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P2P lending in India: A new wave

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Section 1: *How P2P lending platforms could transform the consumer lending industry*

Imagine applying for a loan by entering a few pieces of information into an online application portal, and within hours having your loan approved for funding. Globally, a number of online marketplace lenders have made this a reality and are offering online platforms that match borrowers directly with investors. This so-called peer-to-peer (P2P) or marketplace lending model is growing in popularity with borrowers because of its perceived low interest rates, simplified application process and quick lending decisions. This model is rapidly expanding to new product categories, including mortgages and other secured loans.

In particular, P2P platforms seem to have found a niche by offering borrowers an improved lending experience—and they are quickly gaining momentum.

Although P2P lending is still in its infancy as a market, in 2010, firms in the US and UK generated cumulative lending of 1.5 million USD and this increased to 7 billion USD in 2015, indicating an unprecedented rise in demand.[1]

In the US alone, in 2015, P2P platforms issued approximately 6 billion USD in loans and based on our global analysis, this figure is expected to grow to 150 billion USD by 2025 (i.e. by 25 times or 2400% over 10 years).[2]

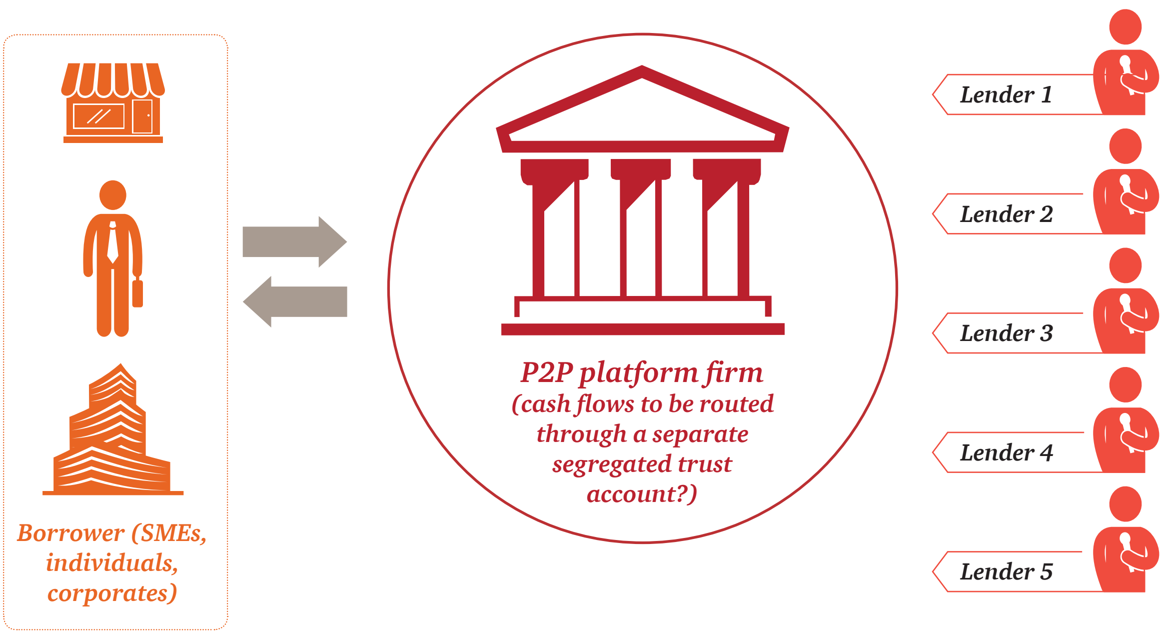
India currently has around 30 online P2P lending platforms with a current loan book of circa USD 25 million.[3] Some of these firms are expected to become the biggest disrupter in democratising the availability of credit to SME borrowers and others in India.

The estimated P2P lending to be generated in India over the next five years is pegged at around 4 billion USD (160 times the current lending size). Nevertheless, this figure is much lower compared to China, where the P2P lending book currently is around 100 billion USD,[4] indicating the potential for exponential growth in India.

The lower cost structure associated with online originations enables P2P platforms to offer borrowers attractive rates.

