licenses is quite strict, so it creates sort of barrier to entry for new entrants because they need to obtain a license from the SEC, which is quite hard, and also from each state government from each state would be able to operate in for the lending side the SEC enforces stricter closing disclosure requirements to the investors.

All these regulations mean the market is quite concentrated, with little scope for offering more loans to small businesses. But the risk to investors of the platform failing is low.

In China there's been the largest growth and this is partly because SMEs find it difficult to get loans from state-owned banks it dominates in China and this is meant that there's more demand for businesses for P2P loans. There's been a big problem of guaranteed returns to investors which meant investors have no incentive to select lower interest loans instead they just go for the highest interest rates. In some cases there have been Ponzi like schemes where there's been investors have been allowed to withdraw money early whereas the loans are more long-term and this has been funded purely by new in investors coming to the platform

So in 2016 the Bluebook internet finance development described one third of Chinese P2P platforms as problematic, which covers a variety of cases, such as shutting down founders disappearing usually with some money and people having problems withdrawing the cash.

Of the problematic platforms, 55% were found to be scams, which led to new regulations to curb malpractice. In 2015 the People's Bank of China released some guidelines, which stated their intention to regulate the sector and handed responsibility to the China Banking Regulatory Commission. Later that year, the commission handed responsibility to local authorities and then published its full regulation, prohibiting guaranteed returns to investors, control the use of fund pools, which can be drawn on when an investor pulls out of a loan agreement, setting borrowing caps for companies and individuals, and requiring lenders' funds to be held in custodian bank accounts so they cannot be accessed by the owners of the platform.

Storey highlighted the engagement in the UK's Financial Conduct Authority—the FCA—which regulates investing and borrowing.

In the UK, the Financial Conduct Authority (FCA) acts as a single body to regulate investing and borrowing, and their approach is more on engagement with P2P platforms. So they have an open door-policy where anybody wishing to start a P2P business or a listing businesses can come talk to the FCA and ask their advice on what would be legal and the appropriate business model to use, and there are regular calls feedback on regulation and they publish feedback reports giving their responses to these so the suggestions given by market participants. And also the award provision their licenses so most the big platforms in the UK have been operating without a full license and they were just canary licenses while the FCA assess their case.

In Japan P2P lending has been mostly to businesses, in particular, hometown funds which ask people to supply credit to their local businesses. There's also one single regulator in Japan which is FSA. Similar to the US. The P2P platforms need separate licenses for money lending and financial instruments. But, in Japan it's much easier to get these licenses which means it has a slightly more competitive market. The fact that those two licenses for each side of the platform means that investors have to balance providing disclosure to investors and also maintaining the anonymity required by the money lending law for the borrowers.

Storey recommended measures for countries that want to establish their own regulatory framework for the P2P industry: establish a dialogue with market participants to see what their needs are and what problems they have; don't simply adapt existing laws for financial institutions but develop new regulations tailored to the P2P industry; and create simple application processes because these businesses are usually startups and don't have a lot of resources to handle complex processes.

Next, to act against fraud and malpractice because if investors lose confidence in these platforms the market will quickly decline; then also to investors there has to be high disclosure and preferably public access to information anonymizing information on borrowers; and then to actively monitor the processes that platforms used for due

diligence and assessment of borrowers and to make sure that in practice these platforms are complying with regulation.

That was David Storey, an analyst at the Asian Development Bank Institute, talking about peer-to-peer financing at a round-table forum at the Tokyo-based think tank.

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