Mains Practice Question

Q. What is peer to peer (P2P) lending? Elucidate the risks and opportunities in P2P lending. (250 words)

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Approach

- Describe P2P lending.
- Explain the risks and opportunities associated with P2P lending.
- Give conclusion.

Introduction:

- P2P lending is the popular type of crowd funding, whereby an internet platform collects small amounts of funds from individuals in a crowd to finance collectively a larger loan to individuals or businesses.
- Websites that facilitate peer-to-peer lending have greatly increased its adoption as an alternative method of financing.P2P lending is also known as social lending and has only existed since 2005.

Body

Risks associated with P2P lending

- **Lack of legal disclosure of risks for lenders:** There are no legally defined disclosure standards to ensure that lenders have a clear and accurate understanding of the risks associated with using a specific P2P platform.
- **No uniform standards to calculate profit returns:** The methods used for calculating the risk-adjusted net returns differ considerably from platform to platform because national laws and regulators have yet to define a common standard for measuring the performance of P2P-loan investments.
- **Lack of disclosure about platforms and borrowers:** There are no disclosure standards for information about borrowers or platforms' credit assessment methods. This makes it impossible for investors to assess and compare the quality of platforms and so make a careful selection of the "right" platform.
- **Lack of transparency regarding credit assessment:** There is lack of transparency about how platforms assess credit. Borrowers may not know what kind of data their platforms are using and how credit ratings are calculated.
- **Lack of central regulation:** Often platforms in countries without dedicated crowdfunding regulation do not need any central authorisation from the national financial regulator to start their business and do not have to fulfil minimum capital requirements

Opportunities

- **Accessibility:** Surveys of P2P borrowers reveal that the convenience of using a web-base to get credit is the highest ranked benefit of P2P-lending.
- **Lower administration cost and enhanced efficiency:** The advantages are seen mainly as lower transaction costs in the loan application process and a much shorter time span, when

compared to bank loans, from first contact until the loan pay-out is received. Lower transaction costs are a result of 24/7 accessibility of the platform, reduced bureaucracy and documentation requirements, and a simple and transparent application process.
- **No mandatory collateral:** Corporate borrowers have the ability to obtain P2P-loans without providing collateral.
- **Cheaper credit:** Due to low administration cost, P2P is able to provide cheaper credit than banks.
- **Extra flexibility that P2P offers over banks:** Most platforms allow borrowers to cancel loan contracts prematurely without paying a prepayment penalty

Conclusion

- Web-based financial intermediation on a peer-to-peer basis will eventually prevail as an economically superior form of organisation compared to the traditional banking business model.
- A uniform and dedicated regulation for crowdfunding through P2P is needed to provide financial service platforms and their users with the necessary legal confidence and certainty to expand their activities freely.