1. PwC analysis on P2P lending Peer pressure: How P2P is transforming consumer lending industry
2. Ibid.
3. RBI's CP on P2P lending
4. NASDAQ September 2016: Rise of P2P lending

Illustrative P2P lending process



Day 1	**Rate check**	Simple, end to end online process that begins with a click of a button
Day 1	**Preliminary loan information collected**	Rapid application process via an online portal. Minimal personal data required for rate quote.
Day 1	**Customised loan quote and alternatives provided**	Quick decisioning. E-sign disclosures.Flexibility to select alternatives
Day 1	**Closing loan information collected**	Clear transparent status indicators. Simple messaging. Email notification providing next steps
Days 2-5	**Loan posted for investors**	Real time updates regarding percentage funded; loan will be funded once investors (whole or fractional) Have committed sufficient funs
	Loan funded	Borrower notified immediately once the loan is fully funded
	Funds deposited	Monthly payment Automatically set-up and deducted from verified bank account. No separate process required
	Bank account and email verification Account and email validated for direct deposit	

Section 2: *Proposed draft of Reserve Bank of India (RBI) regulations on P2P lending in India*

RBI has proposed to bring P2P lending platforms under the purview of the Reserve Bank's regulation *by defining P2P platforms as non-banking finance companies (NBFCs)* under section 45I(f)(iii) of the RBI Act. Accordingly, it issued a notification in consultation with the Government of India. Once these platforms are notified as NBFCs, RBI can issue regulations under sections 45JA and 45L. The proposed regulatory framework will encompass the following:

Permitted activity:

The role of the platform will be limited to bringing the borrower and lender together *without the lending and borrowing getting reflected on its balance sheet*. The platforms will be prohibited from giving any assured return either directly or indirectly. Further, P2P firms will be allowed to opine on the suitability of a lender and creditworthiness of a borrower. Adequate regulations on advertisements will also be put in place. It will also be mandated that funds will have to necessarily move directly from the lender's bank account to the borrower's bank account to obviate the threat of money laundering. The guidelines will also prohibit the use of the platforms for any cross-border transaction in view of FEMA provisions relating to transactions between residents and non-residents.

Prudential requirements:

The prudential requirements will include a *minimum capital of 2 crore INR*. With a view to ensure that there is enough skin in the game at a later date, a leverage ratio may be prescribed so that the platforms do not expand with indiscriminate leverage. Given that the lenders may include uninformed individuals, prudential limits on maximum contribution by a lender to a borrower/segment of activity could also be specified.

Governance requirements:

The guidelines in this regard will include fit and proper criteria for promoters, directors and CEOs. *A reasonable proportion of board members having a financial sector background* could be suggested. The guidelines may also require the P2P lender to have a brick and mortar place of business in India. The management and operational personnel of the platform would need to be stationed within the country.

Business continuity plan (BCP):

The platforms need to put in place adequate risk management systems for smooth operations. A BCP and data backup need to be set up since the platform also acts as a custodian of the agreements/cheques, etc. *In case of failure of the platform to continue operations, it should have a 'living will'* or alternative arrangement in the form of an agreement for continuation of its operations.

Customer interface:

Most of the platforms operating in India provide a credit score for the borrowers using their customised algorithms. Confidentiality of customer data and data security will be the responsibility of the platform. The current regulations applicable to other NBFCs will be made applicable to the P2P platforms in regard to the loan recovery practice. The operators will also be mandated to have a proper grievance redressal mechanism to deal with complaints from both lenders and borrowers and require reporting of the status to the Board.

Reporting requirements:

In order to assist monitoring, the platforms will need to submit regular reports on their financial position, loans arranged each quarter, complaints, etc., to the Reserve Bank. The bank may come out with a detailed reporting requirement.

Scope of Reserve Bank's regulation

- RBI proposes that only P2P lending firms that are incorporated as companies (company structure) will fall under the scope of RBI regulations for such firms.
- However, if the P2P platforms are run by individuals, proprietorship, partnership or limited liability partnerships, they will not fall under the purview of RBI.

Hence, it is essential that P2P platforms adopt the company structure. The notification can therefore specify that no entity other than a company can undertake this activity. This will render such services provided under any other organisational structure illegal.

Key drivers

As you evaluate the changes ahead and the options that are right for your organisation, you should consider developing a response to P2P lending that aligns with your organisation's goals and capabilities. In addition to regulatory compliance expertise, the key considerations that inform your decision can generally be grouped into the three categories explained below.

Key considerations to determine the right strategy for P2P lending

Consumer savvy

- What are the core consumer segments of your organisation?
- Do you have customised strategies for customer segments based on each segment's channel preferences?
- Will P2P lending supplement or cannibalise the existing customer base?
- Will P2P lending expand geographical reach?
- What is your strategy to manage customer retention in your other distribution channels?

Capability to innovate

- What are your current capabilities within operations, technology and credit risk management?
- What level of ability exists to acquire or build new capabilities as needed?
- What is the level of competency in underwriting loans through credit risk management and associated analytics?
- What is the level of financial discipline and controls required to manage a large investment on a new platform?
- What level of product innovation competency exists in your organisation?

