P2P regulations: A missed opportunity

The Reserve Bank of India (RBI) issued the much anticipated regulatory framework for peer-to-peer (P2P) lending earlier this month. This model emerged in 2005 as technology fused with lending and has been replicated across jurisdictions since. In its simplest avatar, it involves a platform that leverages technology to match lenders and borrowers, receiving fees in lieu of transactions successfully closed. Unlike banks that act as intermediaries and engage in liquidity transformation between (retail) lenders and borrowers, these platforms are genuine two-sided markets (similar to say, Uber) bringing lenders and borrowers together without taking any credit risk on their own balance sheet.

An important feature of such platforms is that they leverage technology to filter borrowers, determine interest at which the transactions execute and reduce the risk of lender exposure through diversification (through one-to-many transactions, for example). Since they do not themselves face any asset-liability risk, the P2P lending model has the potential to both contribute to financial stability by making banks leaner and promote financial inclusion by getting more borrowers into the formal financial system.

However, the potential social benefits of P2P lending are contingent on a facilitative and proportionate regulatory ecosystem. A review of the P2P regulations issued by the RBI leaves much to be desired in that sense. Saliently, the P2P regulations delegate potentially arbitrary discretion to RBI in gatekeeping, impose high market-access barriers that would inhibit innovation in a technology-intensive sector, and lack clarity around critical issues like leverage ratio. Let's address each of those in turn.

A. Excessive regulatory discretion: One of the principal governance issues of a modern state is injecting accountability into regulatory discretion. The P2P regulations fail on this parameter, and underscore the need for Parliament to implement reform through legislation rather than delegate it to regulators. Notice for example, the "prejudicial to public interest" factor that the RBI states it will rely on to decide whether to grant a company the licence to operate. Such broad discretion without effective oversight is effectively a permission to engage in arbitrary behaviour.

B. Disproportionate minimum capital requirements: The RBI has prescribed a mandate that would require a minimum net-owned fund (NOF) of Rs2 crore. That would exclude innovative, lean start-ups from entering the market, and it is unclear if there would be any benefit net of costs. As discussed, the P2P model "disintermediates" credit risk. In light of the fact, it may be feasible for the RBI to tailor minimum capital based on the value of loans made through the platform.

The application for certificate of registration may be required to project the size of loans to be intermediated through the platform, say in the next three years, and then work out the minimum capital as a percentage of that. By way of benchmark, the Financial Conduct Authority, UK, requires 0.2% of the first £50 million of the total value of loaned funds outstanding.

C. Lack of clarity around critical issues like leverage ratio: Leverage ratio is defined as "total outside liabilities divided by owned funds, of the non-banking financial corporation in P2P (NBFC-P2P)". This leverage ratio has been capped at 2. Now the text appears clear but consider the following two scenarios:

(A) Total outside liabilities as long-term plus short-term borrowing on the P2P platform company's balance sheet; or

(B) Total outside liabilities as total amount of outstanding loans facilitated through the platform.

If total outside liabilities were to mean (A), then a P2P lending company with no debt on its balance sheet could potentially operate say a Rs5,000 crore outstanding credit facilitation with equity capital of as little as Rs2 crore. This may beat the idea of defining a leverage cap—to ensure adequate capital for continuous servicing (collection, information and reporting) of outstanding loans by the NBFC-P2P.

If, to avoid the interpretation above, total outside liabilities were to be construed to mean (B), then the leverage limit of 2 is abysmally low to justify a business. The revenue sources for a P2P platform company include: processing fees charged to borrowers and lenders, origination fees for loan-specific insurance products and fees charged from lenders for collection. From regular market numbers, the sum of these three sources of revenue is in the order of 4-8% of the credit facilitated through the platform. And let us say, conservatively, the overall costs of a tech-enabled P2P lending platform is in the range of 2-4% of credit facilitated through the platform (even though we expect actual cost of borrower and lender acquisition to be higher). The leverage cap of 2 will mean this regulation effectively limits return on equity in the 10-12% range. No technology business can operate with such paltry returns.

Other concerns in the P2P regulations include ultra-conservative lender exposure limits; data-sharing mandate with credit information companies and disclosure of borrower information to the lenders. To conclude, fintech may have an important say in furthering financial inclusion and financial stability goals. In that context, this incrementalism appears to be a missed opportunity.

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