Capital and risk appetite

- What is the level of capital available to invest in building new platforms?
- Is the cost of capital lower than that of most competitors, thereby creating a pricing advantage?
- What is the level of flexibility in your cost structure to create a competitive advantage?
- What other alternatives are available to achieve the return on equity target?
- What is the expected timeline to generate return on investments?

Consumers are hungry for a simplified, streamlined lending process, and P2P firms are capitalising on this need by creating a loyal and growing following. It's this recent growth and future growth potential that has banks taking notice. P2P lending has already begun its expansion beyond simple loans largely used by consumers to consolidate credit card debt. Auto loans and mortgages—once the territory of 'traditional lenders'—are now among the trailblazing offerings of P2P lending platforms.

Many financial institutions are beginning to examine the changes that are on the horizon. As new players, P2P companies could shake up the market—and along with any disruption is the potential for opportunity. The question financial institutions should start considering is whether their organisations will collaborate or compete with P2P lending platforms.

Section 3: *Risks involved in the P2P lending sector*

- The weak underwriting process can lead to bankruptcy of the P2P firm if it has a poorly executed business model. As a result, loans are granted to scrupulous borrowers with a poor credit history.
- Regulating the loan disbursement cash flow model to transfer cash from a lender's bank account to a borrower's bank account directly (as currently contemplated by RBI in its draft consultation paper) could result in huge operational complexities for the platform firm in terms of keeping track of loans disbursed and amounts repaid.
- The absence of a segregated trust account by the P2P firm to track cash flows between lenders and borrowers could result in misappropriation of funds by the platform firm.
- Data privacy laws may be breached if the platform firms disclose the names of borrowers and lenders on their website.
- If KYC and AML checks are not carried out robustly, the platform firms could be used for money laundering and routing illegal sources of funding.
- The absence of an adequate recovery and resolution process (RRP) among failed platform firms could put lenders' money at stake and may cause operational and legal challenges for borrowers as well.
- The absence of a robust front-to-back IT system could result in various errors and breaches of RBI regulations, including inaccurate record-keeping by firms.
- Lack of strong cyber security controls could expose the platform firm and the money held by it on behalf of its lenders to attacks by hackers who can penetrate and access all the required details from the platform to siphon the money and use their details to gain competitive advantages.

Section 4: *Our perspective*

- Platform-based lending will invariably gain huge momentum over the next three to five years due to competitive interest rates and ease of making finance available.
- P2P lending is a unique model as it is predominantly an online business in which individual and institutional investors provide funding to people seeking loans.
- Secured lending (e.g. loans against securities) may have a better preference from a risk-averse investor's standpoint due to the fact that this business has progressed very well since the past five years, and there are established RBI regulations governing this type of lending.
- RBI may potentially exercise greater regulatory scrutiny of unsecured P2P lending due to the systemic nature of risks involved for end customers, wherein they may lose all their money if the loan underwriting process is not robustly managed.
- Unsecured lending, if managed meticulously, could result in astronomical returns after five years.
- Over a period of time, if unsecured P2P lending is well established, as in developed markets (e.g. Funding Circle in the UK), banks and institutional investors will potentially look to buy blocks of P2P loans to add to their portfolios.
- With the increasing focus on automation and innovation in offering loan products to lenders and borrowers, P2P firms may need to seek periodic assurance on the design and operating effectiveness of their processes and internal controls from both a business and IT perspective. This will ensure that data integrity of the platform is not compromised at any given point in time, both externally and internally within the firm.

Section 5: *Contacts*

Vivek Iyer
Partner, Financial Services – Risk Assurance Services
(M) +91 9167745318
Email: vivek.iyer@in.pwc.com

Vivek Iyer leads the Financial Services – Risk Assurance Services practice of PwC India and is based in Mumbai. He has over 13 years of experience, with a specialisation in governance, risk and compliance in the financial services space. Vivek has worked with most of the leading organisations in the BFSI space and also regularly works back with the regulators on matters of industry importance in the banking and capital markets domain.

Shiva Iyer
Director, Financial Services – Risk Assurance Services
(M) +91 9930169439
Email: shiva.iyer@in.pwc.com

Shiva has more than 15 years of experience in financial services risk and regulation, including 10 years in London, where he predominantly focused on global investment banks, broker-dealers, retail and commercial banks, asset managers, NBFCs and leading P2P lending firms in the world. He currently leads the Global Risk and Regulatory practice within the Financial Services – Risk Assurance practice, and focuses on both conduct and prudential regulations like MiFID 2, Basel 3, BCBS, OTC Margin reforms, EU regulatory reporting and RBI regulations. He was actively involved in various advisory, assurance and remediation projects on risk and regulation with various global banks in London, including P2P firms like Funding Circle and Zoopa.

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